

Equity Research

SEC Approves Consolidated Rule to Address Conflicts of Interest Relating to the Publication and Distribution of Equity Research Reports

Effective Date: September 25, 2015, or December 24, 2015

Executive Summary

The SEC approved the adoption of FINRA Rule 2241 (Research Analysts and Research Reports), a consolidated rule to address conflicts of interest relating to the publication and distribution of equity research reports.¹ Provisions of Rule 2241 become effective either on September 25, 2015, or December 24, 2015, as set forth below.

The rule text is available at www.finra.org/notices/15-30.

Questions regarding this *Notice* should be directed to:

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Background and Discussion

NASD Rule 2711 and Incorporated NYSE Rule 472 (Communications with the Public) set forth requirements to foster objectivity and transparency in equity research and provide investors with more reliable and useful information to make investment decisions. The rules require disclosure of conflicts of interest in research reports and public appearances by research analysts and further prohibit conflicted conduct—investment banking personnel involvement in the content of research reports and determination of analyst compensation, for example—where the conflicts are too pronounced to be cured by disclosure. Several of the rules' provisions implement provisions of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), which mandates separation between research and investment banking, proscribes conduct that could compromise a research analyst's objectivity, and requires specific disclosures in research reports and public appearances.²

August 2015

Suggested Routing

- ▶ Compliance
- ▶ Investment Banking
- ▶ Legal
- ▶ Research
- ▶ Senior Management
- ▶ Trading

Key Topics

- ▶ Conflicts of Interest
- ▶ Investment Banking
- ▶ Research Analysts
- ▶ Research Reports

Referenced Rules & Notices

- ▶ FINRA Rule 0140
- ▶ FINRA Rule 2210
- ▶ FINRA Rule 2241
- ▶ FINRA Rule 3110
- ▶ FINRA Rule 9600 Series
- ▶ Incorporated NYSE Rule 344
- ▶ Incorporated NYSE Rule 472
- ▶ NASD Rule 1050
- ▶ NASD Rule 2711

NASD Rule 1050 (Registration of Research Analysts) and Incorporated NYSE Rule 344 (Research Analysts and Supervisory Analysts) require any person associated with a member and who functions as a research analyst to be registered as such and pass the Series 86 and 87 exams, unless an exemption applies. Those rules define “research analyst” for registration purposes as an associated person who is primarily responsible for the preparation of the substance of a research report or whose name appears on a research report.

The SEC has approved a new consolidated FINRA Rule 2241.³ In general, the rule retains the core provisions of the current rules, broadens the obligations on members to identify and manage research-related conflicts of interest, restructures the rules to provide some flexibility in compliance without diminishing investor protection, extends protections where gaps have been identified, expands an exemption for firms with limited investment banking activity, and provides clarity to the applicability of existing rules. The SEC also approved an accompanying amendment to NASD Rule 1050 and Incorporated NYSE Rule 344 that creates a limited exception from the research analyst registration and qualification requirements for “research reports” produced by individuals whose primary job function is something other than producing investment research.

Definitions

The rule mostly maintains the definitions in current NASD Rule 2711, with the following modifications:

- ▶ Rule 2241(a)(5) clarifies that “investment banking services” includes all acts in furtherance of a public or private offering on behalf of an issuer.⁴
- ▶ Rule 2241(a)(9) clarifies that “research analyst account” does not apply to a registered investment company over which a research analyst or member of the research analyst’s household has discretion or control, provided that the research analyst or member of the research analyst’s household has no financial interest in the investment company, other than a performance or management fee.
- ▶ Rule 2241(a)(11) excludes from the definition of “research report” communications concerning open-end registered investment companies that are not listed or traded on an exchange.
- ▶ Rule 2241(a)(11)(D) excludes from the definition of “research report” communications that constitute private placement memoranda and comparable offering-related documents prepared in connection with investment banking services transactions, other than those that purport to be research.
- ▶ Rules 2241(a)(3) and (14) move into the definitional section the definitions of “independent third-party research report” and “third-party research report,” respectively, that are now in a separate provision of the rule.
- ▶ Rule 2241(a)(12) adopts a definition of “sales and trading personnel” to include persons in any department or division, whether or not identified as such, who perform any sales or trading service on behalf of a member.

