FREQUENTLY ASKED QUESTIONS ABOUT SEPARATION OF RESEARCH AND INVESTMENT BANKING

Background

What rules apply to the research department and its relationship with the investment banking department?

The rules and regulations that apply to the relationship between the research and investment banking departments of a firm include:

- FINRA Rule 2241 (covering equity securities);[1]
- FINRA Rule 2242 (covering debt securities);
- SEC Regulation AC (Analyst Certification); and
- SEC Rules 137, 138 and 139 under the Securities Act of 1933, as amended (the "Securities Act").

What is the Global Research Analyst Settlement?

The Global Research Analyst Settlement (the "Global Settlement") is an enforcement agreement first announced in December 2002, and finalized on April 28, 2003, among the SEC, NASD, the NYSE, the New York State Attorney General and 10 of the then-largest investment banking firms in the United States (the "Settling Firms").[2] On October 31, 2003, William H. Pauley III, United States District Judge for the Southern District of New York (the "Court"), approved the $1.4 billion Global Settlement.[3] The Global Settlement addressed issues related to conflicts of interest between the research and investment banking departments of these firms that became apparent during the "dot com" boom and then bust of the late 1990s and early 2000s.

As part of the Global Settlement, the Settling Firms agreed to several rules designed to prevent abuse stemming from pressure by investment bankers on research analysts to provide favorable coverage of specific issuers or securities. The Settling Firms were required to separate their investment banking and

[1] As used herein, "FINRA" means the Financial Industry Regulatory Authority, "NASD" means the National Association of Securities Dealers, Inc., "NYSE" means the New York Stock Exchange, and "SEC" means the Securities and Exchange Commission. In July 2007, FINRA consolidated the NASD and the member regulation, enforcement, and arbitration functions of the NYSE.

[2] The 10 firms were: Bear, Stearns & Co. Inc.; Citigroup Global Markets Inc. (f/k/a Salomon Smith Barney, Inc.); Credit Suisse First Boston LLC; Goldman, Sachs & Co.; J.P. Morgan Securities Inc.; Lehman Brothers Inc.; Merrill Lynch, Pierce, Fenner & Smith Incorporated; Morgan Stanley & Co. Incorporated; UBS Warburg LLC; and U.S. Bancorp Piper Jaffray Inc.

[3] *See* "Federal Court Approves Settlement of SEC Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking," SEC Press Release 2003-144 (Oct. 31, 2003), available at: https://www.sec.gov/news/press/2003-144.htm.

research departments from each other both physically and with information "firewalls." Additionally, the budget allocation for the research department was to be independent of the investment banking department. Research analysts were also prohibited from attending pitches and road shows with investment bankers during the advertising and promotion of initial public offerings ("IPOs"). Finally, research analysts' previously issued ratings about issuers had to be disclosed and made available.

In addition to these regulatory actions, each Settling Firm was enjoined from violating the statutes and rules that it was alleged to have violated. The Settling Firms were also required to pay fines to their investors, fund investor education and pay for independent third-party market research. The total fine paid by the Settling Firms was approximately $1.435 billion, of which $387.5 million was restitution to harmed investors. The Global Settlement was amended in March 2010 (*see* "2010 Amendments to the Global Settlement" below).[4]

What events led to the Global Settlement?

During the "dot com" boom and then bust of the late 1990s and early 2000s, research analysts published reports recommending investments in the securities of many companies with which their firms had an advisory or investment banking relationship. In 1999, the SEC began a review of industry practices regarding the disclosure of research analysts' conflicts of interest.

Committees of the U.S. House of Representatives and the Senate also held hearings on research analysts' conflicts of interests. In April 2002, the SEC announced a formal inquiry into industry practices concerning research analysts, their conflicts of interest and their relationships with the investment banking departments within their firms. Civil complaints were filed by the SEC and other federal and state regulatory and law enforcement authorities against these firms. Some of the violations that led to the Global Settlement include:

- issuing fraudulent research reports in violation of Section 15(c) of the Securities Exchange Act of 1934, as amended (the "Exchange Act");
- issuing research reports that violated the principles of fair dealing and good faith and related obligations in applicable NASD and NYSE rules;
- allegedly receiving payments for investment research without properly disclosing such payments, in violation of Section 17(b) of the Securities Act; and
- failing to maintain appropriate supervision over their research and investment banking departments in violation of FINRA Rule 3010.

Do firms not included in the Global Settlement need to comply with its requirements?

Technically, the Global Settlement applied only to the 10 Settling Firms and their successors. However, many institutional investors have required non-settling firms to agree to follow its provisions. In addition, many of the Global Settlement provisions are now embodied in the SRO Rules (*see* "*What are the SRO Rules*?" below).

[4] The Global Settlement has not been amended to reflect the new rules concerning emerging growth companies ("EGCs") under the Jumpstart Our Business Startups Act (the "JOBS Act"). *See* the SEC's "Jumpstart Our Business Startups Act Frequently Asked Questions About Research Analysts and Underwriters," at Question 2 (Aug. 22, 2012) (the "SEC FAQs"), available at: http://www.sec.gov/divisions/marketreg/tmjobsact-researchanalystsfaq.htm.

Is the Global Settlement still in effect?

Yes. *See* "2010 Amendments to the Global Settlement" below.

What kinds of research reports are subject to the Global Settlement and FINRA rules?

For purposes of the Global Settlement, the term "research report" includes any written communication (including an electronic communication) that is furnished by the firm to investors in the United States and that includes an analysis of the common stock, any security convertible into common stock, or any derivative thereof, including American Depositary Receipts, of an issuer or issuers and provides information reasonably sufficient upon which to base an investment decision.

FINRA Rules 2241 and 2242 define a "research report" as any written communication (including an electronic communication) that includes an analysis of a security or an issuer and provides information reasonably sufficient to form the basis for an investor's investment decision.

The Global Settlement and FINRA Rules 2241 and 2242 expressly exclude certain reports from the definition of "research report" (i.e., those reports that do not include a specific analyst's recommendation or rating of individual securities or issuers), including:

- reports discussing broad-based indices;
- reports commenting on economic, political or market conditions;
- technical or quantitative analysis concerning the demand and supply for a sector or industry index or based on trading volume and price;
- reports that recommend increasing or decreasing holdings in particular industries, sectors or types of securities;
- notices of certain ratings or price target changes; and
- statistical summaries of multiple companies' financial data and broad-based summaries or listings of recommendations or ratings contained in previously issued research reports, provided that such summaries do not include any analysis of individual companies.

Other types of reports, even if they do include a specific recommendation or rating of individual securities or issuers, are also excluded from the definition of a research report, including:

- periodic reports or other communications prepared for investment company shareholders or discretionary investment account clients, which discuss individual securities in the context of a fund's account or past performance;
- communications that constitute statutory prospectuses that are filed as part of a registration statement; and
- communications that constitute private placement memoranda and comparable offering-related documents prepared in connection with investment bank transactions (other than those purported to be research).

FINRA Rule 2241 further excludes from the definition of "research report" any communication distributed to fewer than 15 persons, while FINRA Rule 2242 provides exclusions from the definition of "research report" for:

- an analysis prepared for a specific person or a limited group of fewer than 15 persons; and
- commentaries on or analyses of particular types of debt securities or characteristics.

Source: FINRA Rule 2241(a)(11); FINRA Rule 2242(a)(3); Global Settlement Addendum A, available at: http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf

SRO Rules

What are the SRO Rules?

The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") required the SEC to address conflicts of interest involving research analysts and investment banking personnel. In response to Sarbanes-Oxley, the NASD and the NYSE established rules and safeguards to separate research analysts from the review, pressure and oversight of investment banking personnel. These rules were intended to ensure the integrity of research and to protect investors from being misled as a result of a failure to disclose potential conflicts of interest.

On July 29, 2003, the SEC announced the approval of a series of changes to the rules affecting research analysts, generally embodied in FINRA Rule 2711 and NYSE Rule 472, and commonly referred to as the "SRO Rules" (SRO refers to "self-regulatory organization"). It is worth noting that the SRO Rules had already generally incorporated the terms of the updated Global Settlement approved in March 2010.

The SRO Rules have since been amended multiple times. On October 11, 2012, the SRO Rules were amended to conform the SRO Rules to provisions of the JOBS Act. In November 2014, and further amended in February 2015, FINRA announced additional comprehensive revisions to its research rule, including the finalization of new FINRA Rule 2241 (for equity research) to replace FINRA Rule 2711 and new FINRA Rule 2242 (for debt research). *See* "*How does FINRA Rule 2241 affect the relationship between equity research personnel and investment banking personnel?*" and "*How does FINRA Rule 2242 affect the relationship between debt research personnel and investment banking, sales and trading, and principal trading personnel?*" below. Appendix A to these Frequently Asked Questions contains a comparison chart, which illustrates the specific overlapping provisions of FINRA Rules 2241 and 2242.

How is compliance with the SRO Rules monitored by a firm?

FINRA Rules 2241 and 2242, unlike FINRA Rule 2711, no longer contain an express requirement that a senior officer of the firm attest annually that the firm has adopted and implemented procedures reasonably designed to achieve compliance with FINRA's research rules. However, such underlying supervisory obligations are still imposed pursuant to FINRA Rule 3110, which requires, among other things, that each firm establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, as well as applicable FINRA rules.

Moreover, a firm must maintain and enforce policies and procedures reasonably designed to ensure that any third-party research report it distributes: (i) is clearly labeled to ensure there is no confusion on the part of the recipient as to the person or entity that prepared the

report; (ii) does not contain any untrue statement of material fact; (iii) is not otherwise false or misleading; and (iv) is reliable and objective.

