

## **SEC APPROVES RULE TO REGULATE DEBT RESEARCH REPORTS AND DEBT RESEARCH ANALYSTS**

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## BACKGROUND

Eight years in the making, the US Securities and Exchange Commission (SEC) has finally approved the Financial Industry Regulatory Authority's (FINRA's) proposed Rule 2242 (the Rule or Rule 2242), which will regulate the activities of debt research analysts and the research reports they produce. New Rule 2242 will fundamentally change the way that FINRA member firms handle the production and dissemination of debt research reports. The Rule begins with the core principle that there will be no "carve-out" from the definition of "debt research reports" for the materials that are produced by desk analysts or strategists. Desk analysts and debt sales and trading personnel whose written product falls within the broad definition of "debt research reports" will therefore be deemed "debt research analysts" for purposes of the Rule. At the same time, FINRA has created an exemption from many of the proscriptive aspects of the Rule for "institutional debt research."<sup>1</sup>

New Rule 2242 will be effective on February 22, 2016.<sup>2</sup>

Rule 2242—like Rule 2241 amending the rules that regulate equity research—will impose separations between sales and trading and research beyond those already in place under FINRA Rule 5280,<sup>3</sup> and will require extensive conflict of interest disclosure. In many ways, new Rule 2242 closely tracks new equity research rule, Rule 2241, and its predecessors, NASD Rule 2711 and parts of NYSE Rule 472 (SRO Rules). However, Rule 2242 exempts from much of the rule "institutional debt research" that is provided exclusively to institutional investors that have confirmed that they do not wish to receive "retail debt research."

This LawFlash provides an overview of the components of new Rule 2242 for firms that produce material that is debt research under the Rule, with a focus on the exemption for "institutional debt research." Firms can use this information to assess what enhancements they must make to their current research regulatory programs and evaluate whether any exemptions are available for some or all of the debt research they produce or distribute.

## DEFINITIONS

The Rule includes a section that defines the terms used in Rule 2242. Definitions of key terms are summarized below:

"Debt Research Report" is "any written (including electronic) communication that includes an analysis of a debt security or an issuer of a debt security and that provides information reasonably sufficient upon which to base an investment decision, excluding communications that solely constitute an equity research report as defined in Rule 2241(a)(11)." The carve-outs for communications that do not include analysis of individual debt securities or issuers found in Regulation AC and in Rule 2241 are carried into Rule 2242, as are the carve-outs for communications that do include such analysis, such as statistical summaries, analysis prepared for fewer than 15 persons, periodic reports for investment company shareholders or discretionary investment account clients, and internal communications.<sup>4</sup>

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<sup>1</sup> Rule 2242(j)(3) defines "institutional debt research" as debt research reports provided to institutional investors pursuant to the exemption provided in Rule 2242(j).

<sup>2</sup> "Debt Research," Regulatory Notice 15-31 (August 2015).

<sup>3</sup> FINRA Rule 5280(b) requires member firms to establish, maintain, and enforce policies and procedures reasonably designed to restrict or limit the information flow between research department personnel (or other persons with knowledge of the content or timing of a research report) and trading department personnel, so as to prevent trading department personnel from utilizing non-public advance knowledge of the issuance or content of a research report for the benefit of the member firm or any other person.

<sup>4</sup> See Rule 2242(a)(3).

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This definition is quite comprehensive and—without the institutional debt research exemption discussed below—would have fundamentally altered how written information about credit markets is provided to core institutional investors, because much of the information would have become subject to the extensive provisions of Rule 2242 that apply to debt research reports that are not institutional debt research.

The definition of "debt security" is carried over from the Securities Exchange Act, but expressly excludes equity securities, municipal securities, securities-based swaps, and US Treasury securities, as those terms are defined in the Exchange Act (or, in the case of US Treasury securities, FINRA Rule 6710(p)).<sup>5</sup>

"Debt Research Analyst" is "an associated person who is primarily responsible for, and any associated person who reports directly or indirectly to a debt research analyst in connection with, the preparation of the substance of a debt research report, whether or not any such person has the job title of 'research analyst.'"<sup>6</sup>

Because the definition of "debt research report" is so broad, the definition of "debt research analyst" captures individuals who have traditionally been considered sales and trading personnel, specifically "desk analysts."