Identifying and Managing Conflicts of Interest

The rule includes a new section entitled “Identifying and Managing Conflicts of Interest.” Rule 2241(b)(1) contains an overarching requirement to establish, maintain and enforce written policies and procedures reasonably designed to identify and effectively manage conflicts of interest related to the preparation, content and distribution of research reports and public appearances by research analysts and the interaction between research analysts and persons outside of the research department, including investment banking and sales and trading personnel, the subject companies and customers. Rule 2241(b)(2) requires the written policies and procedures to be reasonably designed to promote objective and reliable research that reflects the truly held opinions of research analysts and to prevent the use of research or research analysts to manipulate or condition the market or favor the interests of the member or a current or prospective customer or class of customers. These provisions, therefore, set out the fundamental obligation for a member to establish and maintain a system to identify and mitigate conflicts to foster integrity and fairness in its research products and services. The required policies and procedures also must prohibit or restrict specified conduct, as set forth in more detail below.

Prepublication Review

The rule modifies the current restrictions on prepublication review of research reports. Rule 2241(b)(2)(A) requires the written policies and procedures to prohibit prepublication review, clearance or approval of research reports by persons engaged in investment banking services activities and restrict or prohibit such review, clearance or approval by other persons not directly responsible for the preparation, content and distribution of research reports, other than legal and compliance personnel. This provision effectively eliminates an exception in NASD Rule 2711 that allows investment bankers to review a research report prior to publication for factual accuracy or to assist in a conflicts review. A firm must specify in its policies and procedures the circumstances, if any, where prepublication review by other non-research personnel would be permitted as necessary and appropriate; for example, where non-research personnel are best situated to verify select facts or where administrative personnel review a research report for formatting.

Rule 2241(b)(2)(N) requires the written policies and procedures also to prohibit prepublication review of a research report by a subject company for purposes other than verification of facts. Supplementary Material .05 maintains the current guidance applicable to the prepublication submission of a research report to a subject company. Specifically, sections of a draft research report may be provided to non-investment banking personnel or the subject company for factual review, provided that:

1. the draft sections do not contain the research summary, research rating or price target;
2. a complete draft of the report is provided to legal or compliance personnel before sections are submitted to non-investment banking personnel or the subject company; and
3. any subsequent proposed changes to the rating or price target are accompanied by a written justification to legal or compliance and receive written authorization for the change.

The member also must retain copies of any draft and the final version of the report for three years.

Coverage Decisions

The rule includes a new provision that codifies an interpretation regarding investment banking input into research coverage decisions. Rule 2241(b)(2)(B) requires that the written policies and procedures restrict or limit input by the investment banking department into research coverage decisions to ensure that research management independently makes all final decisions regarding the research coverage plan. However, the provision does not preclude personnel from investment banking or any other department from conveying customer interests or providing input into coverage considerations, so long as final decisions regarding the coverage plan are made by research management. This provision makes express FINRA's interpretation that the separation requirements in NASD Rule 2711(b)(1) prohibit investment banking from making any final coverage decisions.

Supervision and Control of Research Analysts

The rule effectively retains the prohibitions regarding supervision and control of research analysts by investment banking personnel. Rule 2241(b)(2)(C) requires that the written policies and procedures prohibit persons engaged in investment banking activities from supervision or control of research analysts, including influence or control over research analyst compensation evaluation and determination. This provision is substantively the same as NASD Rule 2711(b).

Research Budget

The rule includes a new provision that codifies an interpretation with respect to research budget determination. Rule 2241(b)(2)(D) requires that the written policies and procedures limit determination of the research department budget to senior management, excluding senior management engaged in investment banking services activities. This provision makes express FINRA's interpretation that the separation requirements in current Rule 2711(b)(1) prohibit investment banking personnel from making any determination of research budget decisions.

Compensation

The rule effectively maintains the compensation determination requirements in NASD Rule 2711(d). Rule 2241(b)(2)(E) requires that the written policies and procedures prohibit compensation based upon specific investment banking services transactions or contributions to a member's investment banking services activities. Rule 2241(b)(2)(F) further provides that the written policies and procedures must require a committee that reports to the member's board of directors—or if none exists, a senior executive officer—to review and approve at least annually the compensation of any research analyst who is

primarily responsible for preparation of the substance of a research report. The committee may not have representation from a member's investment banking department. The committee must consider, among other things, the productivity of the research analyst and the quality of his or her research and must document the basis for each research analyst's compensation.