Source: FINRA Rule 2241.07; FINRA Rule 2242.07; and FINRA Rule 3110

How does FINRA Rule 2241 affect the relationship between equity research personnel and investment banking personnel?

In November 2014, FINRA proposed to adopt NASD Rule 2711 as new FINRA Rule 2241, with several modifications in February 2015, to address conflicts of interest relating to equity research analysts and research reports. FINRA Rule 2241 not only addresses equity research, but also incorporates NYSE Rule 472. A finalized version of FINRA Rule 2241 was approved by the SEC in July 2015, and became effective on December 24, 2015.[5]

The changes provided in FINRA Rule 2241 reflect a more flexible principles-based approach and incorporate many of the FINRA interpretations that have developed over the last decade. FINRA Rule 2241 also seeks to establish a level playing field between investment banks subject to the Global Settlement and those that are not, as well as for issuers that are EGCs.

The main part of FINRA Rule 2241 is section (b), "Identifying and Managing Conflicts of Interest." The section fundamentally reorganizes NASD Rule 2711 and sets forth the principles underlying the new rule. FINRA Rule 2241(b)(1) requires each firm to establish, maintain and enforce written policies and procedures reasonably designed to identify and effectively manage conflicts of interest (*see* "*How must the research and investment banking departments be structured to maintain separation?*" below).

FINRA Rule 2241(c) sets forth the general principle that a firm should adopt written policies and procedures relating to the content of, location of disclosures within, and procedures for research reports. There are a few changes from existing requirements, although some are recast as policies and procedures rather than requirements.

How does FINRA Rule 2242 affect the relationship between debt research personnel and investment banking, sales and trading, and principal trading personnel?

In November 2014, FINRA proposed to adopt new FINRA Rule 2242, as amended in February 2015, which is designed to address conflicts of interest relating to the publication and distribution of debt research reports.[6] A finalized version of FINRA Rule 2242 was approved by the SEC in July 2015, and became effective on July 16, 2016.

Like FINRA Rule 2241, FINRA Rule 2242 differs from NASD Rule 2711 in three key respects:

- it delineates the prohibited and permissible communications between debt research analysts and principal trading and sales and trading personnel;
- it exempts debt research provided solely to institutional investors from many of the structural protections and prescriptive disclosure requirements that apply to research reports distributed to retail investors (a "retail

[5] *See* FINRA Regulatory Notice 15-30 (Aug. 2015), available at: http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-15-30.pdf.

[6] *See* Proposed Rule Change to Adopt FINRA Rule 2242 (Debt Research Analysts and Debt Research Reports), SR-FINRA-2014-048, available at: http://www.finra.org/Industry/Regulation/RuleFilings/2014/P601677.

investor" means any person other than an institutional investor);[7] and

- in addition to the exemption for limited investment banking activity found in the prior equity research rules (as well as FINRA Rule 2241), FINRA Rule 2242 adds an exemption for members that engage in limited investment banking activity or those with limited principal trading activity and revenues generated from debt trading.

Separation of Research and Investment Banking Departments

What is the purpose of the separation of a firm's research and investment banking departments?

The separation of the research and investment banking departments under the Global Settlement and FINRA rules is intended to provide investors with confidence as to the integrity of the research and knowledge of the potential conflicts of interest that could affect the research analyst's opinion.

How must the research and investment banking departments be structured to maintain separation?

FINRA Rules 2241 and 2242 each require that a firm's policies and procedures establish information barriers or other institutional safeguards that ensure that the research department is insulated from the review, pressure or oversight by persons engaged in investment banking services, sales and trading (or, in the case of debt research, principal trading, or sales and trading activities) and other persons who may be biased in their judgment or supervision.

To that effect, firms must establish, maintain and enforce written policies and procedures that are reasonably designed to identify and effectively manage any conflicts of interest related to research reports. Specifically, a firm's policies must address the preparation, content and distribution of research reports, public appearances by research personnel, and the interaction between research personnel and those outside of the firm's research department.

Written policies must also be reasonably designed to:

- promote objective and reliable research that provides only the truly held opinions of research personnel;
- affirmatively seek to diminish the manipulation of research personnel (or their research reports) in an attempt to favor the interests of the firm or a current or prospective customer or class of customers;
- provide for separate reporting lines for both research and investment banking personnel;
- provide for a dedicated legal and compliance staff for the research department;
- prohibit investment banking personnel from threatening to retaliate against research personnel for an unfavorable report;[8]
- prohibit investment banking personnel, and other firm employees engaged in investment banking services activities, from directing research personnel to engage in sales or marketing efforts related to any investment banking transactions;

[7] *See* FINRA Rule 2242(a)(13).

[8] While FINRA Rule 2242 maintains an analogous anti-retaliation provision, it created a broader prohibition by applying it to any employee of the firm and not just those engaged specifically in investment banking services activities. *See* FINRA Rule 2242(b)(2)(I).

- prohibit three-way meetings with research personnel, investors and investment banking personnel (with the exception of certain meetings with EGCs, described under "*How does the JOBS Act affect the SRO Rules?*" below); and
- ensure the independent review of the research department.

The head of the research department may report to or through a person or persons to whom the head of investment banking also reports, provided that such person(s) have no direct responsibility for investment banking activities or decisions.

Source: Global Settlement, Section (I)(1), available at: http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf; FINRA Rule 2241(b)(2); Rule 2242(b)(2)

How must research and investment banking departments be separated? Is a physical separation required?

In addition to the restrictions upon the interactions between the research and investment banking departments described above, the Global Settlement required a physical separation between a firm's research and investment banking departments. This physical separation must be reasonably designed to ensure that there will not be any intentional or unintentional flow of information between a firm's research and investment banking departments. While there are no specific guidelines for the physical separations required, separate floors, doors, and restricted access for the respective departments are generally believed to comply with the physical separation required between the two departments.

Likewise, FINRA Rules 2241 and 2242 do not expressly require physical separation between research analysts and investment banking personnel. However, FINRA has stated that it expects physical separation except in "extraordinary circumstances where costs are unreasonable due to a firm's size and resources."[9]

Source: Global Settlement, Section (I)(4), available at: http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf

Who are considered investment banking personnel for purposes of the Global Settlement and FINRA rules?

"Investment banking" is defined under the Global Settlement as all firm personnel engaged principally in investment banking activities, including the solicitation of issuers and structuring of public offering and other investment banking transactions. It also includes all firm personnel who are directly or indirectly supervised by such persons and all personnel who directly or indirectly supervise such persons, including the management of the investment banking department.

Source: Global Settlement Addendum A, Section I, available at: http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf

The FINRA rules define "investment banking department" similarly as any department or division, whether or not identified as such, that performs any investment banking service on behalf of a firm. "Investment banking services" include: (i) acting as an underwriter; (ii) participating in a selling group in an offering for the issuer or otherwise acting in furtherance

[9] *See* Order Approving a Proposed Rule Change, as Modified by Amendment No. 1 Thereto, to Adopt FINRA Rule 2241 in the Consolidated FINRA Rulebook, SEC Release No. 34-75741, at 56 n.193 (July 16, 2015).

of a public offering of the issuer; (iii) acting as a financial adviser in a merger or acquisition; (iv) providing venture capital or equity lines of credit; (v) serving as placement agent for the issuer; or (vi) otherwise acting in furtherance of a private offering of the issuer.

Source: FINRA Rules 2241(a)(4)-(5); FINRA Rules 2242(a)(8)-(9)

Who are considered research personnel for purposes of the Global Settlement and FINRA rules?

Under the Global Settlement, research personnel include all firm personnel engaged principally in the preparation and/or publication of research reports. It also includes all firm personnel who are directly or indirectly supervised by such persons and all personnel who directly or indirectly supervise such persons, including the management of the research department.

Source: Global Settlement Addendum A, available at: http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf

The FINRA rules define "research analyst" as an associated person who is primarily responsible for, and any associated person who reports directly or indirectly to a research analyst in connection with, the preparation of the substance of a research report, whether or not any such person maintains the job title of research analyst.

Source: FINRA Rule 2241(a)(8); FINRA Rule 2242(a)(1)

How does the required separation between the research and investment banking departments affect the budgets for each department?

The budgets for each department must be determined by the senior management of the firm. Under FINRA Rules 2241 and 2242, senior management engaged in investment banking services, or investment banking activities or principal trading activities, respectively, are expressly prohibited from providing any input on such determinations.

However, FINRA Rule 2242 further specifies that revenues and results of the firm as a whole may be considered in determining the debt research department's budget and expense allocation.

There must also be an annual review of the research department budgeting and expense allocation by an audit committee (or comparable independent group that does not have any management responsibilities) to ensure compliance with these requirements.

Source: FINRA Rule 2241(b)(2); FINRA Rule 2242(b)(2); Global Settlement Addendum A, Section I, available at: http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf

How may the compensation of research personnel be determined or structured?

In accordance with FINRA Rules 2241 and 2242, firms must implement written policies and procedures that at a minimum prohibit investment banking personnel (or, in the case of debt research, personnel engaged in investment banking services transactions, principal trading activities, or sales and trading), from supervising or controlling research analysts, including exerting any influence or control over research analyst compensation and determinations.

Such policies and procedures must prohibit compensation of research analysts based upon specific contributions to investment banking activities (or, for debt research, principal trading activities), as well as require that compensation of research analysts

primarily responsible for the preparation of the substance of a research report be reviewed and approved on an annual basis by a compensation committee (*see "What functions must the compensation committee perform?"* below).

