

## Shaping FINRA's Desk Commentary Safe Harbor

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The Financial Industry Regulatory Authority has proposed in-concept amendments to FINRA Rules 2241 and 2242 (research rules), which regulate the preparation and distribution of “research reports” and “debt research reports” (referred to here, generally, as “research reports”).<sup>[1]</sup>

The proposed amendments described in Regulatory Notice 17-16 (desk commentary safe harbor) would provide a limited, nonexclusive safe harbor for FINRA member firms that distribute desk commentary as well as the sales and trading desk personnel who write it. The safe harbor would relieve firms that distribute desk commentary from certain research rule requirements and free personnel preparing such desk commentary from the registration and qualification requirements imposed on equity research analysts. FINRA has yet to provide the text for the proposed rule changes.

The safe harbor would ease many of the regulatory burdens of the research rules for certain communications that industry participants were concerned might be deemed “research reports,” but many elements of the research rules would be retained. For instance, the safe harbor would allow for the dissemination — on a “negative consent” basis — of “desk commentary” that could be deemed research reports to institutional accounts as defined in FINRA Rule 4512(c), and would allow firms to use “health warning” disclosures on desk commentary in lieu of issuer-specific disclosure. However, the safe harbor for equity desk commentary — like FINRA Rule 2241 — would require policies and procedures that implement prohibitions on investment banking personnel (1) supervising or controlling and/or making compensation decisions regarding personnel preparing desk commentary, (2) having input into the budget of the research department (which should not impact desk commentary under the safe harbor), and (3) receiving compensation based on specific investment banking services transactions or specific contributions to the firm’s investment banking services activities.

This article discusses the key elements of the proposed safe harbor and highlights those aspects of the proposal that would benefit from clarification or modification if the safe harbor is to be of maximum utility to sales and trading personnel who regularly send out a range of commentary on markets, trading and related subjects.



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## **“Desk Commentary”**

At the core of the safe harbor is FINRA’s concept of “desk commentary.” FINRA describes “desk commentary” as sales materials that are “brief observations” for eligible institutional investors that come from sales and trading or principal trading personnel and that could rise to the level of a research report. FINRA further states that these brief communications usually are focused on the “near term” and are “prepared and disseminated quickly in response to trading events or news flashes” — implying a temporal aspect to desk commentary.

FINRA notes in Regulatory Notice 17-16 that it understands that desk commentary, as sales material sent by sales and trading or proprietary traders, often is used by buy-side traders, rather than portfolio managers, to carry out previously made investment decisions; FINRA also observes that the recipients of desk commentary understand the types of potential conflicts that may exist between the trading ideas and recommendations generated by desk personnel and a member’s trading interests, and therefore such recipients are less in need of the specific conflict of interest disclosures required by the research rules.

FINRA further states that the safe harbor is not intended for those materials that “do not meet the definition of a research report due to either insufficient analysis or because the communication falls into a specified exception [to the definition of research report].” Rather, the safe harbor is for desk commentary that could technically fall within the research report definition “even where it falls well short of the type of fundamental research that originally gave rise to the research conflict of interest rules.”

FINRA also states that it “understands that discerning between those desk communications that fall just on either side of the line of being a research report can sometimes be difficult and that the supervisory scrutiny required to make those judgments can impede the timely receipt of the information by those institutional investors that value it.” However, even if desk commentary is produced in reliance on the safe harbor, there still are conditions to satisfy that could limit the safe harbor’s utility — unless the final rule and regulatory materials provide additional clarity on several points.

### **Safe Harbor Conditions**

The safe harbor would require a firm to meet author, content and recipient conditions, as well as satisfy the conflict management requirements described in the next section of this article. As a nonexclusive safe harbor, even if the conditions are not satisfied, desk commentary nevertheless could be analyzed and found not to be a “research report” subject to Rule 2241 or 2242.

### ***Author Conditions***

The safe harbor would be available only for material produced by sales and trading and principal trading personnel who:

- are not primarily engaged in the preparation of research reports that are outside the content limitation for “desk commentary,”
- are not required to register as research analysts pursuant to NASD Rule 1050 because their primary job function is not the provision of investment research, and

- do not report directly or indirectly to research department personnel.[2]

### ***Content Conditions***

The content of “desk commentary” relying on the safe harbor must be limited to brief observations and cannot include the author’s rating, price target or earnings estimate. Note, however, that FINRA states in a footnote that desk commentary could refer to a rating, price target or earnings estimate from published research reports and could discuss the directional effect of an event on an issuer’s rating, price target or earnings.[3] The content also must be regarding recent, current or near-term expected trading activity, trading ideas or opportunities, market conditions, economic statistics or company results, or regarding a recent recommendation or research report (presumably prepared by a “research analyst” and subject to the research rules). This suggests that desk commentary expressing long-term views may be problematic, although the regulatory notice does not provide any guidance as to what might be “near-term” as distinguished from longer-term views.