Information Barriers

The rule includes a new information barrier requirement drawn from Sarbanes-Oxley. Rule 2241(b)(2)(G) requires that the written policies and procedures establish information barriers or other institutional safeguards reasonably designed to ensure that research analysts are insulated from the review, pressure or oversight by persons engaged in investment banking services activities or other persons, including sales and trading personnel, who might be biased in their judgment or supervision. FINRA believes the other policies and procedures required by the proposed rule change to identify and manage research-related conflicts of interest should effectively result in compliance with this provision. The provision is included to emphasize that the conflicts management must extend to persons other than investment banking personnel, including sales and trading personnel, who a firm may place in a position to supervise or influence the content of research reports or public appearances.

Retaliation

The rule modifies the current retaliation prohibition. Rule 2241(b)(2)(H) requires that the written policies and procedures prohibit direct or indirect retaliation or threat of retaliation against research analysts employed by the member or its affiliates by persons engaged in investment banking services activities or other employees as the result of an adverse, negative, or otherwise unfavorable research report or public appearance written or made by the research analyst that may adversely affect the member's present or prospective business interests. This provision is consistent with NASD Rule 2711(j), except that it extends the retaliation prohibition to employees other than investment banking personnel.

Quiet Periods

The rule modifies the quiet periods after an initial public offering (IPO) or secondary offering and before and after the expiration, waiver or termination of a lock-up agreement. Rule 2241(b)(2)(I) requires that the written policies and procedures define quiet periods of a minimum of 10 days following the date of an IPO, and a minimum of three days following the date of a secondary offering, during which the member must not publish or otherwise distribute research reports, and research analysts must not make public appearances, relating to the issuer if the member has participated as an underwriter or dealer in the IPO or, with respect to the quiet periods after a secondary offering, acted as a manager or co-manager of that offering.⁵ FINRA interprets the date of the offering to be the later of the effective date of the registration statement or the first date on which the securities were bona fide offered to the public.

The rule therefore reduces the current 40-day and 25-day IPO quiet periods to a minimum of 10 days after the date of the offering for any member that participated as an underwriter or dealer, and reduces the 10-day secondary offering quiet period to a minimum of three days after the completion of the offering for any member that has acted as a manager or co-manager in the secondary offering. The rule maintains exceptions to the quiet periods for research reports or public appearances concerning the effects of significant news or a significant event on the subject company and, for secondary offerings, research reports or public appearances pursuant to Securities Act Rule 139 regarding a subject company with “actively-traded securities.”

The rule also eliminates the current quiet periods 15 days before and after the expiration, waiver or termination of a lock-up agreement.

Personal Trading Restrictions

The rule establishes a new standard with respect to personal trading by research analysts, supervisors of research analysts, and persons with the ability to influence the content of a research report. Rule 2241(b)(2)(J) requires firms to establish written policies and procedures that restrict or limit research analyst account trading in securities, any derivatives of such securities and funds whose performance is materially dependent upon the performance of securities covered by the research analyst. Rule 2241(b)(2)(J)(i) requires the policies and procedures to ensure that research analyst accounts, supervisors of research analysts and associated persons with the ability to influence the content of research reports do not benefit in their trading from knowledge of the content or timing of a research report before the intended recipients of such research have had a reasonable opportunity to act on the information in the research report. Rule 2241(b)(2)(J)(ii) maintains the current prohibition on research analysts trading against their most recent recommendations, but allows firms to define financial hardship circumstances, if any, in which a research analyst would be permitted to trade against his or her most recent recommendation. Rule 2241(b)(2)(J)(iii) maintains the current prohibition on research analysts receiving pre-IPO shares in the sector they cover.