While persons engaged in principal trading activities may not provide input on a debt research analyst's compensation, sales and trading personnel may provide their input to debt research management on the evaluation of the debt research analyst in order to convey customer feedback. Nevertheless, all final compensation determinations must be made by research management and the compensation committee.

Source: FINRA Rule 2241(b)(2); FINRA Rule 2242(b)(2)

Who may participate on the compensation committee?

The compensation committee must report to the firm's board of directors, as applicable, and may not consist of any of the firm's investment banking personnel (or, in the case of debt research, any persons engaged in principal trading activities).

Source: FINRA Rule 2241(b)(2); FINRA Rule 2242(b)(2)

What functions must the compensation committee perform?

Under FINRA Rule 2241, the compensation committee is required to consider several factors when setting the appropriate compensation for equity analysts, including:

- individual performance (e.g., productivity and quality of research);
- the correlation between the analyst's recommendations and actual performance of the recommended securities; and
- the overall ratings received from clients, sales forces and peers independent of the firm's investment banking department.

Similarly, FINRA Rule 2242 requires that the compensation committee consider with regard to compensation of debt research analysts:

- individual performance (e.g., productivity and quality of debt research); and
- the overall ratings received from customers and peers.

Lastly, the compensation committee of the firm's holding/parent company (or comparable independent group that does not have any management responsibilities) must conduct an annual review of the compensation process for research personnel. This review is designed to ensure that compensation decisions are made in a manner consistent with the appropriate requirements.

Source: FINRA Rule 2241(b)(2); FINRA Rule 2242(b)(2); Global Settlement Addendum A, available at: http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf

How may the job performance of research personnel be evaluated?

Under FINRA Rule 2241, a firm's written policies and procedures must be reasonably designed to promote objective and reliable research, including prohibiting investment banking personnel from influencing or exerting control over research analyst compensation evaluations and determinations. Evaluations of research personnel must be conducted only by other research personnel (as part of a compensation committee) and cannot be conducted by, nor can there

be any input from, investment banking personnel. The firm, in assessing the quality and accuracy of a research analyst's work, may rely on evaluations by the firm's investing customers, sales personnel, rankings in independent surveys and the actual performance of a company or its equity securities in comparison to the analyst's ratings, price targets and forecasts.

Like FINRA Rule 2241, FINRA Rule 2242 requires that all final compensation determinations for debt research personnel be made by research management and a compensation committee. Persons engaged in principal trading activities may not provide input on debt research personnel compensation; however, sales and trading personnel may provide their input to debt research management on the evaluation of debt research personnel in order to convey customer feedback.

Source: FINRA Rule 2241(b)(1); FINRA Rule 2242(b)(2)

How does FINRA Rule 2241 shorten quiet periods surrounding equity offerings?

FINRA Rule 2241 has further shortened the various quiet periods surrounding equity offerings. Specifically, a firm must implement policies and procedures that stipulate the following quiet periods: (i) a minimum of 10 days in the case of an IPO and (ii) a minimum of three days in the case of a secondary offering. FINRA interprets the date of the offering to be the later of either (x) the effective date of the registration statement or (y) the first date on which the securities were bona fide offered to the public.

FINRA Rule 2241 also expressly excludes from the quiet period: (i) the publication or distribution of a research report or public appearance following an IPO or secondary offering by an EGC, as defined under Section 3(a)(80) of the Securities Act; (ii) the publication or distribution of a research report, or making of a public appearance, concerning the effects of a significant news or event on an issuer provided that the firm's legal or compliance personnel provided prior authorization before such publication was distributed or public appearance made; and (iii) the distribution of research reports or making of a public appearance pursuant to Rule 139 under the Securities Act.

FINRA Rule 2241 also eliminates the quiet periods of 15 days before and after the expiration, waiver or termination of a lock-up agreement that had previously applied.

Source: FINRA Rule 2241(b)(2)(I)

Exceptions, Exclusions and Safe Harbors to Separation Requirement

When may research and investment banking personnel communicate and work jointly?

There are express exceptions to the ban on general communications between research and investment banking personnel in the Global Settlement:

- investment banking personnel may seek the views of research personnel on the merits of proposed investment banking transactions;
- research personnel may give their views on the views of a specific transaction in the presence of investment banking personnel;

- research personnel may give their views on the structuring and pricing of a transaction to the firm's equity capital markets group;[10]
- research personnel may participate in efforts to educate the firm's sales personnel regarding a transaction;
- research personnel may communicate with investment banking personnel regarding legal or compliance matters; and
- research personnel may attend a widely attended conference or meeting given by investment banking personnel.

Proposed Transactions. Investment banking personnel may seek, through research management or in the presence of internal compliance or legal staff, the views of research personnel on the merits of a proposed transaction, a potential candidate for a transaction, or market trends, conditions or developments. Research personnel may respond to these inquiries through their management or in the presence of compliance or legal staff. Once investment banking personnel has initiated the process, research personnel may contact them to inform them of a change in their views regarding the transaction discussed without prompting from investment banking personnel. However, these conversations may not be initiated by investment banking personnel, directly or indirectly, for the purpose of having the research analyst identify a specific company or transaction. Research personnel also may initiate discussions with investment banking personnel relating to market trends, conditions or developments, provided that the conversations are consistent in nature with the types of communications that an analyst might have with investing customers.

Specific Transactions. Research personnel may communicate their views about a specific transaction, or candidate for a transaction, in the presence of a committee that is reviewing the specific transaction. Investment banking personnel are allowed to be present during such discussions; however, research personnel must have the opportunity to speak to the committee outside the presence of investment banking personnel. Research personnel are also permitted to assist the firm in confirming the adequacy of disclosure in the offering or other disclosure documents based on the analyst's communications with the company or other vetting previously conducted without the presence of investment banking personnel.

Equity Capital Markets. Research personnel also may participate in certain communications with equity capital markets personnel after the firm receives an investment banking mandate or in connection with a block bid or similar transaction. Research personnel are entitled to communicate their views on the structuring and pricing of a transaction to the firm's equity capital markets group and can provide information obtained from investing customers relevant to the pricing and structuring of a transaction.

Sales Force Education. Research personnel also may participate, either with the equity capital markets group or independently, in efforts to educate the firm's sales personnel regarding the transaction, such as preparing internal-use memoranda and communicating with the sales force. These communications may not occur with

[10] The equity capital markets group usually functions as an intermediary between companies and financial institutions and raises equity capital for the companies. The equity capital markets group also typically handles the overall marketing, distribution and allocations of new equity securities and derivative instruments.

investment banking personnel and the following conditions must be satisfied:

- oral communication in which research personnel express a view or recommendation must have a reasonable basis;
- oral communication made to 10 or more of the firm's sales force must satisfy a "fair and balanced" standard, as that phrase is generally understood under FINRA rules;[11]
- all internal-use memoranda that express the views of research personnel must also comply with the fair and balanced standard;
- internal-use memoranda that are distributed to 10 or more of the sales force must first be reviewed by internal legal or compliance personnel;
- a written log of oral communications to a group of 10 or more of the sales force must be maintained; and
- internal-use memoranda that are distributed to 10 or more of the sales force and the written log of oral communications to a group of 10 or more of the sales force must be maintained for at least three years.

After a firm receives an investment banking mandate relating to a public offering, research personnel may communicate with investors regarding the offering, provided that these communications may not occur jointly with the issuer's management or members of the investment banking department.

Legal or Compliance Matters. Research and investment banking personnel also may communicate with each other, in the presence (live or email) of the legal or compliance department, regarding legal or compliance matters. Research and investment banking personnel may have an unchaperoned call or meeting solely for the purpose of scheduling a later chaperoned call.

Conferences and Meetings. Research personnel may attend or participate in a widely attended conference attended by investment banking personnel or in which investment banking personnel participate (but may not participate in otherwise prohibited activities). Research and investment banking personnel may attend or participate in widely attended firm or regional meetings at which matters of general firm interest are discussed. Research and investment banking management may attend meetings or sit on firm management, risk or similar committees at which general business and plans (including those of the investment banking and research departments) and other matters of general firm interest are discussed. Communications between research personnel and investment banking personnel that do not relate to any research or investment banking issues are not restricted.[12]

Source: Global Settlement Addendum A, Section (I)(10), available at:

http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf

In addition, both FINRA Rules 2241 and 2242 provide several exemptions from their stated requirements, including exemptions for: (i) limited investment

[11] *See* FINRA Rule 2210(d)(1).

[12] As discussed above, Title I of the JOBS Act permits research and investment banking personnel to communicate and work together in connection with offerings by EGCs. For all broker-dealers who are not signatories to the Global Settlement, the provisions of the JOBS Act became effective immediately upon it being signed into law. However, as the Global Settlement is a judicial order and not an SEC or SRO Rule, it is technically unaffected by the JOBS Act and would require another amendment in order for the provisions of the JOBS Act to apply to the Settling Firms.

banking activity; (ii) good cause; (iii) limited principal trading activity (FINRA Rule 2242 only); and (iv) debt research reports provided to institutional investors (FINRA Rule 2242 only).

Exemption for Limited Investment Banking Activity. Both FINRA Rules 2241 and 2242 provide an exemption from their respective requirements for firms that: (i) have participated in one or fewer investment banking services transactions over the past three years as manager or co-manager and (ii) have generated no greater than $5 million in gross investment banking revenues from those transactions. This exemption is only available for firms that establish information barriers or other institutional safeguards to ensure that their analysts are insulated from pressure 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.

Source: FINRA Rule 2241(i); FINRA Rule 2242(h)

Exemption for Good Cause. Both FINRA Rules 2241 and 2242 provide an exemption for "good cause." FINRA may, in certain limited and exceptional circumstances, grant a conditional or unconditional exemption from any requirement under either FINRA Rules 2241 or 2242 for good cause shown after taking into account the following factors: (i) the extent to which such an exemption is consistent with the purposes of FINRA Rules 2241 or 2242, as applicable; (ii) the protection of investors; and (iii) the public interest.

