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SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-75471; File No. SR-FINRA-2014-047)

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving a Proposed Rule Change, as Modified by Amendment No. 1 Thereto, to Adopt FINRA Rule 2241 (Research Analysts and Research Reports) in the Consolidated FINRA Rulebook

July 16, 2015

I. Introduction

On November 14, 2014, Financial Industry Regulatory Authority, Inc. ("FINRA") filed with the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] a proposed rule to adopt NASD Rule 2711 (Research Analysts and Research Reports) as a FINRA rule, with several modifications, amend NASD Rule 1050 (Registration of Research Analysts) and Incorporated NYSE Rule 344 to create an exception from the research analyst qualification requirement, and renumber NASD Rule 2711 as FINRA Rule 2241 in the consolidated FINRA rulebook. The proposal was published for comment in the Federal Register on November 24, 2014.[3] The Commission received four comments on the original proposal.[4] On February 19,

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 Exchange Act Release No. 73622 (Nov. 18, 2014); 79 FR 69939 (Nov. 24, 2014) ("Notice"). On January 6, 2015, FINRA consented to extending the time period for the Commission to either approve or disapprove the proposed rule change, or to institute proceedings to determine whether to approve or disapprove the proposed rule change, to February 20, 2015.

4 See Letter from Kevin Zambrowicz, Associate General Counsel & Managing Director and Sean Davy, Managing Director, SIFMA, dated Dec. 15, 2014 ("SIFMA"), Letter from Hugh D. Berkson, President-Elect, Public Investors Arbitration Bar Association, dated Dec. 15, 2014 ("PIABA Equity"), Letter from Stephanie R. Nicholas, WilmerHale,

2015, FINRA filed Amendment No. 1 responding to these original comments received to the proposal as well as to propose amendments in response to these comments. The proposal, as amended by Amendment No. 1, was published for comment in the Federal Register on March 18, 2015.[5] On February 20, 2015, the Commission issued an order instituting proceedings pursuant to section 19(b)(2)(B) of the Act[6] to determine whether to approve or disapprove the proposal. This order was published for comment in the Federal Register on February 26, 2015.[7] The Commission received a further three comments regarding the proceedings or in response to Amendment No. 1,[8] to which FINRA responded via letter on May 5, 2015.[9]

This order approves the proposed rule change.

II. Description of the Proposed Rule Change

As described more fully in the Notice, FINRA proposed to adopt, in the Consolidated FINRA Rulebook, NASD Rule 2711 (Research Analysts and Research Reports), with several modifications, as FINRA Rule 2241. The proposed rule change also would amend NASD Rule

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dated Dec. 16, 2014 ("WilmerHale Equity One"), and Letter from William Beatty, President and Washington (State) Securities Administrator, North American Securities Administrators Association, Inc., dated Dec. 19, 2014 ("NASAA Equity One").

5 Exchange Act Release No. 74488 (Mar. 12, 2015); 80 FR 14174 (Mar. 18, 2015) ("Amendment Notice").

6 15 U.S.C. 78s(b)(2)(B).

7 Exchange Act Release No. 74339 (Feb. 20, 2015); 80 FR 10528 (Feb. 26, 2015).

8 Letter from Egidio Mogavero, Managing Director and Chief Compliance Officer, JMP Securities, dated Mar. 19, 2015 ("JMP"), Letter from Stephanie R. Nicholas, WilmerHale, dated Apr. 6, 2015 ("WilmerHale Equity Two"), and Letter from William Beatty, President and Washington (State) Securities Administrator, North American Securities Administrators Association, Inc., dated Apr. 17, 2015 ("NASAA Equity Two").

9 Letter from Philip Shaikun, Vice President and Associate General Counsel, FINRA, dated May 5, 2015 ("FINRA Response").

1050 (Registration of Research Analysts) and Incorporated NYSE Rule 344 (Research Analysts and Supervisory Analysts) to create an exception from the research analyst qualification requirements.

FINRA believes that the proposed rule change would retain the core provisions of the current rules, broaden the obligations on members to identify and manage research-related conflicts of interest, restructure the rules to provide some flexibility in compliance without diminishing investor protection, extend protections where gaps have been identified, and provide clarity to the applicability of existing rules. Where consistent with protection of users of research, FINRA believes that the proposed rule change reduces burdens where appropriate. The description below is the proposal as amended by Amendment No. 1.[10]

As stated above, the Commission originally received four comments on the proposal. Of these, three expressed general support for the proposal,[11] but one objected to the general formulation of the proposal as a principles-based rule.[12] Of the three comments received in regards to the proceedings or Amendment No. 1, one had comments limited to specific provisions of the proposal,[13] one was supportive of the proposal as amended by Amendment No. 1 with certain specific comments,[14] and one reiterated prior concerns regarding the principles-based nature of the proposal.[15]

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10 See Notice for a description of the original proposal. See also Exhibit 4 to SR-FINRA-2014-047 for a comparison of changes made in the rule text in Amendment No. 1.

11 SIFMA, PIABA Equity, and WilmerHale Equity One.

12 NASAA Equity One.

13 JMP.

14 WilmerHale Equity Two.

15 NASAA Equity Two.

A. Definitions

FINRA proposed to mostly maintain the definitions in current NASD Rule 2711, with certain modifications. Specifically, FINRA made minor changes to the definition of "investment banking services" to clarify that such services include all acts in furtherance of a public or private offering on behalf of an issuer.[16] FINRA also would clarify, in the definition of "research analyst account," that the definition 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.[17] FINRA proposed to exclude from the definition of "research report" communications concerning open-end registered investment companies that are not listed or traded on an exchange (i.e., mutual funds).[18] FINRA further proposed to exclude 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

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16 See proposed FINRA Rule 2241(a)(5). The current definition includes, without limitation, many common types of investment banking services. FINRA proposed to add 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.

17 See proposed FINRA Rule 2241(a)(9).

18 See proposed FINRA Rule 2241(a)(11). In the Notice, FINRA explained that it was proposing this change because "sales material regarding mutual funds is already subject to a separate regulatory regime... [t]he extensive content standards of these rules, combined with the filing and review of mutual fund sales material by FINRA staff, substantially reduce the likelihood that such material will include materially misleading information about the funds." FINRA also stated their belief that because these products are pooled investment vehicles, "it is much less likely that a report on a mutual fund would affect the fund's NAV to the same extent that a research report on a single stock might impact its share price."

those that purport to be research.[19] FINRA sought to move the definitions of "third-party research report" and "independent third-party research report" into the definitional section of the proposed rule that are, in NASD Rule 2711, in a different section of that rule.[20] Lastly, FINRA would adopt 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.[21]

B. Identifying and Managing Conflicts of Interest

FINRA proposed to create a new section entitled "Identifying and Managing Conflicts of Interest." This section contains an overarching provision that requires members 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.[22] The written policies and procedures would be required 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

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19 See proposed FINRA Rule 2241(a)(11)(D).

20 See proposed FINRA Rules 2241(a)(3) and (14). FINRA stated it believes this change would create a more streamlined and user friendly rule to combine defined terms in a single definitional section.

21 See proposed FINRA Rule 2241(a)(12).

22 See proposed FINRA Rule 2241(b)(1).

member or a current or prospective customer or class of customers.[23] These provisions, FINRA asserted, set out the fundamental obligation for a member to establish and maintain a system to identify and mitigate conflicts and to foster integrity and fairness in its research products and services. The proposed rule change then sets forth the requirements for those written policies and procedures. According to FINRA, this approach would allow for some flexibility to manage identified conflicts, with some specified prohibitions and restrictions where disclosure does not adequately mitigate them. FINRA asserted that most of these requirements have been experience tested and found effective.[24]

1. Prepublication Review

As proposed, the first of these minimum requirements would require that the policies and procedures 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.[25]

2. Coverage Decisions

The proposed rule change would require that the policies and procedures restrict or limit input by the investment banking department into research coverage decisions to ensure that

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23 See proposed FINRA Rule 2241(b)(2).

24 See, e.g., Joint Report by NASD and the NYSE on the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules (December 2005), available at http://www.finra.org/web/groups/industry/@ip/@issues/@rar/documents/industry/p015803.pdf.

25 See proposed FINRA Rule 2241(b)(2)(A).

research management independently makes all final decisions regarding the research coverage plan.[26]

3. Supervision and Control of Research Analysts

The proposed rule change would require that the 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.[27]

4. Research Budget Determinations

The proposed rule change would require that the policies and procedures limit determination of the research department budget to senior management, excluding senior management engaged in investment banking services activities.[28]

5. Compensation

The proposed rule change would require that the policies and procedures prohibit compensation based upon specific investment banking services transactions or contributions to a member's investment banking services activities.[29] The policies and procedures further would 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 would not be permitted to have representation from a member's investment banking

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[26] See proposed FINRA Rule 2241(b)(2)(B).