The institutional debt research exemption helps to limit the impact of these broad definitions by allowing desk analysts who interact with institutional investors who are debt research analysts under the new rule to continue their activities.<sup>7</sup>

## **SIGNIFICANT RULE 2242 REQUIREMENTS**

Like Rule 2241, Rule 2242 is structured around four core sections:

- (1) Identifying and Managing Conflicts of Interest
- (2) Content and Disclosure in Debt Research Reports
- (3) Distribution of Third Party Debt Research Reports
- (4) Exemptions

Both rules include "Supplemental Material" sections that provide deeper information related to these core parts. However, Rule 2242 (unlike Rule 2241) also includes an "Exemption for Debt Research Reports Provided to Institutional Investors," which we describe below.

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<sup>5</sup> See Rule 2242(a)(5).

<sup>6</sup> See Rule 2242(a)(1).

<sup>7</sup> Many definitions track those in Rule 2241, including but not limited to the definition of a "debt research analyst account," which refers to personal accounts of analysts and their household members (Rule 2242(a)(2)); "independent third party debt research report," which refers to a debt research report that is distributed by a member firm unrelated to the preparer of the debt research report (Rule 2242(a)(6)); and "investment banking services," which refers to underwriting, participating in a selling group for a public offering, acting as a financial adviser in a merger or acquisition, providing venture capital or equity lines of credit, or acting as placement agent or otherwise furthering a private offering by an issuer (Rule 2242(a)(9)).

## Identifying and Managing Conflicts of Interest

FINRA has included in Rule 2242(b) the components it expects to see in a supervisory program of written policies and procedures reasonably designed to identify and effectively manage conflicts of interests. These components generally relate to the preparation, content, and distribution of debt research reports; public appearances by debt research analysts; and the interaction between debt research analysts and personnel outside of the research department, including investment banking department personnel, sales and trading personnel, principal trading personnel, subject companies, and customers.<sup>8</sup> This articulation of the principles is followed by a detailed articulation of standards, disclosure and behavioral requirements, limitations on interactions, and expectations for debt research analysts and the products that they produce. These detailed provisions generally track those found in Rule 2241 with regard to equity research, and are (for the most part) closely modeled on the requirements in the SRO Rules regarding the preparation, content, and distribution of equity research reports; public appearances by equity research analysts; and the interaction of equity research analysts with personnel outside of the research department.

Rule 2242 incorporates many of the modifications to the SRO Rules that are now found in Rule 2241, such as a new requirement in Rule 2242(c) that a firm provide disclosure when the research analyst or a family member in his/her household has a financial interest in the equity or debt securities of the subject company.

## Disclosures

Debt research reports must reflect policies and procedures reasonably designed to ensure that statements in the reports are based on reliable information and that any recommendation or rating has a reasonable basis, is accompanied by a clear explanation of valuation method, and has a fair presentation of risks that may impede achieving the recommendation or rating.<sup>9</sup>

Rule 2242(c) outlines the disclosures that must be included in debt research reports. These generally track the disclosures from the SRO Rules that are found in Rule 2241 regarding equity research. However, as mentioned above, a new disclosure requirement in both Rule 2241 and Rule 2242 requires disclosure if the debt research analyst or a member of his/her household has a financial interest in the debt or equity securities of the subject company(ies), and the nature of such interest.<sup>10</sup>

As discussed below, institutional debt research reports are exempt from the granular disclosure requirements of Rule 2242, but are required to provide prominent disclosure of the nature of the research and any conflicts.<sup>11</sup>

## Institutional Investor Exemption

The most significant development with the approval of Rule 2242 is the addition of an exemption for debt research that is provided only to institutional investors.<sup>12</sup> This exemption permits member firms to distribute debt research that has been produced under circumstances that might otherwise have been

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<sup>8</sup> Rule 2242(b)(1)(A)-(C).

<sup>9</sup> Rule 2242(c)(1).