Supplementary Material .10 provides that FINRA would not consider a research analyst account to have traded in a manner inconsistent with a research analyst’s recommendation where a member has instituted a policy that prohibits any research analyst from holding securities, or options on or derivatives of such securities, of the companies in the research analyst’s coverage universe, provided that the member establishes a reasonable plan to liquidate such holdings consistent with the principles in paragraph (b)(2)(J)(i) and such plan is approved by the member’s legal or compliance department.

Promises of Favorable Research

The rule effectively maintains the current prohibition on promises of favorable research. Rule 2241(b)(2)(K) requires that the written policies and procedures prohibit explicit or implicit promises of favorable research, a particular research rating or recommendation or specific research content as inducement for the receipt of business or compensation. This provision is substantively the same as NASD Rule 2711(e).⁶

Solicitation and Marketing of Investment Banking Transactions

The rule effectively carries over the prohibitions on solicitation and marketing of investment banking transactions. Rule 2241(b)(2)(L) adds a requirement that the written policies and procedures restrict or limit activities by research analysts that can reasonably be expected to compromise their objectivity. These must include the existing prohibitions on participation in pitches and other solicitations of investment banking services transactions and road shows and other marketing on behalf of issuers related to such transactions. Consistent with existing guidance, analysts may listen to or view a live webcast of a transaction-related road show or other widely attended presentation by investment banking to investors or the sales force from a remote location, or another room if they are in the same location.⁷

Supplementary Material .01 codifies the existing interpretation that the solicitation provision prohibits members from including in pitch materials any information about a member's research capacity in a manner that suggests, directly or indirectly, that the member might provide favorable research coverage.⁸

Joint Due Diligence and Other Interactions With Investment Banking

The rule establishes a new proscription with respect to joint due diligence activities—*i.e.*, due diligence by the research analyst in the presence of investment banking department personnel. Supplementary Material .02 states that FINRA interprets the overarching principle requiring members to, among other things, establish, maintain and enforce written policies and procedures that address the interaction between research analysts and those outside of the research department, including investment banking and sales and trading personnel, subject companies and customers, to prohibit the performance of joint due diligence prior to the selection of underwriters for the investment banking services transaction.

FINRA will interpret this provision to apply only to the extent it is not contrary to the JOBS Act. Among other things, the JOBS Act prohibits FINRA from restricting an analyst from participating in any communications with the management of an emerging growth company (EGC) that is also attended by another associated person of a broker-dealer whose functional role is other than as a research analyst. Thus, for example, FINRA does not interpret the joint due diligence prohibition to apply where the joint due diligence activities involve a communication with the management of an EGC that is attended by both the research analyst and an investment banker.

Rule 2241(b)(2)(M) continues to prohibit investment banking department personnel from directly or indirectly directing a research analyst to engage in sales or marketing efforts related to an investment banking services transaction, and directing a research analyst to engage in any communication with a current or prospective customer about an investment banking services transaction. Supplementary Material .03 clarifies that three-way meetings

between research analysts and a current or prospective customer in the presence of investment banking department personnel or company management about an investment banking services transaction are prohibited by this provision. Supplementary Material .03 also retains the current requirement that any written or oral communication by a research analyst with a current or prospective customer or internal personnel related to an investment banking services transaction must be fair, balanced and not misleading, taking into consideration the overall context in which the communication is made.

Content and Disclosure in Research Reports

With a couple of modifications, the rule maintains the current disclosure requirements. Rule 2241(c)(1)(A) adds a requirement that a firm must establish, maintain and enforce written policies and procedures reasonably designed to ensure that purported facts in its research reports are based on reliable information. Rule 2241(c)(1)(B) requires that the policies and procedures also must be reasonably designed to ensure that any recommendation, rating or price target has a reasonable basis and be accompanied by a clear explanation of any valuation method used and a fair presentation of the risks that may impede achievement of the recommendation, rating or price target. That provision is consistent with NASD Rule 2711(h)(7).

Rule 2241(c)(2) maintains the requirement that a firm that employs a ratings system must clearly define the meaning of each rating, including the time horizon and any benchmarks on which a ratings is based. The ratings definitions must be consistent with their plain meanings. In addition, Rules 2241(c)(2)(A) and (B) require that, irrespective of the ratings system a firm employs, it must disclose in each research report the percentage of all securities rated to which the firm would assign a “buy,” “hold,” or “sell” rating, as well as the percentage of subject companies within each category for which the firm has provided investment banking services in the previous 12 months. Rule 2241(c)(2)(C) requires this information to be current as of the end of the most recent calendar quarter or the second most recent calendar quarter if the publication date of the research report is less than 15 days after the most recent calendar quarter. These provisions are consistent with NASD Rules 2711(h)(4) and (5).