Source: FINRA Rule 2241(j); FINRA Rule 2242(k)

Exemption for Limited Principal Trading Activity. FINRA Rule 2242 contains an exemption for firms that engage in limited principal trading activity. To qualify for the exemption, the firm must:

- have trading gains or losses on principal trades in debt securities (in absolute value on an annual basis) that do not exceed $15 million or over the previous three years, on average per year;
- employ fewer than 10 debt traders; and
- maintain records sufficient to establish eligibility for the exemption and also maintain (for at least three years) any communication that, but for this exemption, would be subject to the provisions of FINRA Rule 2242.

Source: FINRA Rule 2242(i)

Solicitation of Business

Can research personnel help solicit business for the investment banking department under the Global Settlement?

Research personnel may not participate in efforts to solicit business for the investment banking department, including, among other things, participating in any "pitches" or otherwise communicating with a company or prospective client for the purpose of soliciting investment banking business. Further, SEC interpretive guidance states that it would be inconsistent with Section I.9 of Addendum A to the Global Settlement to allow investment banking personnel to include any information regarding any research analyst employed by the firm in a "pitch book" or any other presentation materials used to solicit investment banking business.[13]

[13] *See* Letter to Dana G. Fleischman from James A. Brigagliano, SEC Division of Market Regulation (Nov. 2, 2004), at Question 10, available at: http://www.sec.gov/divisions/marketreg/mr-noaction/grs110204.htm.

Source: Global Settlement Addendum A, available at: http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf

Can research personnel help solicit business for the investment banking department under FINRA Rules 2241 and 2242?

Under FINRA Rules 2241 and 2242, a firm must restrict the activities of research personnel that can reasonably be expected to compromise the objectivity of research personnel. Equity and debt research personnel also are prohibited from participating in pitches and other solicitation of investment banking services transactions.[14] Moreover, equity and debt research personnel are prohibited from participating in road shows and other marketing on behalf of an issuer related to investment banking services. The supplementary materials to FINRA Rules 2241 and 2242 further stipulate that pitch materials cannot include any information about the firm's research capacity in a manner that suggests the firm would provide, either directly or indirectly, favorable research.

However, SEC interpretive guidance provides that research personnel may listen (in listen-only mode) or view a live webcast of these road shows.[15] Research personnel also may access other widely attended presentations to investors from a remote location, but if the presentation is in the firm's building, they must be in a separate room.

Are there any communications between a research analyst and an issuer permitted in connection with an offering?

Yes. Certain communications between a research analyst and an issuer *are* permitted in connection with an offering. At an issuer's request, investment banking personnel may arrange for a department of the firm other than the research department to provide the issuer access to previously published reports regarding that issuer that would be available from other sources. Should an issuer request investment banking personnel to arrange a meeting between the issuer and a research analyst, the investment bankers must instruct the issuer to contact the research department directly and may not notify the research department in advance.

A research analyst is permitted to attend a meeting with an issuer and answer questions regarding the analyst's views on the company but may not use it as an opportunity to solicit investment banking business, and investment banking personnel may not be present or participate in any of these meetings.

Source: FINRA Rule 2241(b)(2); FINRA Rule 2242(b)(2)

How has FINRA policed research analysts involved in the solicitation of business for the investment banking department?

In December 2014, FINRA fined 10 firms a total of $43.5 million for allowing their equity research analysts to solicit investment banking business and for offering favorable research coverage in connection with the 2010 planned IPO of Toys "R"Us. As detailed in the settlement documents, each of the firms implicitly or explicitly, at the initial pitch meetings or in follow-up

[14] However, under the JOBS Act, research personnel can participate in meetings with representatives of an EGC in connection with that company's IPO, even if investment banking personnel are present. *See* "*How does the JOBS Act affect the SRO Rules?*" below.

[15] *See* SEC FAQs, *supra* note 4 at Question 6.

communications, offered favorable research coverage in return for a role in the IPO.[16]

Shortly after reaching a settlement with the 10 firms involved in the Toys"R"Us IPO, FINRA published in May 2015 a set of Frequently Asked Questions regarding NASD Rule 2711 in an attempt to clarify what constitutes prohibited conflicts of interest between research analysts and investment banking personnel (the "FINRA Research FAQs"). The FINRA Research FAQs, which were recently updated in March 2016, contain frequently asked questions related to requirements under FINRA's research rules, including, but not limited to: (i) registration requirements; (ii) disclosure requirements; (iii) separation requirements; (iv) exemptions for institutional debt research; (v) solicitation and marketing; and (vi) communications or conduct by issuers.[17] FINRA Rules 2241 and 2242 incorporate the guidance provided under the FINRA Research FAQs issued in May 2015.

FINRA has also indicated in its Regulatory and Examination Priorities Letter for 2016 that it will continue to focus on whether a firm's research analysts are inappropriately involved in the firm's investment banking activities and whether investment banking personnel are exercising undue influence over analysts.[18]

[16] *See* Release dated December 11, 2014, available at: http://www.finra.org/Newsroom/NewsReleases/2014/P602059, which links to each firm's Letter of Acceptance, Waiver and Consent.

[17] *See* FINRA Research Rules Frequently Asked Questions (FAQs), available at: http://www.finra.org/industry/faq-research-rules-frequently-asked-questions-faq (accessed Aug. 2016).

[18] *See* FINRA Regulatory and Examination Priorities Letter for 2016 (Jan. 5, 2016), available at: http://www.finra.org/industry/2016-regulatory-and-examination-priorities-letter.

Coverage Decisions

How must the coverage of specific companies be determined?

FINRA Rule 2241 diminishes the input and influence that investment banking personnel may have on equity research reports and equity research analysts. Firms are required to limit or restrict investment banking personnel's input or influence on coverage determinations and instead, provide such final discretion regarding coverage to equity research personnel and management.

Source: FINRA Rule 2241(b)(2)(B)

FINRA Rule 2242 similarly limits the input and influence of sales and trading and principal trading personnel on debt research analysts. FINRA Rule 2242 further limits the supervision of debt research analysts to persons not engaged in (i) investment banking services transactions, (ii) principal trading activities, or (iii) sales and trading.

Source: FINRA Rule 2242(b)(2)(C)-(D)

However, FINRA Rules 2241 and 2242 do not expressly prohibit investment banking or sales and trading and principal trading personnel, or any other department, from conveying customer interests or providing input into coverage considerations, so long as research analysts are able to make final decisions regarding a particular coverage plan.[19]

Investment banking personnel may not have any input into determinations of companies to be covered by research personnel and whether to initiate or

[19] *See* FINRA Regulatory Notice 15-30 (Aug. 2015), at 4, available at: http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-15-30.pdf.

terminate coverage of a specific company. Investment banking revenues or potential revenues may not be taken into account in making company-specific coverage decisions. These requirements do not apply to category-by-category coverage decisions (e.g., an industry sector, all issuers underwritten by the firm, or companies meeting a certain market-cap threshold).

What are the procedures if a firm decides to stop covering a specific company in its research reports?

FINRA Rule 2241, but not FINRA Rule 2242, expressly requires that a firm promptly notify its customers if it intends to terminate coverage of a subject company. This notice must be made to the firm's customers using the firm's ordinary means to disseminate research reports on the subject company. The firm must also accompany the notice with a final research report and a final recommendation or rating. Where it is impracticable to provide such a final research report, a recommendation or rating, a firm may alternatively disclose to its customers its reason for terminating coverage.

Source: FINRA Rule 2241(f)

Personal Trading

Are there restrictions on personal trading by research analysts?

Yes. Under FINRA Rules 2241 and 2242, a firm must maintain policies and procedures that restrict research analyst account trading in:

- securities (or any derivatives of such securities); and
- any funds whose performance is materially dependent upon the performance of any securities covered by the research analyst.

Furthermore, policies and procedures must ensure that research analyst accounts, supervisors of such analysts and associated persons able to influence the content of research reports do not benefit from knowledge of the content or the timing of the report before recipients of the report have a reasonable opportunity to act on the report's information. Unlike FINRA Rule 2242, Rule 2241 further prohibits equity analysts from (i) receiving pre-IPO shares in the sector that he or she covers and (ii) trading against his or her recent recommendations.

What are the exclusions from trading restrictions imposed on research analysts?

Both FINRA Rules 2241 and 2242 provide exclusions from the above-described restrictions on personal trading. Specifically, an equity or debt research analyst may:

- be permitted to trade against his or her most recent recommendation as long as the trade falls within the firm's definition of "financial hardship circumstances;" and
- trade in securities in a manner that is inconsistent with his or her recommendation (even where the firm has instituted a policy that prohibits any analyst from holding securities, or options on, or derivatives of, securities), provided that: (i) the firm establishes a reasonable plan to liquidate such

holdings[20] and (ii) the plan is approved by the firm's legal or compliance personnel.

Source: FINRA Rules 2241(b)(2)(J) and 2241.10; FINRA Rules 2242(b)(2)(J) and 2242.10

Joint Due Diligence

What communications are permitted between the research and investment banking departments with regard to joint due diligence sessions?