<sup>10</sup> Rule 2241 (c)(4)(A), Rule 2242(c)(4)(A). This same disclosure is required in public appearance disclosure. See Rule 2241(d)(1)(a) and Rule 2242(d)(1)(A).

<sup>11</sup> See Rule 2242(j)(1) and Rule 2242(j)(2).

<sup>12</sup> Rule 2242(j).

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prohibited based on actual or perceived conflicts of interest, provided that such debt research is distributed only to institutional investors.

A firm must institute policies and procedures to ensure that institutional debt research will be provided only to eligible institutional investors. If there is reason to believe that the research will be distributed to retail investors, the exemption is not available.<sup>13</sup>

## **a. Institutional Debt Research Disclosure**

Institutional debt research need not include the comprehensive disclosures that other debt research and equity research reports must provide. Rather, debt research that is institutional debt research must include the following disclosure "prominently on the first page":

This document is intended for institutional investors and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors.

When applicable, the report must also state the following:

The views expressed in this report may differ from the views offered in [Firm's] debt research reports prepared for retail investors.

In certain instances, the report must also state the following:

This report may not be independent of [Firm's] proprietary interests. [Firm] trades the securities covered in this report for its own account and on a discretionary basis on behalf of certain clients. Such trading interests may be contrary to the recommendations(s) offered in this report.<sup>14</sup>

## **b. Permitted Contacts and Activities**

With regard to institutional debt research, this exemption allows

- prepublication review, clearance or approval by principal trading personnel and/or sales and trading personnel, as well as other persons not directly responsible for preparation, content, and distribution of debt research reports (however, investment banking personnel remain prohibited from participating in any way in prepublication review, clearance and/or approval);
- input by sales and trading and principal trading personnel into debt research coverage decisions;
- supervision of debt research analysts by personnel outside of research, such as investment banking, sales and trading, and principal trading;
- budget decisions regarding a debt research department to include investment banking and principal trading senior management;

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<sup>13</sup> Rule 2242(j)(4).

<sup>14</sup> Rule 2242(j)(3).

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- debt research analyst compensation made, at least in part, on specific investment banking services or specific trading transactions or contributions to investment banking services or principal trading activities;
- compensation decisions for debt analysts preparing institutional debt research to be made without regard to the requirement that such decisions must be reviewed and approved by a committee excluding investment banking and principal trading personnel; and
- debt research analysts to maintain personal accounts that may trade in securities that the analyst covers.<sup>15</sup>

## **c. Information Barriers Applicable to Institutional Debt Research**

If a member firm produces research that is institutional debt research, then information barriers regarding such research—between debt research analysts and investment banking, principal trading, and sales and trading personnel and activities—are required only to the extent that they prohibit and prevent any **pressure** that could be applied by personnel outside the research function on the debt research analyst.<sup>16</sup> From the discussion in the SEC's release that announced approval of Rule 2242, FINRA appears most concerned with avoiding pressure that would impact the independence of the research analyst, even when the institutional debt research exemption allows for interaction and input from persons outside of the research function. As a result, this could present an interesting situation for firms as they develop policies and procedures around institutional debt research.<sup>17</sup>

Certain prohibitions continue to apply to institutional debt research—and the debt research analysts that prepare it—to insulate the debt research function (like the equity research function) from pressure that might cause debt research analysts to express views that do not reflect the independent and objective views resulting from their research.

In particular, the following prohibitions apply:

- Member firms and their personnel are prohibited from applying or threatening any retaliatory action against a debt research analyst with regard to the content of a research report—in particular, any adverse, negative, or otherwise unfavorable report or public appearance by the debt research analyst.
- Member firms and their personnel cannot explicitly or implicitly promise favorable debt research, a particular debt research rating, or recommendation of specific debt research content as an inducement for business or compensation.
- Member firms must restrict or limit activities of debt research analysts that could compromise their objectivity—in particular, research analysts cannot participate in pitches and other solicitations of investment banking services transactions and cannot participate in “road shows” and other marketing on behalf of an issuer related to an investment banking transaction.
- Member firms must prohibit investment banking department personnel from (i) directing debt research analysts to engage in sales and marketing related to an investment banking transaction, and (ii) directing debt research analysts to communicate with customers about a specific investment banking transaction.