Rule 2241(c)(3) further retains the price chart provision in NASD Rule 2711(h)(6), which requires for any research report that contains a rating or price target, a line graph of the security’s daily closing prices for the period that the member has assigned any rating or price target or for a three-year period, whichever is shorter. The chart must indicate the dates on which the firm assigned or change each rating or price target. The provision applies where a firm has assigned a rating or price target for at least one year and must be current as of the end of the most recent calendar quarter or the second most recent calendar quarter if the publication date of the research report is less than 15 days after the most recent calendar quarter.

In addition, the rule carries over in substance⁹ from NASD Rule 2711 the following disclosure requirements that must be made in any research report at the time of publication or distribution of the report:

- ▶ if the research analyst or a member of the research analyst's household has a financial interest in the debt or equity securities of the subject company (including, without limitation, whether it consists of any option, right, warrant, future, long or short position), and the nature of such interest (Rule 2241(c)(4)(A));
- ▶ if the research analyst has received compensation based upon (among other factors) the member's investment banking revenues (Rule 2241(c)(4)(B));
- ▶ if the member or any of its affiliates: (i) managed or co-managed a public offering of securities for the subject company in the past 12 months; (ii) received compensation for investment banking services from the subject company in the past 12 months; or (iii) expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months (Rule 2241(c)(4)(C));
- ▶ if, as of the end of the month immediately preceding the date of publication or distribution of a research report (or the end of the second most recent month if the publication or distribution date is less than 30 calendar days after the end of the most recent month), the member or its affiliates have received from the subject company any compensation for products or services other than investment banking services in the previous 12 months (Rule 2241(c)(4)(D));
- ▶ if the subject company is, or over the 12-month period preceding the date of publication or distribution of the research report has been, a client of the member, and if so, the types of services provided to the issuer. Such services, if applicable, must be identified as either investment banking services, non-investment banking services, non-investment banking securities-related services or non-securities services (Rule 2241(c)(4)(E));
- ▶ if the member or its affiliates beneficially own 1 percent or more of any class of common equity securities of the subject company (Rule 2241(c)(4)(F));¹⁰
- ▶ if the member was making a market in the securities of the subject company at the time of publication or distribution of the research report (Rule 2241(c)(4)(G)); and
- ▶ if the research analyst received any compensation from the subject company in the previous 12 months (Rule 2241(c)(4)(H)).

The rule expands upon the current "catch-all" disclosure in NASD Rule 2711(h)(1)(C), which mandates disclosure of any other material conflict of interest of the research analyst or member that the research analyst knows or has reason to know of at the time of the publication or distribution of a research report. Rule 2241(c)(4)(I) requires disclosure of material conflicts known not only by the research analyst, but also by any "associated person of the member with the ability to influence the content of a research report."

Supplementary Material .08 defines a person with the “ability to influence the content of a research report” as an associated person who is required to review the content of the research report or has exercised authority to review or change the research report prior to publication or distribution. This term does not include legal or compliance personnel who may review a research report for compliance purposes but are not authorized to dictate a particular recommendation, rating or price target. The “reason to know” standard in this provision does not impose a duty of inquiry on the research analyst or others who can influence the content of a research report. Rather, it covers disclosure of those conflicts that should reasonably be discovered by those persons in the ordinary course of discharging their functions.

Rule 2241(c)(5) modifies the current exception in Rule 2711(h)(2)(C) for disclosure that would reveal material non-public information regarding specific potential future investment banking transactions of the subject company to include specific potential future investment banking transactions of other companies, such as a competitor of the subject company.