In the introductory section of the regulatory notice, as noted earlier in this article, FINRA references materials that do not meet the definition of “research report” due to “insufficient analysis.” Hopefully, when the actual rule text for the safe harbor is proposed, it will reflect that desk commentary with “brief analysis” would not be deemed a “research report” but that brief writings with analysis may rely on the safe harbor if the conditions are satisfied.

### ***Recipient Conditions***

The safe harbor would permit the provision of “desk commentary” to “institutional accounts” as defined in Rule 4512(c). This includes natural persons with at least \$50 million in assets.[4] The safe harbor would require that a firm obtain “negative consent” from such institutional accounts that the firm, pursuant to Rule 2111(b), has a reasonable basis to believe are capable of evaluating investment risks independently, generally, and regarding particular transactions and investment strategies. Furthermore, such institutional accounts must have affirmatively indicated that they are exercising independent judgment in evaluating a firm’s recommendations.

FINRA states that negative consent could be obtained by providing written disclosure to an institutional account regarding (1) the provision of desk commentary that may at times constitute research reports under FINRA rules and (2) that the desk commentary is intended only for institutional investors/accounts and is not subject to the independence and disclosure standards applicable to research reports prepared for retail investors.[5] Requiring receipt of the Rule 2111 suitability statements from all recipients of desk commentary, however, could be difficult and could undermine the flexibility that the safe harbor strives to provide, especially because desk commentary may be sent to a firm’s prospective clients as well as to existing clients.

In addition, the safe harbor would require a firm to have policies and procedures reasonably designed to (1) ensure that desk commentary is available only to eligible institutional investors, and (2) safeguard against the dissemination of internal material nonpublic information from the research department.[6]

### ***Conflict Management***

While FINRA acknowledges that the conflicts inherent in desk commentary will not impede an institutional investor that can make independent evaluation of risks, FINRA nevertheless would limit

firms' practices when they produce desk commentary in reliance on the safe harbor. To that end, FINRA would require a firm to have policies and procedures reasonably designed to address a subset of the conflicts of interest covered in the research rules. These requirements track with the conflict of interest requirements found in Rule 2242(j) for the "institutional debt research exemption." [7]

The required conflict of interest policies and procedures would cover the following:

- Prevention of the use of desk commentary and its authors to manipulate markets.
- Prohibitions on prepublication review, clearance or approval of desk commentary by investment banking personnel and a prohibition on prepublication review by a subject company.
- Establishment of information barriers or other safeguards similar to those designed to insulate research analysts from pressure by persons engaged in investment banking or others, including sales and trading personnel, who might be biased in their judgment or supervision of the authors of the desk commentary.
  - FINRA helpfully clarifies in a footnote that this would not require physical separation of persons producing desk commentary from other sales and trading and principal trading department personnel.[8]
  - FINRA also states, helpfully, that in the context of desk commentary, "pressure" by sales and trading or principal trading personnel would not be deemed to exist merely because a firm produces desk commentary on securities in which it trades, or where the authors of desk commentary report to such personnel. FINRA suggests, however, that a firm would need to have policies and procedures reasonably designed to ensure that investment banking personnel or sales and trading or principal trading personnel do not overtly pressure a person who produces desk commentary to express a particular view.[9]
- Prohibitions on explicit or implicit promises of favorable research.[10]
- Limitations on activities of desk commentary authors that reasonably could be expected to compromise objectivity such as (1) participating in pitches and other solicitation of investment banking services transactions, (2) participating in road shows, and (3) other marketing on behalf of issuers related to an investment banking services transaction.
  - Regarding transaction-related road shows, FINRA states in a footnote that sales and trading personnel may listen in from a remote location (or view a live webcast) of a transaction-related road show or similarly widely attended presentation related to a transaction.
  - Regarding marketing on behalf of issuers, FINRA clarifies in a footnote that the prohibition on marketing on behalf of issuers would prohibit sales and trading personnel from engaging in communications regarding an offering (such as forwarding written materials to customers) when they are concurrently publishing desk commentary related to the issuer or the investment banking services transaction.
    - In order to ensure that this limitation does not impede permitted ordinary course communications by sales and trading personnel, it would be helpful if this

language were included in the rule text or supplemental material for the safe harbor rather than relegated to a footnote.[11]

- FINRA does not clarify or condition in any way, however, the proposed prohibition on sales and trading personnel who write desk commentary from participating in pitches to issuers. In some instances, these personnel are best situated to explain the current market, market trends and similar concepts to issuers considering investment banking services transactions, and therefore clarification would be helpful that sales and trading personnel who write desk commentary would be permitted to participate in a pitch to an issuer for an investment banking services transaction if they cease writing about the issuer during the pitch and during any subsequent period during which knowledge of the pitch or related information about the issuer would constitute material nonpublic information.
- Prohibitions on investment banking department personnel directing the author of desk commentary, directly or indirectly, to engage in sales or marketing related to an investment banking services transaction or to communicate with a customer about an investment banking services transaction.[12]
- Prohibitions on the author of desk commentary from engaging in communications with a customer in the presence of investment banking department personnel or issuer management regarding an investment banking services transaction of the issuer.[13]

### **“Health Warnings” Disclosure**

The safe harbor incorporates — from FINRA Rule 2242’s “institutional debt research exemption” — the concept of providing “health warnings” in lieu of the detailed issuer-specific disclosure required by the research rules.