Research and investment banking personnel may simultaneously participate in meetings or calls with an issuer or third parties, subject to certain conditions. One such condition is that joint due diligence sessions be chaperoned by either in-house counsel or outside counsel. Other conditions apply as well:

- the meeting or call must be for gathering or confirming information about the issuer or be related to the proposed transaction;
- the firm's legal or compliance staff must reasonably believe that the investment banking department will not have a meaningful opportunity to conduct separate due diligence communications with the relevant parties before the award of a mandate if they do not do so in conjunction with the research department; and
- the meeting or call must take place in connection with:
  - an IPO and be scheduled only after the firm has been granted an investment banking mandate; or
  - a block bid or competitive secondary or follow-on offering or similar transaction in which the issuer or selling shareholder has contacted the investment banking department to request that it submit a proposal.

Source: Global Settlement Addendum A, Section (I)(10)(c)(i), available at: http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf

Pursuant to FINRA Rules 2241 and 2242, a firm's policies and procedures must prohibit equity and debt research personnel from participating in due diligence in the presence of investment banking personnel prior to the selection of underwriters for an investment banking services transaction. However, once a mandate has been awarded, joint diligence sessions are permitted with appropriate institutional safeguards.

FINRA has additionally clarified that the joint due diligence requirement under FINRA Rule 2241 should apply only to the extent that it does not run counter to the JOBS Act. For example, the joint due diligence proscription would not apply where the joint due diligence activities involve a communication with the management of an EGC that is attended by both the equity research analyst and investment banking personnel.[21]

Source: FINRA Rule 2241.01; FINRA Rule 2242.02

[20] For a plan to be "reasonable" under FINRA Rules 2241 and 2242, the plan must be consistent with the principles provided in FINRA Rules 2241(b)(2)(J)(i) and 2242(b)(2)(J)(i), respectively.

[21] *See* Order Approving a Proposed Rule Change, *supra* note 9 at 10 n.39.

Who should act as a chaperone during joint diligence sessions?

For an IPO, a joint due diligence session can be chaperoned by the investment banking department's internal legal or compliance staff or underwriters' counsel or other counsel on the transaction. For a non-IPO, internal legal or compliance staff should serve as chaperone. In response to the general requirements of the Global Settlement, the Securities Industry and Financial Markets Association ("SIFMA") recommends that if outside counsel chaperones a joint due diligence meeting or call, outside counsel's role should be limited to that particular meeting or call. If any follow-up discussions take place, outside counsel should not be expected to chaperone. Outside counsel also should direct research or investment banking personnel to their respective compliance departments for further instructions. In all cases, the chaperone must be knowledgeable regarding research and investment banking conflicts and the terms of the modified Global Settlement. In addition, SIFMA recommends that, as a matter of best practice, the chaperone be a partner or other senior attorney of his or her firm.

What are the duties of the chaperone?

The Global Settlement does not contain specific chaperone obligations for joint due diligence sessions. SIFMA has developed guidelines for the duties of a chaperone. Before any joint due diligence session, the chaperone should obtain a list of names and titles, specifying whether each person is from the research or investment banking department. If there are any changes to the roster of participants, the chaperone should obtain an updated list after the due diligence session so he or she can complete his or her recordkeeping obligations. If the due diligence session is an in-person meeting, the chaperone must be physically present at the meeting. If the due diligence session is a conference call, the chaperone should be dialed in and able to speak whenever he or she wishes or an active participant in the call. It is also important that the chaperone set up a contact person from each participating firm. The contact person will be the recipient of any recordkeeping information and contact person for issues that may arise during or after the due diligence session. If a due diligence questionnaire is going to be used, research and investment banking personnel should prepare separate questionnaires or agendas.

During the due diligence session, the chaperone should introduce him or herself at the very beginning of the meeting or call.[22] The chaperone should encourage speakers to identify themselves, including by mentioning which institution they represent and their role at that institution. The chaperone should be engaged in the conversation and be attentive for any actions by participants inconsistent with the purpose of the due diligence session (to gather or confirm factual information). The chaperone should consider whether any participant is deviating from this purpose, including attempts to influence an analyst's views on the proposed transaction or frustrate the ability of an analyst to participate in the due diligence session. SIFMA recommends that participants in the joint due diligence session, whether research or investment banking personnel, direct their comments, questions or other communications to the issuer or its

[22] SIFMA has provided a sample introduction. *See* Lloyd Harmetz, "Chaperoning Joint Due Diligence," PLC Practice Note (accessed July 2016), available at: http://us.practicallaw.com/cs/Satellite/6-504-6486.

representatives and not to each other. This helps prevent, for example, an exchange between investment banking personnel and a research analyst that may appear to be a debate about a factual matter or the character of a factual matter.

If the chaperone perceives an improper communication is occurring, the chaperone should interject and steer the discussion away from the topic. This might include reminding participants that comments be directed to the issuer and not be between investment banking personnel and research analysts. If the chaperone thinks an improper communication has occurred, the chaperone may remove the relevant persons from the due diligence session and/or terminate the meeting or call immediately. The chaperone should promptly call his or her contact person at the relevant investment bank to report what happened and to discuss appropriate follow-up actions. If some of the meeting participants plan to remain in the room or on the call after the joint due diligence session to conduct other business, the chaperone should excuse the research or investment banking personnel from the meeting or call, as applicable.

After the due diligence session is complete, the chaperone should send an email to the legal or compliance department of the institutions that participated in the due diligence session. The recordkeeping email should include:

- the date and time of the meeting or call;
- the duration of the meeting or call;
- the list of participants;
- the name of the issuer;
- the type of transaction;
- the topic of the meeting or call; and
- the name of the firm acting as chaperone.

SIFMA suggests that the email also include a confirmation by the chaperone that he or she is knowledgeable about the Global Settlement and conflicts of interest between the research and investment banking departments. If the chaperone believes any improper communications occurred at the meeting, the chaperone should promptly call the contact person at the relevant institution to report what happened and to discuss appropriate follow-up actions.

The JOBS Act

How does the JOBS Act affect the SRO Rules?

Recognizing the contribution of research coverage to the market for emerging companies, the JOBS Act attempted to address some logistical issues relating to the diligence activities undertaken in connection with IPOs. However, the JOBS Act did not supersede the Global Settlement. The JOBS Act also eliminated certain quiet period restrictions on publication of research reports in offerings by EGCs. Under Title I of the JOBS Act, an EGC is defined as an issuer with total gross revenues of under $1 billion (subject to inflationary adjustment by the SEC every five years) during its most recently completed fiscal year. An issuer that qualifies as an EGC will remain an EGC until the earliest of:

- the last day of the fiscal year during which the issuer's total gross revenues exceed $1 billion;
- five years from the issuer's IPO;
- the date on which the issuer has sold more than $1 billion in non-convertible debt;

- the date on which the issuer becomes a large accelerated filer (i.e., has a public float of $700 million or more).

A broker-dealer participating in an issuer's IPO is generally subject to certain "quiet periods" with respect to the publication of research reports regarding such issuer. The publication of research is generally prohibited in advance of the IPO, and, once the IPO has priced, no research can be published until 40 days following the offering.

Section 105 of the JOBS Act permits a broker-dealer to publish or distribute a research report about an EGC that proposes to register an offering of common stock under the Securities Act or has a registration statement pending, and the research report will not be deemed an "offer" under Section 2(a)(3) of the Securities Act, even if the broker-dealer will participate or is participating in the offering.

Does the JOBS Act affect the ability of investment banking personnel to arrange communications between a research analyst and a potential investor?

Under Section 105(b) of the JOBS Act, an associated person of a broker-dealer, including investment banking personnel, may arrange communications between research analysts and investors. This activity would include, for example, an investment banker forwarding a list of clients to the research analyst that the analyst could contact, at his or her own discretion and with appropriate controls. In turn, a research analyst could forward a list of potential clients with whom it intends to communicate to investment banking personnel as a means to facilitate scheduling. Investment banking personnel can also arrange, but not participate in, calls between analysts and clients.[23]

How does the JOBS Act affect the ability of research personnel to attend meetings or "pitches" with the management of an EGC in the presence of investment banking personnel?

The JOBS Act prohibits a national securities association or the SEC from maintaining rules restricting research analysts from participating in meetings with investment banking personnel and an EGC in connection with an EGC's IPO. Prior to the enactment of the JOBS Act, research personnel were prohibited from attending meetings with an issuer's management that were also attended by investment banking personnel in connection with an IPO, including pitch meetings. Section 105(b) of the JOBS Act permits research personnel to participate in any communication with the management of an EGC concerning an IPO 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, including investment banking personnel. The SEC has interpreted this section as primarily reflecting a Congressional intent to allow research personnel to participate in EGC management presentations with sales force personnel so that the issuer's management would not need to make separate and duplicative presentations to research personnel at a time when resources of the EGC may be limited.

[23] In the past, the SEC has stated that such arranging activity, without more, would not violate FINRA Rule 2711 or NYSE Rule 472, although the SEC has indicated that firms should be mindful of other provisions of the Exchange Act and the SRO Rules as well as the applicability of the Global Settlement. *See* SEC FAQs, *supra* note 4 at Question 3.

The SEC stated in the SEC FAQs that research personnel must limit their participation in such meetings to introducing themselves, outlining their research program and the types of factors that they would consider in their analysis of a company, and asking follow-up questions to better understand a factual statement made by the EGC's management. In addition, after the firm is formally retained to underwrite the offering, research personnel could, for example, participate in presentations by the management of an EGC to educate a firm's sales force about the company and discuss industry trends, provide information obtained from investing customers, and communicate their views.[24]

Under FINRA Rules 2241 and 2242, research analysts are prohibited from soliciting business for the investment banking department, but they are not prevented from attending a pitch meeting in connection with an IPO of an EGC that is also attended by investment banking personnel; provided, however, that a research analyst may not engage in otherwise prohibited conduct in such meetings.[25]

Does the JOBS Act permit research personnel to participate in a road show or other communications with investors in the presence of investment banking personnel or the management of an EGC about an existing or potential investment banking transaction?