As with the current rules, Rule 2241(c)(6) provides that all disclosures must be presented on the front page of a research report or the front page must refer to the page on which the disclosures are found. Electronic research reports may provide a hyperlink directly to the required disclosures. All disclosures and references to disclosures must be clear, comprehensive and prominent. Rule 2241(c)(7) also continues to permit a member that distributes a research report covering six or more companies (compendium report) to direct the reader in a clear manner as to where the applicable disclosures can be found. An electronic compendium research report may hyperlink to those disclosures. A paper compendium report must include a toll-free number or a postal address where the reader may request the disclosures. In addition, paper compendium reports may include a Web address where the disclosures can be found.

Disclosures in Public Appearances

Rule 2241(d) groups in a separate provision the disclosures required when a research analyst makes a public appearance, but the required disclosures remain substantively the same as under the current rules.¹¹ The disclosures include if the member or its affiliates beneficially own 1 percent or more of any class of common equity securities of the subject company, as computed in accordance with Section 13(d) of the Exchange Act. Unlike in research reports, the “catch all” disclosure requirement in public appearances applies only to a conflict of interest of the research analyst or member that the research analyst knows or has reason to know at the time of the public appearance and does not extend to persons with the ability to influence the content of a research report. Rule 2241(d)(2) provides that a research analyst need not make an otherwise required disclosure during a public appearance if it would reveal material non-public information regarding specific future investment banking transactions of the subject company. Rule 2241(d)(3) also retains the current requirement in NASD Rule 2711(h)(12) to maintain records of public appearances sufficient to demonstrate compliance by research analysts with the applicable disclosure requirements.

Disclosure Required by Other Provisions

With respect to both research reports and public appearances, Rule 2241(e) continues to require members and research analysts to comply with applicable disclosure provisions of FINRA Rule 2210 and the federal securities laws.

Termination of Coverage

Rule 2241(f) retains with non-substantive modifications the provision in the current rule that requires a member to notify its customers if it intends to terminate coverage of a subject company. Such notification must be made promptly¹² using the member's ordinary means to disseminate research reports on the subject company to its various customers. Unless impracticable, the notice must be accompanied by a final research report, comparable in scope and detail to prior research reports, and include a final recommendation or rating. If impracticable to provide a final research report, recommendation or rating, a firm must disclose to its customers the reason for terminating coverage.

Distribution of Member Research Reports

The rule includes a new provision with respect to selective dissemination of research reports. Rule 2241(g) requires firms to establish, maintain and enforce written policies and procedures reasonably designed to ensure that a research report is not distributed selectively to internal trading personnel or a particular customer or class of customers in advance of other customers that the firm has previously determined are entitled to receive the research report. The rule includes further guidance in Supplementary Material .07 to explain that firms may provide different research products and services to different classes of customers, provided the products are not differentiated based on the timing of receipt of potentially market moving information and the firm informs its other customers that its alternative research products and services may reach different conclusions or recommendations that could impact the price of the equity security. The notification need not be included in every research report; however, a customer must be notified of the alternative research products, services and dissemination practices prior to receiving or accessing a research report for the first time and promptly after any material changes to the firm's research products, services or dissemination practices.

Distribution of Third-party Research Reports

Rule 2241(h) maintains the existing third-party disclosure requirements,¹³ incorporating the change to the "catch-all" provision to include material conflicts of interest that an associated person of the member with the ability to influence the content of a research report knows or has reason to know at the time of the distribution of the third-party research report. Rule 2241(h)(4) also requires members to disclose any other material conflict of interest that can reasonably be expected to have influenced the member's choice of a third-party research provider or the subject company of a third-party research report.

In addition, the rule continues to address qualitative aspects of third-party research reports. For example, the rule maintains, but in the form of policies and procedures, the existing requirement that a registered principal or supervisory analyst review and approve third-party research reports distributed by a member. To that end, the Rules 2241(h)(1) and (3) require a member to establish, maintain and enforce written policies and procedures reasonably designed to ensure that any third-party research it distributes contains no untrue statement of material fact and is otherwise not false or misleading. For the purpose of this requirement, a member's obligation to review a third-party research report extends to any untrue statement of material fact or any false or misleading information that should be known from reading the research report or is known based on information otherwise possessed by the member. Rule 2241(h)(2) further prohibits a member from distributing third-party research if it knows or has reason to know that such research is not objective or reliable.