[27] See proposed FINRA Rule 2241(b)(2)(C).

[28] See proposed FINRA Rule 2241(b)(2)(D).

[29] See proposed FINRA Rule 2241(b)(2)(E).

department. The committee would be required to consider, among other things, the productivity of the research analyst and the quality of his or her research and would also be required to document the basis for each research analyst's compensation.[30] FINRA stated that these provisions are consistent with the requirements in current Rule 2711(d).

6. Information Barriers

The proposed rule change would require that the 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.[31]

7. Retaliation

The proposed rule change would require that the 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.[32]

8. Quiet Periods

The proposed rule change would require that the policies and procedures define quiet periods of a minimum of ten days after an initial public offering ("IPO"), and a minimum of

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30 See proposed FINRA Rule 2241(b)(2)(F).

31 See proposed FINRA Rule 2241(b)(2)(G).

32 See proposed FINRA Rule 2241(b)(2)(H).

three days after 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.[33]

With respect to these quiet-period provisions, the proposed rule change would reduce the current forty day quiet period for IPOs to a minimum of ten days after the completion of the offering for any member that participated as an underwriter or dealer, and reduces the ten 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 proposed rule change would maintain exceptions to these 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 Rule 139 under the Securities Act of 1933 regarding a subject company with "actively-traded securities."

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

9. Solicitation and Marketing

In addition, the proposed rule change would require firms to adopt written policies and procedures to restrict or limit activities by research analysts that can reasonably be expected to

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[33] See proposed FINRA Rule 2241(b)(2)(I). 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 Act.

compromise their objectivity.[34] This would include the existing prohibitions on participation in pitches and other solicitations of investment banking services transactions as well as road shows and other marketing on behalf of issuers related to such transactions. We understand these to be a non-exhaustive list of the types of activities that can violate this provision.[35] FINRA noted that, 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.[36]

The proposed rule change also would add Supplementary Material .01, which would codify FINRA's 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.[37]

10. Joint Due Diligence and Other Interactions with Investment Banking

The proposed rule would establish 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 – during a specified time period. Specifically, proposed Supplementary Material .02 states that FINRA interprets the overarching principle requiring members to, among

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34 See proposed FINRA Rule 2241(b)(2)(L).

35 See id. (requiring procedures that "restrict or limit activities by research analysts that can reasonably be expected to compromise their objectivity, including prohibiting [participation in pitches and other solicitations and participation in certain road shows]") (emphasis added).

36 See NASD Notice to Members 07-04 (January 2007) and NYSE Information Memo 07-11 (January 2007).

37 See proposed FINRA Rule 2241.01 and Notice to Members 07-04 (January 2007).

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 clarified that, in response to a comment that this provision may interfere with the JOBS Act,[38] they "would interpret the provision to apply only to the extent it is not contrary to the JOBS Act" and "[t]hus, for example, would 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."[39]

The proposed rule would continue 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.[40] 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 would be prohibited by this provision.[41] FINRA believes that the presence of investment bankers or issuer management could compromise a research analyst's candor when talking to a

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38 JMP.

39 FINRA Response.

40 See proposed FINRA Rule 2241(b)(2)(M).

41 See proposed FINRA Rule 2241.03.

current or prospective customer about a deal. Supplementary Material .03 would also retain 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.

11. Promises of Favorable Research and Prepublication Review by Subject Company

FINRA proposed to maintain the current prohibition against promises of favorable research, a particular research recommendation, rating, or specific content as inducement for receipt of business or compensation.[42] The proposed rule would further require policies and procedures to prohibit prepublication review of a research report by a subject company for purposes other than verification of facts.[43] Supplementary Material .05 would maintain the current guidance applicable to the prepublication submission of a research report to a subject company. Specifically, sections of a draft research report would be permitted to 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 would be required to retain copies of any draft and the final version of the report for three years.[44]

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42 See proposed FINRA Rule 2241(b)(2)(K).

43 See proposed FINRA Rule 2241(b)(2)(N).

44 See proposed FINRA Rule 2241.05.

12. Personal Trading Restrictions

FINRA proposed to require that firms 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.[45] Such policies and procedures would be required 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.[46] The proposal would maintain the current prohibitions on research analysts receiving pre-IPO shares in the sector they cover and trading against their most recent recommendations. However, members would be permitted to define financial hardship circumstances, if any, in which a research analyst would be permitted to trade against his or her most recent recommendation.[47] The proposed rule change includes Supplementary Material .10, which would provide 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

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45 See proposed FINRA Rule 2241(b)(2)(J).

46 See proposed FINRA Rule 2241(b)(2)(J)(i).

47 See proposed FINRA Rule 2241(b)(2)(J)(ii).

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.[48]

C. Content and Disclosure in Research Reports

With some modification, the proposed rule change would maintain the current disclosure requirements. The proposed rule change would add a requirement that a member 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.[49] FINRA stated that it has included this provision because it believes members should have policies and procedures to foster verification of facts and trustworthy research on which investors may rely. The policies and procedures would also be required to be reasonably designed to ensure that any recommendation, rating or price target has a reasonable basis and is 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.[50]

In addition, the proposed rule change would require a member to disclose in any research report at the time of publication or distribution of the report:[51]

- 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,

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48 See proposed FINRA Rule 2241.10.

49 See proposed FINRA Rule 2241(c)(1)(A).

50 See proposed FINRA Rule 2241(c)(1)(B).

51 See proposed FINRA Rule 2241(c)(4).

without limitation, whether it consists of any option, right, warrant, future, long or short position), and the nature of such interest;[52]

- If the research analyst has received compensation based upon (among other factors) the member's investment banking revenues;[53]
- 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;[54]
- 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;[55]
- 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

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52 See proposed FINRA Rule 2241(c)(4)(A).

53 See proposed FINRA Rule 2241(c)(4)(B).

54 See proposed FINRA Rule 2241(c)(4)(C).

55 See proposed FINRA Rule 2241(c)(4)(D).

identified as either investment banking services, non-investment banking services, non-investment banking securities-related services or non-securities services;[56]

- 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;[57] and
- If the research analyst received any compensation from the subject company in the previous 12 months.[58]

The proposed rule change would also expand upon the current "catch-all" disclosure, 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. The proposed rule change would go beyond the existing provision by requiring 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."[59] The proposed rule change 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.[60] FINRA stated that the "reason to know" standard in

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56 See proposed FINRA Rule 2241(c)(4)(E).

57 See proposed FINRA Rule 2241(c)(4)(G).

58 See proposed FINRA Rule 2241(c)(4)(H).

59 See proposed FINRA Rule 2241(c)(4)(I).

60 See proposed FINRA Rule 2241.08.

this provision would not impose a duty of inquiry on the research analyst or others who can influence the content of a research report. Rather, it would cover disclosure of those conflicts that should reasonably be discovered by those persons in the ordinary course of discharging their functions.

The proposed rule change also maintains the requirement to disclose when a member or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company.[61] The determination of beneficial ownership would continue 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.

The proposal would modify the exception for disclosure that would reveal material non-public information regarding specific potential future investment banking transactions of the subject company to also include specific potential future investment banking transactions of other companies, such as a competitor of the subject company.[62] The proposal 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 the 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.[63]

D. Disclosures in Public Appearances

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61 See proposed FINRA Rule 2241(c)(4)(F).

62 See proposed FINRA Rule 2241(c)(5).

63 See proposed FINRA Rule 2241(c)(7).

The proposal would group in a separate provision the disclosures required when a research analyst makes a public appearance.[64] The required disclosures would remain substantively the same as under the current rules,[65] including if the member or its affiliates beneficially own 1% 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 would apply 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. FINRA stated it understands that supervisors or legal and compliance personnel, who otherwise might be captured by the definition of an associated person "with the ability to influence," typically do not have the opportunity to review and insist on changes to public appearances, many of which are extemporaneous in nature. The proposal would also retain 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.[66]

E. Disclosure Required by Other Provisions

With respect to both research reports and public appearances, members and research analysts would continue to be required to comply with applicable disclosure provisions of FINRA Rule 2210 and the federal securities laws.[67]

F. Termination of Coverage

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64 See proposed FINRA Rule 2241(d).