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<sup>15</sup> See Rule 2242(j)(2).

<sup>16</sup> *Id.*

<sup>17</sup> See Regulatory Notice 15-31 at 16.

- Supplemental Material .02 articulates the restrictions that need to be in place to implement this prohibition. Specifically, debt research analysts cannot discuss investment banking transactions in the presence of investment banking department personnel or company management, and any written material prepared by a debt research analyst regarding an investment banking services transaction, whether for internal use or for provision to customers, must be "fair, balanced and not misleading, taking into consideration the overall context in which the communication is made."
- Debt research reports cannot be reviewed before publication by the subject company, other than to verify facts.
  - Supplemental Material .05 regarding the process of seeking and obtaining such factual reviews also would apply to institutional debt research, to prevent the prepublication provision to the subject company of research summaries, recommendations, or ratings that will appear in the debt research report.

## **d. "Eligible Institutional Investors"**

In order for a firm to benefit from the carve-outs described above, the recipients of the debt research reports must fall within one of two categories of institutional investor.

The first category is institutional investors that are "qualified institutional buyers" (QIBs) that the member firm, pursuant to FINRA Rule 2211(b), has a reasonable basis to believe are capable of evaluating investment risks independently (both general and specific to particular transaction and strategies involving debt securities). Such QIBs are eligible to receive institutional debt research if they have affirmed that they are exercising independent judgment in investment decisions, including debt securities pursuant to Rule 2111. If the member provides written disclosure to the QIB that it may receive institutional debt research that is not subject to all of the independence and disclosure standards applicable to retail debt research, and the QIB does not contact the member to request that it not receive institutional debt research, then the member can reasonably conclude that the QIB has consented to receive the institutional debt research (referred to as "negative consent").<sup>18</sup>

The second group of institutional investors eligible to receive institutional debt research are those that are "institutional accounts" (but are not QIBs) as defined in Rule 4512(c), including natural persons who qualify, provided that these accounts provide affirmative written notice to the FINRA member that they wish to receive the institutional debt research.<sup>19</sup>

## **OTHER IMPORTANT COMPONENTS OF THE NEW RULE**

### **Joint Due Diligence**

New Rule 2242 includes supplemental material that details the prohibition on joint due diligence by research analysts and investment bankers that relates to an investment banking services transaction prior

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<sup>18</sup> See Rule 2242(j)(i)(A).

<sup>19</sup> See Rule 2242(j)(i)(B). Supplemental Material .11 allows member firms to continue to provide institutional debt research to the non-QIB institutional investors, **other than natural persons**, without affirmative consent during a transition period of up to one year from SEC approval, which occurred on July 18, 2015 and was published in the Federal Register on July 22, 2015.

to the selection of the member as an underwriter in the transaction.<sup>20</sup> This supplemental material is also found in new Rule 2241 with regard to equity research analysts.

## Selective Dissemination

Rule 2242 requires member firms to have written policies and procedures reasonably designed to ensure that research reports are not selectively distributed to trading personnel or particular customers or classes of customers.<sup>21</sup> Rule 2242 also includes, however, supplemental material that recognizes that a member may offer different research products and services to different classes of customers (such as research for investors with long-term investment horizons versus those with short-term investment horizons) and that these different products may result in conflicting recommendations or ratings.<sup>22</sup> The supplemental material clarifies that if different products are distributed, then each must reflect its own respective ratings systems. Also, debt research products cannot be differentiated based on the timing to receipt of a recommendation, rating, or other potentially market-moving information, or in a way that allows certain customers to receive the information and trade in advance of other customers receiving the information. Finally, if a member firm has products and services that may reach different conclusions or recommendations, then the member must inform its customers of the alternatives and their availability. This likely will take the form of disclosure in the different research products.<sup>23</sup>

## Third-Party Research

Rule 2242 tracks the principles found in the SRO Rules and Rule 2241 pertaining to equity research with regard to a member firm's obligations when distributing third-party debt research.