In the SEC's view, Section 105(b)(2) of the JOBS Act allows a firm to avoid the ministerial burdens of organizing separate and potentially duplicative meetings and presentations for an EGC's management, investment banking personnel, and research analysts. Section 105(b)(2) did not address communications where investors are present together with an EGC's management, analysts and investment banking personnel. Therefore, the SEC has taken the view that this provision of the JOBS Act does not affect the SRO Rules prohibiting analysts from participating in road shows or otherwise engaging in communications with customers about an investment banking transaction in the presence of investment bankers or an EGC's company's management. These rules apply to communications with customers and other investors and do not depend on whether analysts, investment bankers, and an issuer are participating jointly in such communications.[26]

Does the JOBS Act modify all of the requirements imposed on research analysts by the SRO Rules and other SEC regulations?

No. There are many provisions of the SRO Rules and existing SEC regulations dealing with the separation of the research and investment banking departments that the JOBS Act does not eliminate or modify, even in relation to EGCs, including:

- the prohibition of research personnel from soliciting business for the investment banking department;
- the prohibition on research personnel from engaging in communications with prospective investors in the presence of investment banking personnel;
- the prohibition on sharing pre-deal research such as ratings and price targets, with an issuer;

[24] *See* SEC FAQs, *supra* note 4 at Question 4.

[25] *See* FINRA Rules 2241(b)(2)(L) and 2242(b)(2)(L). *See also* SEC Release No. 34-68037 (Oct. 11, 2012), available at: http://www.sec.gov/rules/sro/finra/2012/34-68037.pdf.

[26] *See* SEC FAQs, *supra* note 4 at Question 5.

- the prohibition on investment banking personnel from requiring a research analyst to arrange investor communications;
- the prohibition on compensating research personnel based on the revenue of the investment banking department;
- the FINRA requirements relating to the preparation, review and approval of research reports disseminated by a firm; and
- compliance of research analysts with Regulation AC (*see* "Regulation AC" below).

Appendix B to these Frequently Asked Questions contains a table that compares the actions, as they relate to the research and investment banking personnel, that are permitted before and after the enactment of the JOBS Act.

How does the JOBS Act define a "research report?"

Section 105(a) of the JOBS Act defines a "research report" as "a written, electronic, or oral communication that includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, *whether or not* it provides information reasonably sufficient upon which to base an investment decision." This differs from the definition of a "research report" in the SRO Rules and Global Settlement, where the information contained in the report must be reasonably sufficient to form the basis for an investor's decision. Accordingly, the definition of research report for purposes of the JOBS Act would encompass nearly any written or oral communication relating to an EGC or its securities made by a broker-dealer.

Is there a difference between the permitted "testing-the-waters" communications prior to the official launch of an offering and distributing research reports once the offering has begun?

Section 105(a) of the JOBS Act provides that a research report published by a broker-dealer about an EGC that is planning a public offering of common equity securities will not be considered an offer for purposes of Section 2(a)(10) and Section 5(c) of the Securities Act. As a result, the issuance of a written research report by a broker-dealer will not trigger a Section 5 violation and would not constitute a written offer "by means of a prospectus" for purposes of potential liability under Section 12(a)(2) of the Securities Act. However, "testing-the-waters" communications under the JOBS Act does not provide an exemption from Section 12(a)(2) liability but only from Section 5. Therefore, a research report would have greater protection from liability under the JOBS Act than "testing-the-waters" materials.

Whether an oral research report may be subject to Section 12(a)(2) liability is more complicated. The JOBS Act does not provide a safe harbor under Section 12(a)(2) with respect to oral research reports. Consequently, an oral research report could still result in Section 12(a)(2) liability if it is deemed to constitute an "offer" of a security.

Does the JOBS Act exempt the permitted research reports from potential liability under Rule 10b-5 of the Exchange Act and/or state anti-fraud laws?

No. The JOBS Act has no impact on liability under Rule 10b-5 of the Exchange Act or state anti-fraud laws.

Does the JOBS Act safe harbor allowing for the publication of research reports apply to a debt offering of an EGC?

No. The safe harbor for the publication of research reports concerning an EGC applies only to a public offering of the common equity securities of an EGC.

Source: JOBS Act Section 105(a)

How does the JOBS Act affect the Global Settlement?

The JOBS Act does not directly address the Global Settlement, and, as the Global Settlement is a judicial order and not an SEC or FINRA rule, it is technically not affected by the enactment of the JOBS Act. However, it is important to remember that the Global Settlement only affects the eight remaining Settling Firms. All other broker-dealers not party to the Global Settlement are able to take advantage of the self-effectuating provisions of the JOBS Act described above. It remains to be seen whether the Settling Firms will petition a U.S. Federal District Court for another amendment to the Global Settlement to conform to the provisions of the JOBS Act. It is also unclear if the SEC will amend Rules 137, 138 and 139 under the Securities Act to address the effects of the JOBS Act.

Disclosure and Transparency

Are subject companies allowed to view research reports prior to publication to the public?

FINRA Rules 2241 and 2242 require that each firm maintain policies and procedures that prohibit pre-publication review of research reports. At a minimum, such policies and procedures must prohibit pre-publication review, clearance or approval of research reports by: (i) investment banking personnel (or, in the case of debt research, any investment banking, principal trading and sales, and trading personnel); and (ii) all other persons not directly responsible for the preparation, content and distribution of research reports, other than the firm's legal and compliance personnel.

Each firm must also maintain policies and procedures that prohibit pre-publication review of a research report by a subject company for purposes other than verification of facts. Firms may provide sections of a draft research report to non-investment banking personnel (or, in the case of debt research, non-principal trading, non-sales and trading personnel) or the subject company for actual review if:

- the draft sections do not consist of any research summary, research rating or price target;
- a complete draft of the report is provided to the firm's legal or compliance personnel prior to the sections being provided to non-investment banking personnel (or, in the case of debt research, non-principal trading, non-sales and trading personnel) or the subject company; and
- any subsequent proposed changes to the rating (or, in the case of equity research, the price target) are accompanied by a written justification to the firm's legal or compliance personnel and the changes are authorized by such legal or compliance personnel.

Source: FINRA Rule 2241(b)(2) and 2241.05; FINRA Rule 2242(b)(2) and 2242.05

Are there prohibitions on promising favorable research?

Both FINRA Rules 2241 and 2242 prohibit a firm and its affiliates from making promises of (i) favorable research and (ii) a particular research recommendation, rating or specific content, as consideration or inducement for the receipt of investment banking business from the company. However, these rules are not intended to prevent a firm from agreeing to provide research as part of its investment banking services.

Source: FINRA Rule 2241(b)(2)(K); FINRA Rule 2242(b)(2)(K)

What are required disclosures in research reports?

Under FINRA Rules 2241 and 2242, a firm must establish policies and procedures that are reasonably designed to ensure that:

- purported facts in research reports are based on reliable information;
- reports disclose any material conflicts known not only by research analysts but also by any associated person with the ability to influence the content of the report;[27] and
- any recommendation or rating (or, in the case of an equity research report, any 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 or rating (or price target).

Source: FINRA Rule 2241(c)(1)-(2); FINRA Rule 2242(c)(1)-(2)

A firm is also required to disclose in any equity or debt research report (at the time of publication of a distributed report):

- if the research analyst or a member of the research analyst's household has a financial interest in the debt or equity security of the subject company;
- if the research analyst has received compensation based upon the firm's investment banking revenues, among other factors;
- if the subject company has paid the firm to prepare and distribute the research report (i.e., issuer paid research);[28] and
- if the firm or any of its affiliates: (i) managed or co-managed a public offering of securities for the subject company; (ii) received compensation for investment banking services from the subject company performed 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.

A firm must additionally, as part of a "catch all" disclosure requirement, disclose in a research report any other material conflict of interest of the research analyst or firm that the research analyst knows or has reason to know of at the time of the publication or distribution of a research report.

[27] FINRA has clarified that a research report would not need to include disclosure of a personal conflict of interest of a supervisory analyst or research principal, unless it rises to the level of a conflict of the firm itself. However, other provisions in the FINRA rules may still require management of those personal conflicts. *See* FINRA FAQs, *supra* note 17 at Question 1 (Disclosure Requirements).

[28] FINRA notes that issuer paid research constitutes an actual material conflict of interest that must be specifically disclosed by the firm in accordance with FINRA Rules 2241(c)(4)(I) and 2242(c)(4)(H). *See* FINRA FAQs, *supra* note 17 at Question 2 (Disclosure Requirements).

Source: FINRA Rule 2241(c)(4); FINRA Rule 2242(c)(4)

In addition to the disclosure requirements expressly provided for in FINRA Rules 2241 and 2242, each firm and their equity and debt research analysts must comply with all applicable disclosure provisions of FINRA Rule 2210 and the U.S. federal securities laws.

Source: FINRA Rule 2241(e); FINRA Rule 2242(e)

There are several content disclosure requirements that are unique to each of FINRA Rule 2241 and FINRA Rule 2242. First, under FINRA Rule 2241, equity research reports must disclose when a firm or its affiliates have a "significant financial interest in the equity of a company" and, at a minimum, beneficial ownership of 1% or more of any class of common equity securities of the subject company. Furthermore, FINRA Rule 2241 also requires that an equity research report disclose whether the firm was making a market in the securities of the subject company at the time of publication or distribution of an equity research report. FINRA Rule 2242, on the other hand, requires each firm to disclose in its debt research reports whether it trades or may trade as principal in the debt securities (or related derivatives) that are the subject of the debt research report.