65 See NASD Rules 2711(h)(1), (h)(2)(B) and (C), (h)(3) and (h)(9).

66 See proposed FINRA Rule 2241(d)(3).

67 See proposed FINRA Rule 2241(e).

The proposed rule change would retain, with non-substantive modifications, the provision in the current rules that requires a member to notify its customers if it intends to terminate coverage of a subject company.[68] Such notification would need to be made promptly,[69] using the member's ordinary means to disseminate research reports on the subject company to its various customers. Unless impracticable, the notice would be required to 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 would be required to disclose to its customers the reason for terminating coverage. FINRA clarified in the Notice that it "expects such circumstances to be exceptional, such as where a research analyst covering a subject company or sector has left the member or the member has discontinued coverage of the industry or sector."

G. Distribution of Member Research Reports

The proposal would require 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.[70] The proposal includes further guidance to explain that firms would be permitted to 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

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68 See proposed FINRA Rule 2241(f).

69 While current 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.

70 See proposed FINRA Rule 2241(g).

and the firm discloses its research dissemination practices to all customers that receive a research product.[71]

H. Distribution of Third-Party Research Reports

The proposal would maintain the existing third-party disclosure requirements,[72] while incorporating a 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. In addition, the proposed rule change would require 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.[73]

FINRA stated that the proposal would continue to address qualitative aspects of third-party research reports. For example, the proposal would maintain, 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 proposed rule change would 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

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71 See proposed FINRA Rule 2241.07.

72 NASD Rule 2711(h)(13)(A) currently requires the distributing member firm to disclose the following, if applicable: (1) if the member owns 1% 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.

73 See proposed FINRA Rule 2241(h)(4).

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 would extend 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.[74] The proposal further would prohibit a member from distributing third-party research if it knows or has reason to know that such research is not objective or reliable.[75]

The proposal would maintain the existing exceptions for "independent third-party research reports." Specifically, such research would not require principal pre-approval or, where the third-party research is not "pushed out," the third-party disclosures.[76] As to the latter, a member would 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, under the proposed rule change, members would be required to 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.[77]

I. Exemption for Firms with Limited Investment Banking Activity

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[74] See proposed FINRA Rules 2241(h)(1) and (h)(3).

[75] See proposed FINRA Rule 2241(h)(2).

[76] See proposed FINRA Rule 2241(h)(5) and (6).

[77] See proposed FINRA Rule 2241(h)(7).

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 because the potential conflicts with investment banking are minimal.[78] However, those firms 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.[79] 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.[80] The proposed rule change would extend the exemption for firms with limited investment banking activity so that such firms would not be subject to the compensation committee provision. The proposal would still prohibit these firms from compensating a

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78 See NASD Rule 2711(k).

79 See NASD Rule 2711(d)(2).

80 See NASD Rule 2711(d) and (k).

research analyst based upon specific investment banking services transactions or contributions to a member's investment banking services activities.[81]

The proposed rule change would further exempt firms with limited investment banking activity from the provisions restricting or limiting research coverage decisions and budget determinations. In addition, the proposal would exempt 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 would still be 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.

J. Exemption from Registration Requirements for Certain "Research Analysts"

The proposed rule change would amend the definition of "research analyst" for the purposes of the registration and qualification requirements to limit the scope to persons who produce "research reports" and whose primary job function is to provide investment research (e.g., registered representatives or traders generally would not be included).[82] FINRA stated 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. The existing research rules, in accordance with the mandates of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), are constructed such that

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81 See proposed FINRA Rules 2241(b)(2)(E) and (i).

82 See proposed NASD Rule 1050(b) and proposed Incorporated NYSE Rule 344.10.

the author of a communication that meets the definition of a "research report" is a "research analyst," irrespective of his or her title or primary job.

K. Attestation Requirement

The proposed rule change would delete the 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, including the compensation committee review provision. As FINRA explained in the Notice, firms already are obligated pursuant to NASD Rule 3010 (Supervision) to have a supervisory system reasonably designed to achieve compliance with all applicable securities laws and regulations and FINRA rules. Moreover, the research rules also are subject to the supervisory control rules (NASD Rule 3012) and the annual certification requirement regarding compliance and supervisory processes (FINRA Rule 3130).[83] As such, FINRA did not believe that a separate attestation requirement for the research rules was unnecessary.

L. Obligations of Persons Associated with a Member

Proposed Supplementary Material .09 would clarify the obligations of each associated person under those provisions of the proposed rule change that require a member to restrict or prohibit certain conduct by establishing, maintaining and enforcing particular written policies and procedures. Specifically, the proposal provides that, consistent with FINRA Rule 0140, persons associated with a member would be required to comply with such member's policies and procedures as established pursuant to proposed FINRA Rule 2241.[84] In addition, consistent with

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83 NASD Rules 3010 and 3012 have been adopted with changes as consolidated FINRA rules. The new rules become effective December 1, 2014. See supra note 20.

84 See proposed FINRA Rule 2241.09. 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.

Rule 0140, Supplementary Material .09 states that it shall be a violation of proposed Rule 2241 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.

M. General Exemptive Authority

The proposed rule change would provide 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.[85]

III. Summary of Comment Letters, Discussion, and Commission Findings

In response to the proposal as originally proposed by FINRA, the Commission received four comments.[86] Of these, three expressed general support for the proposal,[87] but one objected to the general formulation of the proposal as a principles-based rule.[88] The specifics of these comments were summarized when the Commission instituted proceedings and again when the Commission noticed Amendment No. 1.[89] FINRA filed Amendment No. 1 as a response to these earlier comments as discussed when the amendment was noticed.[90] In the time since

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85 See proposed FINRA Rule 2241(j).

86 See note 4, supra.

87 SIFMA, PIABA Equity, and WilmerHale Equity One.

88 NASAA Equity One.

89 Exchange Act Release No. 74339 (Feb. 20, 2015); 80 FR 10528 (Feb. 26, 2015) and Amendment Notice.

90 Id.

Amendment No. 1 was filed, the Commission has received three comment letters on the proposal.[91] FINRA submitted a letter in response to these comments.[92]

Three of the four commenters to the original proposal,[93] and one of the three commenters to the proposal in connection with instituting proceedings or with regards to Amendment No. 1,[94] expressed general support for the proposal. The Commission notes this support.

A. Comments and Discussion Regarding the Principles-Based Approach of the Proposed Rule Change

The rule proposal would adopt a policies and procedures approach to identification and management of research-related conflicts of interest and require those policies and procedures to prohibit or restrict particular conduct. Commenters both to the original proposal and after it was amended by Amendment No. 1 expressed several concerns with the approach.

Two commenters, with regards to the original proposal, asserted that the mix of a principles-based approach with prescriptive requirements was confusing in places and posed operational challenges. In particular, the commenters recommended eliminating the minimum standards for the policies and procedures.[95] One of those commenters had previously expressed support for the proposed policies-based approach with minimum requirements,[96] but asserted that the proposed rule text requiring procedures to "at a minimum, be reasonably designed to

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91 JMP, WilmerHale Equity Two, and NASAA Equity Two.

92 FINRA Response.

93 SIFMA, WilmerHale Equity One, and PIABA Equity.

94 WilmerHale Equity Two.

95 SIFMA and WilmerHale Equity One.

96 Letter from Amal Aly, Managing Director and Associate General Counsel, SIFMA, to Marcia E. Asquith, Corporate Secretary, FINRA, dated November 14, 2008 regarding Regulatory Notice 08-55 (Research Analysts and Research Reports).

prohibit" specified conduct is superfluous or confusing. Another commenter opposed a shift to a policies and procedures scheme "without also maintaining the proscriptive nature of the current rules." The commenter therefore favored retaining the proscriptive approach in the current rules and also requiring that firms maintain policies and procedures designed to ensure compliance.[97] One commenter to the original proposal questioned the necessity of the "preamble" requiring policies and procedures that "restrict or limit activities by research analysts that can reasonably be expected to compromise their objectivity" that precedes specific prohibited activities related to investment banking transactions.[98] Finally, some commenters to the original proposal suggested FINRA eliminate language in the supplementary material that provides that the failure of an associated person to comply with the firm's policies and procedures constitutes a violation of the proposed rule itself.[99] These commenters argued that because members may establish policies and procedures that go beyond the requirements set forth in the rule, the provision may have the unintended consequence of discouraging firms from creating standards in their policies and procedures that extend beyond the rule. One of those commenters suggested that the remaining language in the supplementary material adequately holds individuals responsible for engaging in restricted or prohibited conduct covered by the proposals.[100]

FINRA stated that it believes the framework will maintain the same level of investor protection in the current rules while providing both some flexibility for firms to align their compliance systems with their business model and philosophy and imposing additional

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97 NASAA Equity One.