Third-party debt research reports cannot be distributed by a member if the member knows or has reason to believe that the research is not objective or reliable.<sup>24</sup> This raises the question of whether member firms can continue distributing research reports prepared by firms outside the United States that are deemed "non-independent" under the UK regulatory regime.

Third-party debt research that is "independent" third-party debt research as defined in Rule 2242(a)(6)<sup>25</sup> is not subject to additional review requirements. All other third-party debt research must be reviewed (consistent with a firm's policies and procedures) to ensure that it does not contain untrue statements of material fact and is not otherwise false or misleading based on information that should be known from reading the research report or is known based on other information in possession of the member firm.<sup>26</sup>

Third-party debt research distributed<sup>27</sup> by a member firm also must be accompanied by conflict of interest disclosures or provide a website with such disclosures, specifically (at a minimum) (i) whether the distributing member or any of its affiliates managed or co-managed a public offering for the issuer or received investment banking compensation from the issuer in the past 12 months, or expects to receive

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<sup>20</sup> See Rule 2242 Supplemental Material .09.

<sup>21</sup> Rule 2242(f). This requirement also appears in new Rule 2241(g).

<sup>22</sup> See Rule 2242 Supplemental Material .06. The parallel supplemental material is found for Rule 2241 Supplemental Material .07.

<sup>23</sup> *Id.*

<sup>24</sup> Rule 2242(g)(1).

<sup>25</sup> Definition of "independent third party debt research report."

<sup>26</sup> Rule 2242(g)(2) and (4).

<sup>27</sup> Research is not distributed if it is made available upon request through a member-maintained website or in connection with a solicited order. Rule 2242(g)(5).

or intends to seek compensation for such services in the next three months;<sup>28</sup> (ii) if the distributing member trades or may trade as principal the debt securities (or related derivatives) that are the subject of the debt research report;<sup>29</sup> and/or (iii) any other material conflict of interest of the member firm.<sup>30</sup>

Rule 2242 does not address whether a debt research report prepared by an affiliate of a FINRA member firm that is made available only to eligible institutional investors—through the member firm or otherwise—would be eligible to be treated as institutional debt research in reliance on the exemption for such research, thereby lessening the review and disclosure requirements.

## **DEBT RESEARCH ANALYST LICENSING**

FINRA has not proposed a licensing examination for debt research analysts at this time. Member firms should not, however, assume that debt research analysts will in any way escape regulatory scrutiny.

## **CONCLUSION**

While FINRA has codified requirements for debt research, new Rule 2242 still leaves open questions for member firms that will be subject to its requirements—whether they produce retail debt research, institutional debt research, or both. For firms that have traditionally offered written “desk analysis” and sales and trading commentary, the institutional debt research exemption should be helpful, but even with the exemption, certain changes will be required over the next several months pending the effective date of Rule 2242.

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<sup>28</sup> Rule 2242(1)(4)(C).

<sup>29</sup> Rule 2242(c)(4)(F).

<sup>30</sup> Rule 2242(c)(4)(H).

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## CONTACTS

If you have any questions or would like more information on the issues discussed in this White Paper, please contact the author, Amy Natterson Kroll (+1.202.739.5746 or [amy.kroll@morganlewis.com](mailto:amy.kroll@morganlewis.com)), or any of the following Morgan Lewis lawyers:

### Boston

Timothy P. Burke	+1.617.951.8620	<a href="mailto:timothy.burke@morganlewis.com">timothy.burke@morganlewis.com</a>
Jason S. Pinney	+1.617.951.8684	<a href="mailto:jason.pinney@morganlewis.com">jason.pinney@morganlewis.com</a>

### Washington, DC

John V. Ayanian	+1.202.739.5946	<a href="mailto:jayanian@morganlewis.com">jayanian@morganlewis.com</a>
Elizabeth H. Baird	+ 1.202.373.6561	<a href="mailto:elizabeth.baird@morganlewis.com">elizabeth.baird@morganlewis.com</a>
Amy Natterson Kroll	+1.202.739.5746	<a href="mailto:amy.kroll@morganlewis.com">amy.kroll@morganlewis.com</a>

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