Source: FINRA Rule 2241(c)(4)(F)-(G); FINRA Rule 2242(4)(F)

What are required disclosures for public appearances?

When an equity or debt research analyst makes a public appearance, he or she must largely satisfy the same disclosure requirements that are required when distributing research reports under FINRA Rules 2241 and 2242, as applicable. However, unlike the disclosure requirements for research reports, the "catch all" disclosure requirement for public appearances would only apply to a conflict of interest of the equity or debt research analyst or firm that the research analyst knows or has reason to know at the time of the public appearance. A firm must also maintain records of public appearances sufficient to demonstrate compliance by its research analysts with applicable disclosure requirements.

Source: FINRA Rule 2241(d); FINRA Rule 2242(d)

What must firms generally disclose about their rating systems?

Each firm must make significant disclosures about their rating systems. A firm that employs a rating system must clearly define in each research report the meaning of each rating in the system, including the time horizon and any benchmarks on which a rating is based, and the definitions must be consistent with their plain meaning. Each firm must disclose the percentage of *all* securities it rates to which it would assign a "buy," "hold/neutral" or "sell" rating, and the percentage of companies within each of these companies for which the firm has provided investment banking services within the past year. The above information must be current as of the end of the most recent calendar quarter or the second most recent calendar quarter if the public date of the research report is less than 15 calendar days after the most recent calendar quarter. This requirement only applies if the research report includes a rating, express or implied, of the subject company's stock.

Source: FINRA Rule 2241(c)(2); FINRA Rule 2242(c)(2)

What must firms specifically disclose about their rating systems under FINRA Rule 2241?

Under FINRA Rule 2241, for each rated security, a research report must include a line graph for the prior

year including daily closing prices and the timing of the rating and price target assignments and changes. If the report contains a price target, the firm must disclose the valuation method for reaching that price target. Each target must have a reasonable basis and must be accompanied by a statement explaining the risks that may impede the achievement of that target. A firm must also disclose if it is making a market in the subject company's securities.

Source: FINRA Rule 2241(c)(3)

What must firms specifically disclose about their rating systems under FINRA Rule 2242?

FINRA Rule 2242 specifies that if a debt research report is limited to the analysis of an issuer of a debt security that contains a rating for the subject company and the firm has assigned a rating to such company for at least 12 months, the debt research report must provide each date on which the firm has assigned a rating and the rating assigned on such date. The firm must include this information for the period of the lesser of either (i) the time that the firm has assigned any rating or (ii) a three-year period.

Source: FINRA Rule 2242(c)(3)

What must firms specifically disclose about their rating systems under the Global Settlement?

The Global Settlement requires three disclosures to be made prominently on the first page of any research report and/or summary of recommendations contained in previous reports:

- "The firm does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report;"
- "Customers in the United States can receive independent third-party research on the company or companies covered in this report, at no cost to them, where such research is available. Customers can access this independent research at [the appropriate website] or call [a toll-free number] to request a copy of this research;" and
- "Investors should consider this report only as a single factor in making their investment decision."

Source: Global Settlement Addendum A, Section (II)(1), available at:

http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf

How must a firm disclose the information required by the SRO Rules?

The SRO Rules require certain disclosures on the front page of research reports. If this is not possible, the front page must have a specific reference to the location of the required disclosure. All disclosures must be clear and prominent on the page.

References on the front page of a report to the location of required disclosures must be separated from the body of the report, for example, in a text box, and must be in a larger font size than the body of the text. References must contain the specific page number; section references will not suffice. Hyperlinks may be used to direct the reader to the required disclosures in electronically transmitted reports only. They can, however, be used as an additional point of reference in written reports. Regardless of where the disclosures are

placed, they must be labeled using a heading such as "Important Disclosures" in a large and conspicuous font size. This section must include all the disclosures required and be presented in a clear and logical order.

There can be no disclaimers that contradict or are inconsistent with the disclosures, and conditional or indefinite language is prohibited. Any disclosures not required by the SRO Rules must be clearly separated from the required disclosures and labeled as such. Finally, the use of stock symbols or tickers is only allowed in the disclosures section if they are accompanied by a specific direction where in the report the reader can identify the company by its proper name.

When a firm distributes a research report covering six or more subject companies (a "compendium report"), the compendium report may direct readers in a clear manner to where they may obtain applicable current disclosures. Electronic compendium reports may include a hyperlink to the required disclosures. Written compendium reports must provide either a toll-free number to call or a postal address to write to for the required disclosures and may also include a web address of the firm where the disclosures can be found.

Must a firm disclose the performance results of its research analysts?

In order to make analyst performance more transparent to investors, a firm must make publicly available via its website in a downloadable format, within 90 days of the end of each calendar quarter, the following information provided in its research reports issued during the previous calendar quarter:

- names of subject companies;
- names of the analysts responsible for the certification of the reports (pursuant to Regulation AC — *see* "Regulation AC" below);
- dates of reports;
- price targets and period within which price targets are to be achieved;
- earnings-per-share forecasts for the current quarter and current full year; and
- definitions or explanation of ratings used by the firm.

Independent Third-Party Research

Under what circumstances may a firm provide third-party research to investors?

Under FINRA Rules 2241 and 2242, each firm must establish, maintain and enforce written policies and procedures that are reasonably designed to ensure that a research report is not distributed selectively to certain trading personnel or to select customers of the firm. While different research products may be distributed to different customers, such differentiation cannot be based on the timing of receipt of potentially market-sensitive information.

Moreover, a firm must maintain and enforce policies and procedures reasonably designed to ensure that any third-party research report it distributes: (i) is clearly labeled to ensure there is no confusion on the part of the recipient as to the person or entity that prepared the report; (ii) does not contain any untrue statement of material fact; (iii) is not otherwise false or misleading; and (iv) is reliable and objective.

Source: FINRA Rules 2241(h) and 2241.07; FINRA Rule 2242(h) and 2242.07

Any third-party research report distributed by a firm must be accompanied with, or provide a web address that directs a recipient to, disclosure of any material conflict of interest that can reasonably be expected to influence the selection of a third-party research provider or the subject company of a third-party research report. A firm also is required to make several disclosures in any equity or debt research report at the time of publication of a distributed report. *See "What are required disclosures in research reports?"* below.

Source: FINRA Rule 2241(c)(4); FINRA Rule 2242(c)(4)

Who is considered an independent research provider?

In order for a firm to be considered an independent research provider, it must not perform investment banking services of any kind. The independent provider also must not provide brokerage services in direct and significant competition with the investment banking firm.

Source: Global Settlement Addendum A, Section (III)(3), available at:

http://www.sec.gov/litigation/litreleases/finaljudgadda.pdf

Institutional Investors

Does FINRA Rule 2242 provide any exemptions for the distribution of debt research to qualified institutional buyers?

Yes. FINRA Rule 2242 contains a unique exemption for the distribution of debt research to qualified institutional buyers ("QIBs"), as defined in Rule 144A under the Securities Act. A firm may rely on this exemption if:

- the firm has a reasonable basis to believe that the QIB customer is capable of evaluating investment risks independently, both in general and with regard to the particular transactions and investment strategies involving a debt security; and
- the QIB affirmatively indicates that it is exercising independent judgment pursuant to FINRA's suitability requirement.

Even where a QIB has not contacted a firm to request that such institutional debt research not be provided, the firm may reasonably conclude that the QIB has consented to receive debt institutional research reports (i.e., negative consent).

While not required to do so, a firm may rely on certifications obtained directly, or through third-party vendors, to establish the elements of consent to distribute institutional debt research to QIBs.[29]

Source: FINRA Rule 2242(j)

Does FINRA Rule 2242 provide any exemptions for the distribution of debt research to institutional accounts?

Yes. A firm may provide debt research reports to a person that qualifies as an "institutional account" pursuant to FINRA Rule 4512(c), provided that such person, prior to receiving a debt research report, affirmatively notifies the firm in writing that it wishes to receive institutional debt research and forego treatment as a retail investor for the purposes of FINRA Rule 2242 (i.e., affirmative written consent).

[29] *See* FINRA FAQs, *supra* note 17 at Question 2 (Exemption for Institutional Debt Research).

A firm may rely on certifications obtained directly, or through third-party vendors, to establish the elements of consent to distribute institutional debt research to institutional accounts.[30]

Source: FINRA Rule 2242(j)

Can third-party debt research reports be provided to institutional investors?

Yes. A firm may distribute third-party debt research reports to institutional investors as long as the firm establishes, maintains and enforces written policies and procedures reasonably designed to comply with the accuracy and disclosure requirements for third-party debt research reports (*see "Under what circumstances may a firm provide third-party research to investors?"* above).

Source: FINRA Rule 2242(j)(3)

Must a firm or debt research analyst make disclosures for public appearances where those in attendance are limited to institutional investors?

No. A firm or debt research analyst will not be required to make a disclosure in connection with a public appearance where those in attendance are limited to institutional investors eligible to receive institutional debt research (e.g., QIBs and institutional accounts that have provided affirmative written consent (*see "Does FINRA Rule 2242 provide any exemptions for the distribution of debt research for qualified institutional buyers?"* and *"Does FINRA Rule 2242 provide any exemptions for the distribution of debt research to institutional accounts?"* above).[31]

Each firm must maintain records of such public appearances by debt research analysts sufficient to demonstrate that attendance at the public appearance was limited to institutional investors eligible to receive institutional debt research. Such records must also be maintained for at least three years from the date of the public appearance.

Source: FINRA Rule 2242.14

2010 Amendments to the Global Settlement

What did the Court change in 2010 regarding the Global Settlement?