98 WilmerHale Equity One.

99 SIFMA and WilmerHale Equity One.

100 WilmerHale Equity One.

obligations to proactively identify and manage emerging conflicts. Even under a policies and procedures approach, FINRA believes that the proposals would effectively maintain, with some modifications, the key proscriptions in the current rules – e.g., prohibitions on prepublication review, supervision of research analysts by investment banking and participation in pitches and road shows. FINRA stated it disagrees that the "preamble" to some of those prohibitions is unnecessary. As with the more general overarching principles-based requirement to identify and manage conflicts of interest, the introductory principle that requires written policies and procedures to restrict or limit activities by research analysts that can reasonably be expected to compromise their objectivity recognizes that FINRA cannot identify every conflict related to research at every firm and therefore requires proactive monitoring and management of those conflicts. FINRA stated it does not believe this "preamble" language is redundant with the broader overarching principle because it applies more specifically to the activities of research analysts and, unlike the broader principle, would preclude the use of disclosure as a means of conflict management for those activities.

One commenter, with regards to the proposal as amended by Amendment No. 1, reiterated its earlier comments regarding their concerns relating to the principles-based nature of the proposal. This commenter stated that the historical mismanagement of the conflicts of interest inherent to equity research by firms necessitates a proscriptive, rather than principles-based approach. The commenter noted that violations in this area are "recent and continued" and that they and other commenters noted that the proposal seemed "unclear and likely to result in confusion."[101] FINRA disagreed with the commenter noting that "the proposed framework effectively maintains, with a few modifications, the key proscriptions in the current rules...

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[101] NASAA Equity Two. See also NASAA Equity One, SIFMA, and WilmerHale Equity One.

because the proposals require policies and procedures that must prohibit or restrict specified conduct, such as research analyst participation in soliciting investment banking business or road shows."[102]

In light of the overarching principle that requires firms to establish, maintain and enforce written policies and procedures reasonably designed to identify and effectively manage research-related conflicts, the "at a minimum" language was meant to convey that additional conflicts management policies and procedures may be needed to address emerging conflicts that may arise as the result of business changes, such as new research products, affiliations or distribution methods at a particular firm. FINRA stated it intends for firms to proactively identify and manage those conflicts with appropriately designed policies and procedures. Thus, FINRA's inclusion of the "at a minimum" language was not intended to suggest that firms' written policies and procedures must go beyond the specified prohibitions and restrictions in the proposal where no new conflicts have been identified. However, FINRA stated it believes the overarching requirement for policies and procedures reasonably designed to identify and effectively manage research-related conflicts suffices to achieve the intended regulatory objective, and therefore to eliminate any confusion, FINRA proposed in Amendment No. 1 to amend the proposal to delete the "at a minimum" language.

One commenter regarding the proposal as amended by Amendment No. 1 specifically took issue with this action of removing the "at a minimum" requirement as "this language was helpful in maintaining the prescriptive nature of the current rules by ensuring that a firm's policies and procedures met at least a minimum standard."[103] Another noted its approval.[104]

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[102] FINRA Response.

[103] NASAA Equity Two.

FINRA responded that this change "was meant to clarify that FINRA did not expect firms' written policies and procedures to go beyond the specified prohibitions and restrictions in the proposals where no new conflicts had been identified... [h]owever... removing that language did not change the overarching requirement for written policies and procedures reasonably designed to identify and effectively manage emerging conflicts – a significant additional obligation that does not exist in the current rules."[105]

FINRA clarified in Amendment No. 1 that it appreciates the commenters' concerns with respect to language in the supplementary material that would make a violation of a firm's policies a violation of the underlying rule. According to FINRA, the supplementary material was intended to hold individuals responsible for engaging in the conduct that the policies and procedures effectively restrict or prohibit. FINRA stated that it agrees that purpose is achieved with the language in the supplementary material that states that, consistent with FINRA Rule 0140, "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 [the Rule] or related Supplementary Material." Therefore, FINRA proposed in Amendment No. 1 to amend the proposed rule change to delete the language stating that a violation of a firm's policies and procedures shall constitute a violation of the rule itself.

One commenter responding to the proposal as amended by Amendment No. 1 objected to this change.[106] Another noted its approval for the change.[107] FINRA responded that the change

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104 WilmerHale Equity Two.

105 FINRA Response.

106 NASAA Equity Two.

would not affect the ability of FINRA to "hold individuals responsible for engaging in conduct that the policies and procedures effectively restrict or prohibit." FINRA further suggested that it did not believe that individuals should be punished by FINRA where those individuals violate procedures members instituted voluntarily that go beyond the minimum requirements of the rule.[108]

Lastly, one commenter regarding the institution of proceedings sought leeway or guidance regarding examiners' interpretation of FINRA's rules, specifically, what constitutes "reasonable," with regards to small firms who have only institutional clients.[109] FINRA stated that the proposal is principles-based and is designed to allow some flexibility, but will consider providing additional guidance, as appropriate, where questions arise.[110]

B. Comments and Discussion Regarding Definitions and Terms Used in the Proposal

One commenter requested that the original proposal define the term "sales and trading personnel" as "persons who are primarily responsible for performing sales and trading activities, or exercising direct supervisory authority over such persons."[111] The commenter's proposed definition was intended to clarify that the proposed restrictions on sales and trading personnel activities should not extend to: (1) Senior management who do not directly supervise those activities but have a reporting line from such personnel (e.g., the head of equity capital markets);

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107 WilmerHale Equity Two.

108 FINRA Response. See also WilmerHale Equity One (suggesting the change).

109 JMP.

110 FINRA Response.

111 WilmerHale Equity One. For consistency with the debt research proposal, FINRA also proposed in Amendment No. 1 to amend the proposed rule change to use the term "sales and trading personnel."

or (2) persons who occasionally function in a sales and trading capacity. FINRA stated it intends for the sales and trading personnel conflict management provisions to apply to individuals who perform sales and trading functions, irrespective of their job title or the frequency of engaging in the activities. As such, FINRA clarified it does not intend for the rule to capture as sales and trading personnel senior management, such as the chief executive officer, who do not engage in or supervise day-to-day sales and trading activities. However, FINRA stated it believes the applicable provisions should apply to individuals who may occasionally perform or directly supervise sales and trading activities. Otherwise, investors could be put at risk with respect to the research or transactions involved when those individuals are functioning in those capacities because the conflict management procedures and proscriptions and required disclosures would not apply. Therefore, FINRA proposed in Amendment No. 1 to amend the rule to define 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." FINRA notes that it believes that this proposed definition is more consistent with the definition of "investment banking department" in the current and proposed rules.

One commenter to the original proposal asked FINRA to include an exclusion from the definition of "research report" for private placement memoranda and similar offering-related documents prepared in connection with investment banking services transactions.[112] The commenter noted that such offering-related documents typically are prepared by investment banking personnel or non-research personnel on behalf of investment banking personnel. The commenter asserted that absent an express exception, the proposals could turn investment banking personnel into research analysts and make the rule unworkable. The commenter noted

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112 WilmerHale Equity One.

that NASD Rule 2711(a) excludes communications that constitute statutory prospectuses that are filed as part of a registration statement and contended that the basis for that exception should apply equally to private placement memoranda and similar offering-related documents.

FINRA clarified that the definition of "research report" is generally understood not to include such offering-related documents prepared in connection with investment banking services transactions. In the course of administering the filing review programs under FINRA Rules 2210 (Communications with the Public), 5110 (Corporate Financing Rule), 5122 (Member Private Offerings) and 5123 (Private Placements of Securities), FINRA stated it has not received any inquiries or addressed any issues that indicate there is confusion regarding the scope of the research analyst rules as applied to offering-related documents prepared in connection with investment banking activities. Regardless, FINRA proposed in Amendment No. 1 to amend the proposed rule change to exclude private placement memoranda and similar offering-related documents prepared in connection with investment banking services transactions other than those that purport to be research from the definition of "research report" to provide firms with greater clarity as to the status of such offering-related documents under the proposal. The commenter noted its approval in its comment letter regarding Amendment No. 1.[113]

One commenter asked FINRA to refrain from using the concept of "reliable" research in the proposals as it may inappropriately connote accuracy in the context of a research analyst's opinions.[114] However, another commenter supported the requirement to have policies and procedures reasonably designed to ensure that research reports are based on reliable

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113 WilmerHale Equity Two.

114 SIFMA.

information.[115] FINRA pointed to their discussion in Item 5 of the Proposing Release and stated it believes that the term "reliable" is commonly understood and notes that the term is used in certain research-related provisions in Sarbanes–Oxley without definition. FINRA stated that it did not believe the term connotes accuracy of opinions.