The proposed health warnings for desk commentary are the following:

- “This document is intended for institutional investors and is not subject to all of the independence and disclosure standards applicable to research reports prepared for retail investors.”
- If applicable: “Clients should assume that this document is not independent of [Firm’s] proprietary interests. [Firm] trades, and will continue to trade, the securities covered in this document for its own account and on a discretionary basis on behalf of certain clients. Such trading interests may be contrary to or entered into in advance of this document.”

### **Additional Requirements for Equity Desk Commentary Relying on the Safe Harbor**

FINRA would impose additional restrictions on the writers of equity desk commentary. Such restrictions track with the requirements of Rule 2241, which are intended to mitigate against the influence of investment banking on writings that could be deemed equity research reports.

Specifically, FINRA would require a firm to have policies and procedures reasonably designed to do the following:

- Prohibit investment banking personnel from supervising or controlling “research analysts” — including prohibiting investment banking personnel’s influence or control over the evaluation and determination of analysts’ compensation.[14]
- Limit the determination of the research department budget “to senior management, excluding senior management engaged in investment banking services activities.”
- Prohibit compensation based on specific investment banking services transactions or contributions to a firm’s investment banking services activities.
  - FINRA explains in a footnote that sales and trading personnel could be compensated by sales credits connected with the distribution of securities in an offering if the persons receiving such credits had not published desk commentary related to the transactions for which the credits are received.

These conditions for equity desk commentary relying on the safe harbor should be closely considered in light of the differences in production, dissemination and use of “fundamental research” as opposed to desk commentary. Due to these differences, it is not clear that imposing these conditions for equity desk commentary serves a useful policy purpose.

### **Potential Benefits (and Burdens) for FINRA Member Firms**

FINRA has proposed the safe harbor after extensive contacts with stakeholders, including buy-side firms and sell-side recipients of desk commentary, among others, which suggests that the actual rule text of the safe harbor likely will track closely with the proposal found in Regulatory Notice 17-16.

A final safe harbor rule that incorporates refinements like those discussed in this article could help firms address regulatory considerations in the day-to-day production and distribution of desk commentary, as well as in connection with emails and other materials that could risk after-the-fact designation as “research reports” absent the safe harbor.

Without such refinements, however, the safe harbor could prove to be of less use. As reflected in Regulatory Notice 17-16, the currently proposed safe harbor could have the ironic effect of creating additional uncertainty as it attempts to address existing uncertainty. With any additional uncertainty, firms would have to decide whether the benefits of relying on the safe harbor outweigh the burdens and, if so, whether to rely on the safe harbor for a broad swath of writings from sales and trading.

### **Conclusion**

The text of the safe harbor when ultimately proposed will need to be refined to be useful to firms that have produced desk commentary for decades. FINRA’s publication of draft rule text will assist in providing a closer comparison to existing rules. For now, it is important for industry participants to continue the dialogue on the impact of the proposed concepts in Regulatory Notice 17-16 to help further shape the desk commentary safe harbor.

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[1] Desk Commentary Safe Harbor, Regulatory Notice 17-16 (April 2017).

[2] A “research analyst” is defined in FINRA Rule 1050(b) as an associated person of a FINRA member firm whose primary job function is to provide investment research and who is primarily responsible for the preparation of the substance of a research report or whose name appears on a research report.

[3] Regulatory Notice 17-16, n.6.

[4] The “institutional debt research exemption” allows for the distribution of debt research reports to institutional accounts also, but requires affirmative consent from recipients that are institutional accounts but that are not qualified institutional buyers (QIBs) as defined in Rule 144A under the Securities Act of 1933.

[5] FINRA proposes a 90-day transition period between the effective date of the amendments to 2241 and 2242 implementing the safe harbor to permit firms to continue sending desk commentary to such accounts while the written notices are distributed.

[6] FINRA states that “as a practical matter, desk commentary that includes material nonpublic research information inherently would not satisfy the content limitation to be considered eligible for the proposed safe harbor.”

[7] See Rule 2242(j)(3).

[8] See Regulatory Notice 17-16, n.9.

[9] See *id.*

[10] We note that at various points in the regulatory notice, FINRA refers to “research,” “research reports,” “research analysts” and “research departments.” This may indicate that FINRA intends in the rule text to cross-reference to specific provisions of the research rules. This creates potential confusion, however, that should be addressed in the final rule text of the safe harbor.

[11] See Regulatory Notice 17-16, n.11. In this footnote, FINRA states that “[t]he fact that a person may have previously published desk commentary related to the issuer does not prohibit that person from engaging in the ordinary course communications related to the offering, provided that such commentary ceases during the offering.”

[12] The final rule language should clarify that this limitation would apply only when the author is writing desk commentary on the specific investment banking services transaction.

[13] The final rule language also should clarify that this limitation would apply only when the author is writing desk commentary on the specific investment banking services transaction.

[14] See n.10 above regarding the use of “research” terminology in the regulatory notice, and the potential for confusion.

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