

## **FINRA Podcast – Research Conflicts Rules Part 4**

PS Hello and welcome. I'm Phil Shaikun.

JW And I'm Jeanette Wingler.

PS This is the last podcast in a four-part series about the new FINRA rules about conflicts of interest related to the publication and distribution of research reports. In past episodes, we covered the equity research conflicts rule. Now we will move on to the new rule related to debt research.

JW The Securities and Exchange Commission approved new FINRA Rule 2242 about debt-research analysts and debt-research reports. Like its equity counterpart, it's intended to foster objectivity and transparency in debt research and provide investors with more reliable and useful information to make investment decisions. The rule provides retail debt research recipients with extensive protections similar to those provided to those who get equity research, with changes to reflect differences in the trading of debt securities.

PS The debt rule differs from the equity one in three key ways. First, it sets out prohibited and permissible communications between debt-research analysts and principal trading and sales-and-trading people. It takes into account the need to ration a debt-research analyst's resources among a multitude of debt securities. And it considers the limitations on price discovery in debt markets, as well as the need for trading people to perform credit-risk analyses on current and prospective inventory.

JW The second difference between the equity and debt rules is the debt rule exempts debt research provided solely to institutional investors from many of the structural protections and prescriptive disclosure requirements that apply to reports distributed to retail investors. But it adds a so-called "health-warning" requirement we will talk about later.

PS And the third difference is the debt rule adds an exemption for firms with limited principal trading activity. Firms that employ fewer than ten debt traders and have gains or losses on principal trades and debt securities of \$15 million or less on average over the previous three years are exempt from the review, supervision, budget and compensation provisions in the rule.

JW Now let's dig into each of those three differences. Firms are required to setup, maintain and enforce written policies and procedures reasonably designed to prohibit sales-and-trading and principal-trading people from trying to influence a debt research analyst's opinions or views for the purpose of benefiting the firm's trading position or that of a customer or class of customers. The rule draws a distinction between sales-and-trading personnel and principal-trading personnel. It puts greater restrictions on research analysts' interactions with principal traders because the conflict is larger. Debt-research analysts may not identify or recommend specific potential trades to sales-and-trading and principal-trading people that are inconsistent with the analyst's currently published debt-

research reports. And the analyst must not disclose to them the timing of a pending report or material investment conclusions in it.

PS Sales-and-trading and principal-trading people may communicate customers' interests to a debt-research analyst, so long as the analyst does not respond by publishing debt research for the purpose of benefiting the firm's trading position or that of a customer or class of customers. And debt-research analysts may provide customized analysis, recommendations or trade ideas to sales-and-trading and principal-trading people if they are consistent with the analyst's currently published or pending research, so long as any subsequently published debt research is not for the purpose of benefiting one of those groups.

JW Sales-and-trading and principal-trading people may also seek a debt-research analyst's views about a debt-security issuer's creditworthiness and other details about the issuer reasonably related to the security's price or performance. But again, the information must be consistent with the analyst's published research, and it must be consistent with the types of communications the analyst might have with customers.

Analysts may also seek details from sales-and-trading and principal-trading people about debt instruments, current prices, spreads, liquidity and similar market information relevant to the analyst's valuation of a debt security.

PS Unless otherwise prohibited, communications between debt-research analysts and sales-and-trading and principal-trading people may take place without restrictions, so long as they are not related to sales-and-trading, principal-trading or debt research. When determining whether something is consistent with the analyst's published research, one may consider the context, including the investment objectives or time horizons being discussed.

JW Moving on to the second major difference between the debt and equity rules, which is: Debt research distributed solely to eligible institutional investors is exempt from most of the provisions about supervision, coverage determinations, budget, and compensation determinations and all the disclosure requirements applicable to retail debt research.

PS The rule requires either negative or affirmative written consent for eligible institutional investors to receive the less-protected research. Firms may distribute institutional debt research by negative consent to a person who both meets the definition of a qualified institutional buyer, and FINRA's Rule 2111 – Institutional Suitability Standards for Debt Strategies and Transactions. The firm or associated person must have a reasonable basis to believe the buyer is capable of evaluating investment risk independently, both in general and for the particular transactions and investment strategies in question. And the buyer must affirmatively show it is exercising independent judgment in evaluating the firm's recommendations. This affirmation must be broad enough to encompass debt-securities transactions.