One commenter asked FINRA to eliminate as redundant the term "independently" from the provisions permitting non-research personnel to have input into research coverage, so long as research management "independently makes all final decisions regarding the research coverage plan."[116] The commenter asserted that inclusion of "independently" is confusing since the proposal would, in the commenter's view, permit input from non-research personnel into coverage decisions.[117] One commenter who responded to the order instituting proceedings expressed support for this comment as well.[118] FINRA stated it included "independently" to make clear that research management alone is vested with making final coverage decisions. Thus, for example, a firm could not have a committee that includes a majority of research management personnel but also other individuals make final coverage decisions by a vote. As such, FINRA declined to eliminate the term as suggested.

One commenter to the institution of proceedings suggested that the terms "manager" and

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115 NASAA.

116 WilmerHale Equity One.

117 Proposed FINRA Rule 2241(b)(2)(B) specifically states that the policies and procedures must "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." Presumably, the commenter believes this permits investment banking input so long as the final decisions are made by research management.

118 JMP.

"co-manager" used with regards to the quiet period provisions in the proposal were unclear.[119] FINRA responded that the terms used in the proposal are commonly understood and there had been no previous comments about uncertainty in the terms. FINRA further pointed out that the terms mentioned by the commenter as those used in the industry, "lead manager" and "book-running manager," are both "managers" for these purposes and that, for secondary offerings, both managers and co-managers have the same treatment.[120]

C. Comments and Discussion Regarding Information Barriers

The proposed rule would require written policies and procedures to "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 department personnel, who might be biased in their judgment or supervision." Some commenters to the original proposal suggested that "review" was unnecessary in this provision because the review of research analysts was addressed sufficiently in other parts of the proposed rule.[121] One of these commenters further suggested that the terms "review" and "oversight" are redundant.[122] FINRA stated that it does not agree that the terms "review" and "oversight" are coextensive, as the former may connote informal evaluation, while the latter may signify more formal supervision or authority. While other provisions of the proposed rule change may address related conduct –

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119 Id.

120 FINRA Response.

121 SIFMA and WilmerHale Equity One.

122 WilmerHale Equity One.

e.g., the provision that prohibits investment banking personnel from supervision or control of research analysts – FINRA stated that this provision extends to "other persons" who may be biased in their judgment or supervision. Finally, FINRA noted that "review, pressure or oversight" mirrors language in Sarbanes-Oxley. Accordingly, FINRA declined to revise the proposed rule.

One commenter to the original proposal asked FINRA to clarify that the information barriers or other institutional safeguards required by the proposed rule are not intended to prohibit or limit activities that would otherwise be permitted under other provisions of the rule.[123] FINRA stated that was their intent and believed that the rules of statutory construction would compel that result.

This commenter stated in their comment in response to Amendment No. 1 that they interpreted this to mean that the proposal would permit members to allow persons engaged in sales and trading activities to provide informal and formal feedback on research analysts as one factor to be considered by research management for the purposes of the evaluation of the analyst.[124] FINRA stated that, in general, it agreed with the commenter's interpretation.[125]

The commenter also asserted that the terms "bias" and "pressure" are broad and ambiguous on their face and requested that FINRA clarify that for purposes of the information barriers requirement that they are intended to address persons who may try to improperly influence research.[126] As an example, the commenter asked whether a bias would be present if

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[123] Id.

[124] WilmerHale Equity Two.

[125] FINRA Response.

[126] WilmerHale Equity One.

an analyst was pressured to change the format of a research report to comply with the research department's standard procedures or the firm's technology specifications. FINRA stated that it believes the terms "pressure" and "bias" are commonly understood, particularly in the context of rules intended to promote analyst independence and objectivity. To that end, FINRA noted that the terms appear in certain research-related provisions of Sarbanes–Oxley without definition. Thus, with respect to the commenter's example, FINRA stated it does not believe a bias would be present simply because someone insists that a research analyst comply with formatting or technology specifications that do not otherwise implicate the rules.

One commenter asked FINRA to modify the information barriers or other institutional safeguards requirement to conform the provision to FINRA's "reasonably designed" standard for policies and procedures that members must adopt.[127] FINRA stated it believed the change would be consistent with the standard for policies and procedures elsewhere in the proposals, and therefore proposed to amend the provision as requested in Amendment No. 1. The commenter noted its approval in its comment regarding Amendment No. 1.[128]

One commenter to the original proposal opposed as overbroad the proposed expansion of the current "catch-all" disclosure requirement to include "any other material conflict of interest of the research analyst or member that a research analyst <u>or an associated person of the member with the ability to influence</u> the content of a research report knows or has reason to know" at the time of publication or distribution of research report.[129] (emphasis added) The commenter

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127 <u>Id.</u>

128 WilmerHale Equity Two.

129 WilmerHale Equity One.

expressed concern about the emphasized language. Another commenter supported the proposed expansion of the current "catch-all" disclosure requirement.[130]

FINRA stated that it proposed the change to capture material conflicts of interest known by persons other than the research analyst (e.g., a supervisor or the head of research) who are in a position to improperly influence a research report. FINRA defined "ability to influence the content of a research report" in supplementary material as "an associated person who, in the ordinary course of that person's duties, has the authority to review the research report and change that research report prior to publication or distribution." The commenter stated that the proposed change could capture individuals (especially legal and compliance personnel) who might be required to disclose confidential information that is not covered by the exception in the proposals that would not require disclosure where it would "reveal material non-public information regarding specific potential future investment banking transactions of the subject company." This is because, according to the commenter, legal and compliance may be aware of material conflicts of interest relating to the subject company that involve material non-public information regarding specific future investment banking transactions of a competitor of the subject company. The commenter also expressed concern that the provision would slow down dissemination of research to canvass all research supervisors and management for conflicts. The commenter suggested that the change was unnecessary given other objectivity safeguards in the proposals that would guard against improper influence.

FINRA stated it continues to believe that a potential gap exists in the current rules where a supervisor or other person with the authority to change the content of a research report knows of a material conflict. However, FINRA stated it intended for the provision to capture only those

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130 NASAA Equity One.

individuals who are required to review the content of a particular research report or have exercised their authority to review or change the research report prior to publication or distribution. In addition, FINRA stated it did not intend to capture 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. FINRA proposed in Amendment No. 1 to amend the supplementary material in the proposals consistent with this clarification. In addition, FINRA proposed in Amendment No. 1 to modify the exception in proposed Rules 2241(c)(5) and (d)(2) (applying to public appearances) not to require disclosure that would otherwise reveal material non-public information regarding specific potential future investment banking transactions, whether or not the transaction involves the subject company.

This commenter in their comment in response to Amendment No. 1, while expressing their support for these changes, asked FINRA to make a modification of the parties who trigger disclosure of any other material conflict of interest. Specifically, the commenter asked FINRA to limit this disclosure to only be required when someone has authority to dictate a particular recommendation, rating, or price target.[131] The commenter was seeking to extend this authority requirement to other parities that can trigger the disclosure, specifically persons who review the report and persons who have exercised authority to review or change the report generally. FINRA declined to make further changes, noting that the change in Amendment No. 1 "was meant to limit application of the provision where there is a discrete review by [legal or compliance personnel] outside of the research department who do not have primary content review responsibilities" and that "those individuals that a firm requires to review research reports (e.g., a Supervisory Analyst) or who exercise their authority to change a research report (e.g., a

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131 WilmerHale Equity Two.

Director of Research) by definition have the ability to influence the content of a research report."[132]

One commenter requested confirmation that members may rely on hyperlinked disclosures for research reports that are delivered electronically, even if these reports are subsequently printed out by customers.[133] As long as a research report delivered electronically contains a hyperlink directly to the required disclosures, FINRA stated that the standard will be satisfied.

D. Comments and Discussion Regarding Research Products with Differing Recommendations

The proposal 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 proposals also include supplementary material that explains that firms may provide different research products to different classes of customers – e.g., long term fundamental research to all customers and short-term trading research to certain institutional customers – provided the products are not differentiated based on the timing of receipt of potentially market moving information and the firm discloses, if applicable, that one product may contain a different recommendation or rating from another product.

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132 FINRA Response.