The rule maintains the existing exceptions for "independent third-party research reports." Specifically, Rules 2241(h)(5) and (6) provide that those research reports do not require principal pre-approval or, where the third-party research is not "pushed out," the third-party disclosures. As to the latter, a member will not be considered to have distributed independent third-party research where the research is made available by the member: (a) upon request; (b) through a member-maintained website; or (c) to a customer in connection with a solicited order in which the registered representative has informed the customer, during the solicitation, of the availability of independent research on the solicited equity security and the customer requests such independent research.

Finally, Rule 2241(h)(7) also includes a new requirement that members ensure that a third-party research report is clearly labeled as such and that there is no confusion on the part of the recipient as to the person or entity that prepared the research report.

Obligations of Persons Associated With a Member

The rule includes new supplementary material to address the obligations of associated persons with respect to policies-based provisions. Consistent with FINRA Rule 0140, Supplementary Material .09 provides that persons associated with a member must comply with the member's policies and procedures as established pursuant to the Rule 2241.¹⁴ In addition, consistent with Rule 0140, Supplementary Material .09 states that it shall be a violation of the rule for an associated person to engage in the restricted or prohibited conduct to be addressed through the establishment, maintenance and enforcement of policies and procedures required by Rule 2241, including applicable Supplementary Material.

Exemption for Firms With Limited Investment Banking Activity

The rule expands the current exemption for firms with limited investment banking activity. The current rule exempts firms with limited investment banking activity—those that over the previous three years, on average per year, have managed or co-managed 10 or fewer investment banking transactions and generated \$5 million or less in gross revenues from those transactions—from the provisions that prohibit a research analyst from being subject to the supervision or control of an investment banking department employee.¹⁵ However, those firms currently remain subject to the provision that requires the compensation of a research analyst to be reviewed and approved annually by a committee that reports to a member’s board of directors, or a senior executive officer if the member has no board of directors.¹⁶ That provision further prohibits representation on the committee by investment banking department personnel and requires the committee to consider the following factors when reviewing a research analyst’s compensation: (1) the research analyst’s individual performance, including the research analyst’s productivity and the quality of research; (2) the correlation between the research analyst’s recommendations and the performance of the recommended securities; and (3) the overall ratings received from clients, the sales force and peers independent of investment banking, and other independent ratings services.¹⁷

Rule 2241(i) maintains the same parameters for the exemption for firms with limited investment banking activity and extends the exemption to include the compensation committee provision in Rule 2241(b)(2)(E). However, the rule still prohibits these firms from compensating a research analyst based upon specific investment banking services transactions or contributions to a member’s investment banking services activities.

Rule 2241(i) further exempts firms with limited investment banking activity from the provisions restricting or limiting research coverage decisions and budget determination. In addition, the provision exempts eligible firms from the requirement to establish information barriers or other institutional safeguards to insulate research analysts from the review or oversight by investment banking personnel or other persons, including sales and trading personnel, who may be biased in their judgment or supervision. However, those firms still are required to establish information barriers or other institutional safeguards reasonably designed to ensure that research analysts are insulated from pressure by investment banking and other non-research personnel who might be biased in their judgment or supervision.

Exemption From Registration Requirements for Certain “Research Analysts”

The rule change also creates a new limited exemption from the research registration and qualification requirements. It amends the definition of “research analyst” in NASD Rule 1050(b) and Incorporated NYSE Rule 344.10 to limit the scope of the registration and qualification requirements to persons who produce “research reports” and whose primary job function is to provide investment research. FINRA cautions that the revised definition

is not intended to carve out anyone for whom the preparation of research is a significant component of their job; rather, it is intended to provide relief for those who produce research reports on an occasional basis. FINRA notes that, in accordance with the mandates of the Sarbanes-Oxley, both NASD Rule 2711 and FINRA Rule 2241 are constructed such that the person who is primarily responsible for the preparation of the substance of a communication that meets the definition of a “research report” is a “research analyst,” irrespective of his or her title or primary job (*e.g.*, it could include a registered representative or a trader).

Attestation Requirement

The rule no longer contains a requirement to attest annually that the firm has in place written supervisory policies and procedures reasonably designed to achieve compliance with the applicable provisions of the rules. However, FINRA notes that the underlying supervisory obligations continue to attach pursuant to FINRA Rule 3110.