JW Firms must provide written disclosures to the qualified institutional buyer that they may provide debt-research reports that are intended for institutional investors, but are not

subject to all the independence and disclosure standards applicable to retail reports. If the buyer does not ask the firm to send only retail debt-research reports, the firm may reasonably conclude that the buyer has consented to receive the institutional reports. FINRA interprets this standard to allow an order placer for a qualified institutional buyer to also receive institutional debt research by negative consent.

PS Institutional accounts that do not satisfy the higher requirements may still affirmatively elect in writing to receive institutional debt research. But retail investors may not choose to receive institutional debt research.

JW To avoid disruption, the rule allows firms to send institutional debt research to any institutional account, except a natural person, without consent, for up to one year after SEC approval, while they obtain the necessary consents. The natural persons who qualify as institutional investors must provide affirmative consent to receive institutional debt research during and after this transition period.

PS It's important to note that some provisions still apply to institutional debt research. For instance, investment bankers are still prohibited from reviewing such research before release. And while pre-publication review is allowed for principal traders and sales-and-trading people, other provisions of the rule continue to require management of those conflicts. For example, firms must set up information barriers reasonably designed to insulate debt-research analysts from pressure by those people. Requirements related to submitting sections of a draft debt-research report for factual review still apply to any permitted pre-publication review by anyone not directly responsible for the report's preparation, content or distribution. Firms must still prohibit analysts from participating in the solicitation of investment banking services, road shows or other marketing on behalf of issuers. And they must prohibit investment bankers from directly or indirectly directing a debt-research analyst to engage in sales-and-marketing efforts related to an investment-banking deal, or to communicate with a current or prospective customer about those transactions. The provisions about retaliation against debt-research analysts and promises of favorable debt research also still apply to research distributed to eligible institutional investors.

JW The rule does not require institutional debt research to carry the specific disclosures applicable to retail debt research. But it does require general disclosures prominently on the first page. This is the so-called "health warning" we mentioned earlier. It must warn that the report is intended only for institutional investors and does not carry all of the independence and disclosure standards of retail debt-research reports. It must also warn, if applicable, that the views in the report may differ from those offered in retail reports, and it must warn, if applicable, that the report may not be independent of the firm's proprietary interests. It must also warn that the firm trades the security covered in the report for its own account and on a discretionary basis on certain customers' behalf, and those trading interests may be contrary to the report's recommendation.

PS The rule requires firms to set up, maintain and enforce written policies and procedures reasonably designed to make sure institutional debt research is made available only to eligible institutional investors. Firms may not rely on the exemption if they have reason

to believe the report will be distributed to a retail investor, and the exemption does not relieve the firm of its duty to comply with the anti-fraud provisions of federal securities laws and FINRA rules.

JW Now let's turn to the third key difference between the equity and debt rules: the exemption for limited principal trading activity. The debt rule has the same exemption for limited investment-banking activity as we talked about with the equity rule, but it adds an exemption from more provisions for firms that engage in limited principal trading activity. To qualify, the firm's trading gains or losses on principal trades and debt securities must be \$15 million or less over the three previous years on average, per year. The firm must also employ fewer than ten debt traders.

PS It's important to note that the firm must still set up information barriers or other institutional safeguards reasonably designed to ensure debt-research analysts are insulated from pressure by principal traders or sales-and-trading people, or others who might be biased in their judgment or supervision. And as with the other exemption, firms that qualify must maintain records sufficient to establish eligibility, and they must keep for at least three years any communications that, but for this exemption, would be subject to all of the debt research rule's requirements.

JW And that covers the three key differences between the debt-research rule and the equity one. The debt rule will become effective February 22, 2016. There are other differences between the two rules, so practitioners in this area should carefully read the rule text. To learn more about the equity and debt research rules, you can check out Regulatory Notices 15-30 and 15-31. We hope you found this podcast series helpful, and that you'll share it with your colleagues.

PS And finally, for all of us at FINRA, thanks for listening.