133 WilmerHale Equity One.

One commenter supported the provisions as proposed with general disclosure,[134] while another contended that FINRA should require members to disclose when their research products and services do, in fact, contain a recommendation contrary to the research product or service received by other customers.[135] The commenter favoring general disclosure asserted that disclosure of specific instances of contrary recommendations would impose significant burdens unjustified by the investor protection benefits. The commenter stated that a specific disclosure requirement would require close tracking and analysis of every research product or service to determine if a contrary recommendation exists. The commenter further stated that the difficulty of complying with such a requirement would be exacerbated in large firms by the number of research reports published and research analysts employed and the differing audiences for research products and services.[136] They asserted that some firms may publish tens of thousands of research reports each year and employ hundreds of analysts across various disciplines and that a given research analyst or supervisor could not reasonably be expected to know of all other research products and services that may contain differing views.

The opposing commenter stated that they believed that permitting contrary opinions while only disclosing the possibility of this contrary research to investors was insufficient to adequately protect investors because the use of "may" in a disclosure is not the same as disclosing that there actually are opposing opinions. Further, they questioned whether such disclosure was consistent with the Act in that it may be contrary to Rule 10b-5 by permitting the omission of a material fact in the research report. This commenter did not believe that the

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134 WilmerHale Equity One.

135 PIABA Equity.

136 WilmerHale Equity One.

disclosure of actual opposing views would be burdensome on members as they should be aware of contrasting opinions. As a result, they argue that FINRA should require specific disclosures.[137]

The supplementary material states that products may lead to different recommendations or ratings, provided that each is consistent with the member's ratings system for each respective product. In other words, all differing recommendations or ratings must be reconcilable such that they are not truly at odds with one another. Since the proposals would not allow inconsistent recommendations that could mislead one or more investors, FINRA stated that it believes general disclosure of alternative products with different objectives and recommendations is appropriate relative to its investor protection benefits. The commenter who supported this approach noted FINRA's position with approval in its comment regarding Amendment No. 1.[138]

E. Comments and Discussion Regarding Quiet Periods

The proposal would eliminate or reduce the quiet periods during which a member may not publish or otherwise distribute research reports or make a public appearance following its participation in an offering. Citing recent enforcement actions in the research area, one commenter did not support elimination or reduction of the quiet periods.[139] FINRA stated it believes that the separation, disclosure, and certification requirements in the current rules and Regulation AC have had greater impact on the objectivity of research than maintaining quiet periods during which research may not be distributed and research analysts may not make public appearances. FINRA noted that there is a cost to investors when they are deprived of

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137 PIABA Equity.

138 WilmerHale Equity Two.

139 NASAA Equity One.

information and analysis during quiet periods. FINRA stated it believes that the proposed changes to the quiet periods would promote information flow to investors without jeopardizing the objectivity of research. FINRA also noted that the enforcement actions cited by the commenter that favors retaining the existing quiet periods did not involve the quiet period provisions of the rules, nor, in FINRA's view, would maintaining the current quiet periods have deterred the conduct in those cases.

This commenter restated its objection to the shortened quiet periods mandated by the proposal in its comments regarding Amendment No. 1. The commenter noted that "[t]he current quiet periods allow firms to 'cool off' after the completion of certain activities before their research departments can offer coverage on the subject securities or issuers" and that the commenter had concerns that the shortened periods would lead to more promises of favorable research due to the research being distributed more quickly.[140] FINRA stated its belief that the shorter periods were adequate,[141] noting prior statements that, in their view, the remainder of the proposal as well as Regulation AC[142] will be or is effective in deterring biased research without the need for the longer periods called for in NASD Rule 2711.[143]

Other commenters requested that FINRA retain the exceptions in NASD Rule 2711(f) that permits: (i) the publication and distribution of research or a public appearance concerning the effects of significant news or a significant event on the subject company during the quiet period; and (ii) the publication of distribution of research pursuant to Rule 139 under the

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140 NASAA Equity Two.

141 FINRA Response.

142 17 CFR 242.500-505.

143 See Notice.

Securities Act of 1933.[144] FINRA agreed that those exceptions should be included and therefore amended the proposed rule change in Amendment No. 1. One of these commenters noted its approval of this change in its comment regarding Amendment No. 1.[145]

F. Comments and Discussion Regarding Other Institutional Separation Issues

One commenter with regards to the institution of proceedings suggested that FINRA clarify that the proposal would not interfere with senior managers who oversee research departments along with other non-research departments as they represent is the practice at a number of smaller firms, including pre-publication review by such managers.[146] FINRA responded that, while there is no express exception for managers who manage multiple departments in this way, the rule excepts firms with limited investment banking authority. Further, FINRA stated it did not intend to cover with this rule sales and trading or investment banking personnel who do not engage in or directly supervise day-to-day trading or investment banking activities.[147] The implication of FINRA's response seems to be that, to the extent that the commenter's activities can fall within either of these concepts, it should be permitted under the proposed rule.

This commenter also suggested that FINRA interpret selling concessions from public financings be permitted to be included in compensation decisions for research analysts. This commenter stated that this is because "[b]eing that analysts take part in these [sic] sale efforts,

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144 SIFMA and WilmerHale Equity One.

145 WilmerHale Equity Two.

146 JMP.

147 FINRA Response.

they should be permitted to be compensated from these specific sources of revenue."[148] FINRA noted that such an interpretation "would reintroduce the very conflict that FINRA believes the provision [prohibiting analyst compensation based on specific investment banking revenue] has, in combination with other provisions, effectively alleviated" and declined to agree with the commenter's interpretation.[149]

G. Comments and Discussion Regarding Disclosure Requirements

Two commenters opposed the requirement in the proposal that members disclose, in an equity research report, if they or their affiliates maintain a significant financial interest in the debt of the research company.[150] The commenters noted that the debt research analyst proposal does not contain a dedicated requirement to disclose significant debt holdings. Rather, that proposal relies on the "catch-all" provision, which would require disclosure of a firm's debt holdings of a subject company only where it rises to an actual material conflict of interest.[151] The commenters asserted that the reasoning in the debt proposal – e.g., that firms do not have systems to track ownership of debt securities and that the number and complexity of bonds and the fact that a firm may be both long and short different bonds of the same issuer makes real-time disclosure of credit exposure difficult – applies equally to equity research as far as a member's debt holdings. Another commenter supported the requirement in the equity proposal that members disclose, in an equity research report, if they or their affiliates maintain a significant

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148 JMP.

149 FINRA Response.

150 SIFMA and WilmerHale Equity One.

151 See Exchange Act Release No. 73623 (Nov. 18, 2014); 79 FR 69905 (Nov. 24, 2014).

financial interest in the debt of the research company.[152] One commenter also stated that while FINRA correctly noted that the United Kingdom's Financial Conduct Authority rules require disclosure of debt holdings in equity research reports, that requirement is more akin to the "catch-all" provision because the disclosure is further limited to circumstances where the holdings "may reasonably be expected to impair the objectivity of research recommendations" or "are significant in relation to the research recommendations."[153] FINRA stated it believes that amending the equity proposal to the treat disclosure of debt holdings consistent with the debt proposal would promote consistency and efficiency while maintaining the same level of investor protection. Therefore, FINRA proposed to amend the proposed rule change in Amendment No. 1 accordingly, including modifying a similar disclosure requirement when making public appearances.

One commenter regarding the institution of proceedings had concerns that the provision in the proposal requiring disclosure of when a member "expects to receive or intends to seek" investment banking compensation provides no meaningful disclosure, could mandate disclosure of material, non-public information, and is overly burdensome to track.[154] FINRA noted that this is a disclosure currently required of members under NASD Rule 2711, an exception exists (in that rule and would be retained in the proposal) that does not mandate disclosure to the extent such disclosure would result in disclosure of material, non-public information regarding specific future transactions, and it provides investors with meaningful information regarding the

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152 NASAA Equity One.

153 WilmerHale Equity One.

154 JMP.

member's objectivity that justify the burdens that it may create.[155]

H. Comments and Discussion Regarding Impact on Global Settlement

One commenter asked FINRA to confirm in any Regulatory Notice announcing adoption of the proposed rule change that provisions relating to research coverage and budget decisions and joint due diligence are intended to supersede the corresponding terms of the Global Research Analyst Settlement ("Global Settlement").[156] FINRA reiterated its position, as discussed in the 2012 United States Government Accountability Office ("GAO") Report on Securities Research,[157] that it does not believe that the terms of the Global Settlement should be modified through FINRA rulemaking and instead should be determined by the court overseeing the enforcement action. Therefore, FINRA stated it does not intend for any provisions of the equity proposal that may be adopted to supersede provisions of the Global Settlement. One commenter supported this position.[158]

I. Comments and Discussion Regarding FINRA's Exemptive Authority

One commenter opposed the provision that would give FINRA the authority to grant, in exceptional or unusual circumstances, an exemption from the requirement of the proposed rule for good cause shown.[159] The commenter stated that the provision had not been sufficiently justified by, among other things, providing examples of where an exemption would be justified. FINRA stated that the purpose of exemptive authority is to provide a mechanism of relief in

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155 FINRA Response.