General Exemptive Authority

The rule includes new general exemptive authority for FINRA. Rule 2241(j) provides FINRA, pursuant to the Rule 9600 Series, with authority to conditionally or unconditionally grant, in exceptional and unusual circumstances, an exemption from any requirement of the proposed rule for good cause shown, after taking into account all relevant factors and provided that such exemption is consistent with the purposes of the rule, the protection of investors, and the public interest.

Implementation Schedule

The rule changes will be implemented in two stages:

Effective on September 25, 2015

- ▶ Amendments to NASD Rule 1050 and Incorporated NYSE Rule 344.10 (registration of research analysts)
- ▶ Rule 2241(b)(2)(I) and deletion of NASD Rules 2711(f)(1) through (5) and Incorporated NYSE Rules 472(f)(1) through (6) (quiet periods)
- ▶ Rule 2241(j) (exemption for good cause)
- ▶ Rule 2241.10 (divesting research analyst holdings)
- ▶ Deletion of NASD Rule 2711(i) and Incorporated NYSE Rule 351 (annual attestation requirement)

Effective on December 24, 2015

- ▶ All other provisions

Endnotes

1. See Securities Exchange Act Rel. No. 75471 (July 16, 2015), 80 FR 43482 (July 22, 2015) (Order Approving File No. SR-FINRA-2014-047).
2. 15 U.S.C. 78q-6.
3. The SEC separately approved FINRA's proposal to adopt FINRA Rule 2242 (Debt Research Analysts and Debt Research Reports) to address conflicts of interest relating to the publication and distribution of debt research reports. See Securities Exchange Act Rel. No. 75472 (July 16, 2015), 80 FR 43528 (July 22, 2015) (Order Approving File No. SR-FINRA-2014-048). See also [Regulatory Notice 15-31](#).
4. The current definition in NASD Rule 2711(a)(3) includes, without limitation, many common types of investment banking services. The rule adds the language "or otherwise acting in furtherance of" either a public or private offering to further emphasize that the term "investment banking services" is meant to be construed broadly.
5. Consistent with the Jumpstart Our Business Startups Act (JOBS Act), those quiet periods do not apply following the IPO or secondary offering of an Emerging Growth Company (EGC), as that term is defined in Section 3(a)(80) of the Exchange Act.
6. For additional guidance, see generally [Regulatory Notice 11-41](#) (September 2011) and [Research Rules Frequently Asked Questions](#).
7. See [Notice to Members 07-04](#) (January 2007) and NYSE Information Memo 07-11 (January 2007).
8. See FINRA Rule 2241.01 and [Notice to Members 07-04](#) (January 2007). For additional guidance on the solicitation prohibition, see generally [Research Rules Frequently Asked Questions](#).
9. In some instances, Rule 2241 makes minor word or grammatical changes, uses streamlined language or moves some text to Supplementary Material, but has not changed the substantive disclosure requirements of these provisions.
10. The determination of beneficial ownership continues to be based upon the standards used to compute ownership for the purposes of the reporting requirements under Section 13(d) of the Exchange Act.
11. See NASD Rules 2711(h)(1), (h)(2)(B) and (C), (h)(3) and (h)(9).
12. While NASD Rule 2711(f)(6) does not contain the word "promptly," FINRA has interpreted the provision to require prompt notification of termination of coverage of a subject company.
13. NASD Rule 2711(h)(13)(A) currently requires the distributing member firm to disclose the following, if applicable: (1) if the member owns 1 percent or more of any class of equity securities of the subject company; (2) if the member or any affiliate has managed or co-managed a public offering of securities of the subject company or received compensation for investment banking services from the subject company in the past 12 months, or expects to receive or intends to seek compensation for such services in the next three months; (3) if the member makes a market in the subject company's securities; and (4) any other actual, material conflict of interest of the research analyst or member of which the research analyst knows or has reason to know at the time the research report is distributed or made available.
14. FINRA Rule 0140(a), among other things, provides that persons associated with a member shall have the same duties and obligations as a member under the Rules.
15. See NASD Rule 2711(k).
16. See NASD Rule 2711(d)(2).
17. See NASD Rule 2711(d) and (k).

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