156 WilmerHale Equity One.

157 GAO, Securities Research, Additional Actions Could Improve Regulatory Oversight of Analyst Conflicts of Interest, January 2012.

158 NASAA Equity Two.

159 NASAA Equity One.

unusual factual circumstances that cannot be foreseen, where application of the rule would frustrate or be inconsistent with its intended purposes. As such, FINRA believes that it is difficult if not impossible for it to provide examples of where it would be appropriate to use the authority. However, as FINRA stated in the proposal, it believes that the scope of the rule's subject matter and the diversity of firm sizes, structures and research business and distribution models make it more likely that factual circumstances may arise that had not been contemplated by the rule. In addition, FINRA notes that the authority is limited not only to unusual and exceptional circumstances, but also to a showing of good cause. The Commission notes that the proposal is consistent with other FINRA proposals[160] and expects FINRA to consult with Commission staff prior to issuing such relief, and to discuss whether the proposed exception may be considered a proposed rule change pursuant to section 19(b)(1) of the Act and Rule 19b-4 thereunder.[161]

J. Comments and Discussion Regarding Implementation Date

One commenter requested that the implementation date be at least 12 months after Commission approval of the proposed rule change.[162] Another commenter similarly requested that FINRA provide a "grace period" of one year or the maximum time permissible, if that is less than one year, between the adoption of the proposed rule and the implementation date.[163] FINRA stated it is sensitive to the time firms may require to update their policies and procedures

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160 See FINRA Rule 5131(f).

161 15 U.S.C. 78s(b)(1) and 17 CFR 240.19b-4.

162 SIFMA.

163 WilmerHale Equity.

and systems to comply and will take those factors into consideration when establishing implementation dates.

K. The Proposal Meets the Requirements of Section 15D of the Act

Section 15D requires the Commission, or upon the authorization and direction of the Commission, a registered securities association or national securities exchange to have adopted, not later than July 30, 2003, rules reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances, in order to improve the objectivity of research and provide investors with more useful and reliable information, including rules designed to address certain specific requirements.[164] NASD Rule 2711 and NYSE Rule 472 were adopted to meet this statutory mandate.[165] As the proposed rule change would replace NASD Rule 2711, we considered whether the proposed rule continues to fulfill the mandates of section 15D and, in general, we believe that the proposal does.

Section 15D requires a number of specific provisions, all of which are present in the proposed rule change in the form of required policies and procedures of members. Specifically, the proposed rule change will include rules designed (1) to foster greater public confidence in securities research, and to protect the objectivity and independence of securities analysts, by (a) restricting the prepublication clearance or approval of research reports by persons employed by the broker or dealer who are engaged in investment banking activities, or persons not directly responsible for investment research, other than legal or compliance staff,[166] (b) limiting the

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164 15 U.S.C. 78o-6(a).

165 See Exchange Act Release No. 48252 (Jul. 29, 2003); 68 FR 45875 (Aug. 4, 2003).

166 15 U.S.C. 78o-6(a)(1)(A) and proposed FINRA Rule 2241(b)(2)(A).

supervision and compensatory evaluation of securities analysts to officials employed by the broker or dealer who are not engaged in investment banking activities,[167] and (c) requiring that a broker or dealer and persons employed by a broker or dealer who are involved with investment banking activities may not, directly or indirectly, retaliate against or threaten to retaliate against any securities analyst employed by that broker or dealer or its affiliates as a result of an adverse, negative, or otherwise unfavorable research report that may adversely affect the present or prospective investment banking relationship of the broker or dealer with the issuer that is the subject of the research report, except that such rules may not limit the authority of a broker or dealer to discipline a securities analyst for causes other than such research report in accordance with the policies and procedures of the firm;[168] (2) to define periods during which brokers or dealers who have participated, or are to participate, in a public offering of securities as underwriters or dealers should not publish or otherwise distribute research reports relating to such securities or to the issuer of such securities;[169] and (3) establish structural and institutional safeguards within brokers or dealers to assure that securities analysts are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of those whose involvement in investment banking activities might potentially bias their judgment or supervision.[170]

Further, the proposed rule change mandates the disclosures required by section 15D. Specifically, the proposed rule change requires disclosure of (1) the extent to which the securities

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[167] 15 U.S.C. 78o-6(a)(1)(B) and proposed FINRA Rule 2241(b)(2)(C).

[168] 15 U.S.C. 78o-6(a)(1)(C) and proposed FINRA Rule 2241(b)(2)(H).

[169] 15 U.S.C. 78o-6(a)(2) and proposed FINRA Rule 2241(b)(2)(I).

[170] 15 U.S.C. 78o-6(a)(3) and proposed FINRA Rule 2241(b)(2)(G).

analyst has debt or equity investments in the issuer that is the subject of the appearance or research report;[171] (2) whether any compensation has been received by the broker or dealer, or any affiliate thereof, including the securities analyst, from the issuer that is the subject of the appearance or research report, subject to such exemptions as the Commission may determine as appropriate and necessary to prevent disclosure by virtue of this paragraph of material non-public information regarding specific potential future investment banking transactions of such issuer, as is appropriate in the public interest and consistent with the protection of investors;[172] (3) whether an issuer, the securities of which are recommended in the appearance or research report, currently is, or during the 1-year period preceding the date of the appearance or date of distribution of the report has been, a client of the broker or dealer, and if so, stating the types of services provided to the issuer;[173] and (4) whether the securities analyst received compensation with respect to a research report, based upon (among any other factors) the investment banking revenues (either generally or specifically earned from the issuer being analyzed) of the broker or dealer.[174]

L. The Proposal Is Not Inconsistent with the JOBS Act

The JOBS Act prohibits certain rules by national securities associations with regards to research reports regarding EGCs. Specifically, section 105(b) of the JOBS Act amended section 15D of the Act to prohibit the Commission or a national securities association registered under section 15A of the Act from adopting or maintaining any rule or regulation in connection with an

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[171] 15 U.S.C. 78o-6(b)(1) and proposed FINRA Rule 2241(c)(4)(A).

[172] 15 U.S.C. 78o-6(b)(2) and proposed FINRA Rule 2241(c)(4)(B)-(D), (H), and (c)(5).

[173] 15 U.S.C. 78o-6(b)(3) and proposed FINRA Rule 2241(c)(4)(E).

[174] 15 U.S.C. 78o-6(b)(4) and proposed FINRA Rule 2241(c)(4)(B).

IPO of the common equity of an EGC that either (1) restricts, based on functional role, which associated persons of a broker, dealer, or member of a national securities association, may arrange for communications between an analyst and a potential investor;[175] or (2) restricts an analyst from participating in any communications with the management of an EGC that is also attended by any other associated person of a broker, dealer, or member of a national securities association whose functional role is other than as an analyst.[176] Section 105(d) further prohibits the Commission or any national securities association registered under section 15A of the Act from adopting or maintaining any rule or regulation that prohibits any broker, dealer, or member of a national securities association from publishing or distributing any research report or making a public appearance, with respect to the securities of an EGC, either within any prescribed period of time following the IPO date of the EGC, or within any prescribed period of time prior to the expiration date of any agreement between the broker, dealer, or member of a national securities association and the EGC or its shareholders that restricts or prohibits the sale of securities held by the EGC or its shareholders after the IPO date. The proposal is not inconsistent with these requirements.

One commenter noted that, because joint meetings are permitted by the JOBS Act, the provision in the proposal prohibiting joint due diligence conferences should be clarified.[177] As explained above in the description of the joint due diligence provision, FINRA clarified that it "would interpret the provision to apply only to the extent it is not contrary to the JOBS Act" and "[t]hus, for example, would not interpret the joint due diligence prohibition to apply where the

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175 15 U.S.C. 78o-6(c)(1).

176 15 U.S.C. 78o-6(c)(2).

177 JMP.

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."[178] We believe that, as a result, the joint due diligence provision in the proposal cannot be seen as contrary to section 15D(c)(2) of the Act.[179]

J. Summary of Findings and Conclusion

The Commission has carefully considered the proposed rule change, all of the comments received, and FINRA's responses to the comments. Based on its review of the record, the Commission finds that the proposed rule change, as amended by Amendment No. 1, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.[180] In particular, the Commission finds that the proposed rule change, as amended by Amendment No. 1, is consistent with section 15A(b)(6) of the Act, which requires,

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178 FINRA Response.

179 The staff notes that the proposal is consistent with FAQs issued by the staff concerning the analyst conflicts of interest provisions of the JOBS Act. Specifically, in FAQ 4, the staff provided three examples of purely ministerial statements that an analyst might provide at a pitch meeting for an ECG before the firm is formally retained to underwrite an offering and three examples of purely ministerial statements that an analyst might provide after the firm is formally retained to underwrite an offering, provided such statements are also in compliance with FINRA rules prohibiting promises of favorable research and solicitation. Thus, for instance, the FAQs suggest that an analyst may ask follow up questions in order to understand factual matters being presented provided such questions do not imply that the analyst is soliciting investment banking business or otherwise promising favorable research. The FAQs also suggest that firms should institute and enforce appropriate controls with regards to such pitch meetings to prevent violations of FINRA rules prohibiting solicitations or promises of favorable research, including analysts that may try to imbed such solicitations or promises in follow-up questions, during their introductions, or in outlining their research program and factors the analyst would consider in analyzing the company. Therefore, when taken in context with the entirety of the FAQ, the staff notes that the examples provided in the FAQs did not and were not intended to permit otherwise impermissible activities solely because they are conducted via the ministerial examples given in the FAQ.

180 In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

among other things, that FINRA's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.[181] Further, the Commission finds that the proposed rule change, as amended by Amendment No. 1, is consistent with Section 15D of the Act which requires, among other things, that the Commission, or upon the authorization and direction of the Commission, a registered securities association or national securities exchange, adopt rules reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances, in order to improve the objectivity of research and provide investors with more useful and reliable information.[182]

FINRA stated in their proposal that it "believes the proposed rule change protects investors and the public interest by maintaining, and in some cases expanding, structural safeguards to insulate research analysts from influences and pressures that could compromise the objectivity of research reports and public appearances on which investors rely to make investment decisions" and "that the proposed rule change prevents fraudulent and manipulative acts and practices by requiring firms to identify and manage, often with extensive disclosure, conflicts of interest related to the preparation, content and distribution of research."[183] FINRA also noted that "[a]t the same time, the proposal furthers the public interest by increasing information flow to investors in select circumstances – e.g., before and after the expiration of

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181 15 U.S.C. 78o-3(b)(6).

182 15 U.S.C. 78o-6.

183 Notice.

lock up provisions – where FINRA believes the integrity of research will not be compromised."[184]

The Commission generally agrees with these assertions. The Commission found NASD Rule 2711 (and NYSE Rule 472) to meet the standards of sections 15A(b)(6) and 15D of the Act when adopted and as they have been amended since their original adoption.[185] While the proposed rule change, as amended, is not an exact copy of these earlier provisions, it retains the vast majority of these rules as minimum standards required of members. The Commission believes that the vital elements of NASD Rule 2711 designed to address research analyst conflicts of interest – prohibitions on pre-publication review,[186] institutional separations between investment banking and research,[187] prohibitions on research analyst compensation based on investment banking results,[188] prohibitions on research analysts participating in investment banking efforts,[189] prohibitions on promises of favorable research coverage,[190] and important disclosures,[191] to name a few examples – are carried over to new FINRA Rule 2241.

Further, the proposed rule change includes new provisions that help ensure investor protection. For example, the proposed rule would require research management make

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184 Id.

185 See, e.g., Exchange Act Release No. 48252 (Jul. 29, 2003); 68 FR 45875 (Aug. 4, 2003).

186 NASD Rule 2711(b)(2) and proposed FINRA Rule 2241(b)(2)(A).

187 E.g., NASD Rule 2711 (b)(1) and proposed FINRA Rule 2241(b)(2)(C).

188 NASD Rule 2711(d) and proposed FINRA Rule 2241(b)(2)(E)-(F).

189 E.g., NASD Rule 2711(c)(5)-(6) and proposed FINRA Rule 2241(b)(2)(L)-(M).

190 NASD Rule 2711(e) and proposed FINRA Rule 2241(b)(2)(K).

191 NASD Rule 2711(h) and proposed FINRA Rule 2241(c) and (d).

independent decisions regarding research coverage,[192] information barriers or other institutional safeguards between research and investment banking, sales and trading, and other persons who might be biased in their judgment or supervision including, for certain members, requiring physical separation,[193] and ensure that purported facts in research reports are based on reliable information.[194] Also, where provisions have been altered, FINRA has generally kept the important element of the provision but required members to establish reasonable policies and procedures tailored to a member's business. For example, NASD Rule 2711(g)(2) prohibits "research analyst accounts" from purchasing or selling securities issued by a company that the analyst covers for a period beginning thirty calendar days before and ending five calendar days after the publication of a research report, subject to certain exceptions. Under proposed FINRA Rule 2241(b)(2)(J), the same general principal applies (analysts and accounts they control should not trade in a security in such a way that the analyst benefits from knowledge of the content or timing of a research report ahead of its intended audience) without setting strict numerical timelines that may or may not be appropriate in every circumstance. Members may set periods that are longer or shorter than the current thirty/five day paradigm, but could be subject to liability if they are not reasonably designed to prevent the unwanted conduct.

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192 Proposed FINRA Rule 2241(b)(2)(B).

193 Proposed FINRA Rule 2241(b)(2)(G) and Notice ("Among the structural safeguards, FINRA believes separation between investment banking and research is of particular importance. As such, while the proposed rule change does not mandate physical separation between the research and investment banking departments (or other person who might seek to influence research analysts), FINRA would expect such physical separation except in extraordinary circumstances where the costs are unreasonable due to a firm's size and resource limitations. In those instances, a firm must implement written policies and procedures, including information barriers, to effectively achieve and monitor separation between research and investment banking personnel.")

194 Proposed FINRA Rule 2241(c)(1)(A).

Regarding concerns raised by commenters regarding the principles-based structure of the proposal, we note the proposed rule change retains the key provisions of NASD Rule 2711 and includes a number of new protections for investors including the requirement that research management make independent decisions regarding research coverage,[195] maintenance of information barriers or other institutional safeguards between research and investment banking, sales and trading, and other persons who might be biased in their judgment or supervision including, for certain members, requiring physical separation,[196] and ensure that purported facts in research reports are based on reliable information.[197] Further, FINRA's responses to interpretive questions posed by the commenters to the original proposal in the Amendment Notice seem to have helped reduce uncertainty or confusion regarding how the proposal will operate in light of the principles-based structure. For example, one commenter noted with approval the clarification regarding the "at a minimum" requirement, which seemed to be the source of the commenter's confusion.[198] FINRA also provided guidance in response to comments on other issues in the FINRA Response. For example, FINRA responded to an

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195 Proposed FINRA Rule 2241(b)(2)(B).

196 Proposed FINRA Rule 2241(b)(2)(G) and Notice ("Among the structural safeguards, FINRA believes separation between investment banking and research is of particular importance. As such, while the proposed rule change does not mandate physical separation between the research and investment banking departments (or other person who might seek to influence research analysts), FINRA would expect such physical separation except in extraordinary circumstances where the costs are unreasonable due to a firm's size and resource limitations. In those instances, a firm must implement written policies and procedures, including information barriers, to effectively achieve and monitor separation between research and investment banking personnel.")

197 Proposed FINRA Rule 2241(c)(1)(A).

198 WilmerHale Equity Two.

assertion by a commenter,[199] agreeing that, consistent with the current rule and subject to controls regarding evaluation based on improper or inappropriate reviews, sales and trading personnel can provide feedback for purposes of evaluating an analyst. With regards to the context provided by FINRA, we particularly support the clarification that physical separation is expected except in extraordinary situations where the costs are unreasonable due to a firm's size or resources and that, even then, that the firm must establish written policies and procedures, including information barriers, to effectively achieve and monitor separation between research and investment banking personnel.[200]

In approving this proposal, however, we expect that FINRA will continue to monitor the effectiveness of the rule proposal and modify the rule, or issue further guidance as promised, should it prove to be unworkable or fail to provide the same level of protection to investors as provided NASD Rule 2711.[201]

For the reasons stated above, the Commission finds that the proposed rule change is consistent with the Act and the rules and regulations thereunder.

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199 Id.

200 Notice.

201 We note that, as one commenter suggested, the interpretation of what constitutes "reasonableness" may prove difficult for FINRA and member alike. See JMP.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to section 19(b)(2) of the Act,[202] that the proposed rule change (SR-FINRA-2014-047), as modified by Amendment No. 1 thereto, be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[203]

Brent J. Fields,
Secretary.

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202 15 U.S.C. 78s(b)(2).

203 17 CFR 200.30-3(a)(12).