On August 3, 2009, the remaining Settling Firms, after various discussions with regulators, submitted a motion proposing certain modifications for the Court's consideration. On March 15, 2010, the Court modified the Global Settlement to allow research and investment banking personnel to simultaneously participate in due diligence sessions with securities issuers and other parties in certain types of transactions and subject to certain conditions. Furthermore, research personnel may now assist investment banking personnel in confirming the adequacy of disclosures made in connection with securities offerings or other transactions based on communications of research personnel with the issuers and third parties.

In addition to allowing for joint due diligence sessions, the Court approved the SEC's and the Settling Firms' request to delete the provisions of the Global Settlement that required:

- separate reporting lines for the research and investment banking departments;

[30] *Id.*

[31] FINRA has explained that it would be inconsistent with the rationale of FINRA Rule 2242's institutional investor exemption to allow debt research analysts to make public appearances before an audience that could include retail investors. *See* FINRA FAQs, *supra* note 17 at Question 1 (Exemption for Institutional Debt Research).

- a dedicated legal and compliance staff of the research department;
- annual review by the firm's audit committee of the budget of the research department;
- no investment banking personnel influence over research personnel compensation or evaluations;
- mandatory announcements when coverage of a stock is terminated;
- no research personnel participation in efforts to solicit investment banking business;
- no research personnel participation in road shows;
- no investment banking personnel direction to research personnel to engage in marketing or selling efforts for investment banking transactions; and
- disclosure of analyst performance information.

The Court approved the removal of these terms from the Global Settlement because the SRO Rules generally cover the same issues for all firms. Where not covered by the SRO Rules, the SEC and the Settling Firms simply stated their joint view that elimination of these requirements would be consistent with the public interest.

What changes, if any, did the Court refuse to make in its 2010 Addendum to the Global Settlement?

There were some provisions of the Global Settlement that the Settling Firms had hoped to eliminate through the repeal of the entire Global Settlement, but at the SEC's insistence the Court refused to change. These retained restrictions include the continuation of:

- the physical separation of the research and investment banking departments;
- the prohibition on investment banking personnel's input into company-specific research coverage decisions;
- the requirement that the research department be given the opportunity to express its views on a proposed transaction to the firm's commitment committee outside the presence of investment banking personnel;
- the requirement that communications to the sales force (or to 10 or more investors) be "fair and balanced" and that the views expressed have a reasonable basis;
- the research oversight committee's review or ratings, targets and the overall quality of research; and
- the disclosure of any conflicts of interest that may exist.

Source: Modifications to the Global Settlement (Mar. 15, 2010), available at:

https://www.sec.gov/info/smallbus/acsec/acsec-020112-global-settlement.pdf

Regulation AC

What is Regulation AC?

Regulation AC (Analyst Certification) was adopted by the SEC on February 6, 2003, and became effective on April 14, 2003. Regulation AC requires research analysts to certify the truthfulness of the views they express in research reports and public appearances and to disclose whether they have received any

compensation related to the specific recommendations or views expressed in those reports and appearances.

Why was Regulation AC enacted?

According to the SEC's proposing release,[32] Regulation AC was designed to address the core issues of research analyst integrity: analysts' beliefs in, and the influence of compensation on, their recommendations. Regulation AC was adopted to focus on research that is most susceptible to pressures, like the desire to generate investment banking revenues, which might compromise the integrity of the research. It is directed to broker-dealers and covered persons because the SEC believes that they are subject to the greatest conflicts. Therefore, the research report certification provisions of Regulation AC apply to investment advisers and banks, among others, that are covered persons and publish or provide research reports.

Who must comply with Regulation AC?

Regulation AC applies only to broker-dealers and covered persons, a category that generally includes all associated persons of a broker-dealer and specifically excludes associated persons that satisfy the following two conditions:

- the associated person does not have officers or employees in common with the broker-dealer who are able to influence the activities of research analysts of the broker-dealer or the content of the research reports; and
- the broker-dealer maintains and enforces written policies and procedures that are reasonably designed to prevent the broker-dealer and any of its controlling persons, officers, and employees from influencing the activities of research analysts and the content of research prepared by the associated person.

Neither Regulation AC nor the adopting release specifies what these policies and procedures entail. In the adopting release, the SEC notes that it does not expect these policies and procedures to interfere with other communications made between the broker-dealer and its associated persons made in the ordinary course of business.[33]

In contrast to Rules 137, 138 and 139 under the Securities Act (*see* "SEC Research Reports Rules" below), Regulation AC applies to debt securities as well as equity securities. The SEC has determined that applying Regulation AC to debt securities as well as equity securities provides debt investors with the same benefits provided to equity investors by promoting the integrity of research reports and confidence in research analyst recommendations.

Source: Securities Exchange Act Release No. 34-47384 (Feb. 20, 2003).

What must be provided under Regulation AC in connection with published research reports?

Regulation AC requires that broker-dealers and certain associated persons include in research reports that they provide to U.S. persons a clear and prominent statement by the research analyst certifying that:

- the views expressed in the report accurately reflect the analyst's personal views about the subject securities and issuers; and

[32] *See* Securities Exchange Act Release No. 34-46301 (Aug. 2, 2002).

[33] *See* Securities Exchange Act Release No. 34-47384 (Feb. 20, 2003) at n.20.

- the analyst's compensation is not directly or indirectly related to the specific views or recommendations expressed in the report.

Regulation AC also requires a broker-dealer to maintain quarterly records containing similar certifications regarding public appearances made by its research analysts during the quarter. The term "public appearance" means any participation by a research analyst in a radio, television or other interview in which the research analyst makes a specific recommendation or provides information reasonably sufficient upon which to base an investment decision about a security or an issuer. These public appearance requirements apply only to broker-dealers and not to "covered persons" unless those persons are broker-dealers themselves.

A research analyst does not have the option of certifying that his/her personal views are not accurately reflected in a report. If a research report does not accurately reflect the views of the analyst, then distributing the report would violate Regulation AC. This applies both to the analysis and any summary rating contained in the report. The name of the research analyst need not appear on the report, but it must be clear that the certification was made by the lead analyst who prepared the report. Only the lead analyst need certify the report. Junior analysts do not need to do so. When an analyst is not identifiable because the report is based on the firm's quantitative or technical model, the firm itself may provide the certification.

The certification must appear in a "clear and prominent" place on the report. The adopting release provides that this means that the certification appears on either the cover page or that the cover page specifies where in the report the certification may be found.

Source: Securities Exchange Act Release No. 34-47384 (Feb. 20, 2003).

What reports are excluded from Regulation AC?

The term "research report" as used in Regulation AC means a written communication (including electronic communication) that includes an analysis of a security or an issuer and provides information reasonably sufficient upon which to base an investment decision. This is consistent with the definition of research report that appears in FINRA Rules 2241 and 2242.

The following communications would *not* be considered research reports under Regulation AC as long as they do not include an analysis of, or recommend or rate, individual securities or companies:

- reports discussing broad-based indices such as the Russell 2000 or the S&P 500;
- reports commenting on economic, political or market conditions;
- technical analyses concerning the demand and supply for a sector, index, or industry based on trading volume and price; and
- reports that recommend increasing or decreasing holdings in particular industries or sectors or types of securities.

The following communications would not be considered research reports under Regulation AC even if they recommend or rate individual securities or companies:

- statistical summaries of multiple companies' financial data that do not include any analysis of an individual company's data;
- analyses prepared for a specific person or limited group of fewer than 15 people;

- periodic reports or other communications prepared for investment company shareholders or discretionary investment account clients discussing past performance or the basis for previously made discretionary investment decisions; and
- internal communications not provided to customers.

Are there any exemptions or safe harbors from Regulation AC?

Regulation AC will not apply to a broker-dealer that distributes research prepared by a third-party research analyst whose employer satisfies the following independence criteria:

- the employer does not have officers or employees in common with the broker-dealer or covered person distributing its research; and
- the broker-dealer has written policies and procedures designed to prevent the broker-dealer, its controlling persons, officers, and employees from influencing the activities of the third-party research analyst and the content of his/her research reports.

A narrow exception also has been created for foreign persons located outside of the United States who are not associated with a registered broker-dealer that prepares and provides research on foreign securities to major U.S. institutions in the United States pursuant to Rule 15a-6(a)(2) under the Exchange Act. In the case of a research analyst employed outside the United States by a foreign person located outside the United States, Rule 502 of Regulation AC only applies to public appearances while the research analyst is physically present in the United States.

When a research report covers more than one company, each research analyst must certify with respect to relevant portions of the report that:

- the views expressed in the research report accurately reflect his or her personal views about the subject securities and companies; and
- that no part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendation or views contained in the research report.

A firm may comply with Regulation AC by including one clear and prominent combined certification that, as to each company covered, the applicable research analyst (or analysts) certifies as to the above.

Is Regulation AC affected by the JOBS Act?

No. Regulation AC is not affected by the JOBS Act.[34]

SEC Research Reports Rules

What is Rule 137 under the Securities Act?

Rule 137, along with Rules 138 and 139 under the Securities Act, is designed to protect analysts and broker-dealers from general solicitation and gun jumping violations in connection with their regularly disseminated research reports. Rule 137 applies to broker-dealers *not* participating in a registered offering and therefore not "underwriters." In order not to violate gun jumping provisions and solicitation prohibitions, the broker-dealer:

[34] *See* SEC FAQs, *supra* note 4 at Question 12.

- must publish the research report in the ordinary course of its business; and
- may not receive any consideration from, and may not act under any direct or indirect arrangement with, the issuer of the securities, a selling security holder, any participant in the distribution of the securities, or any other person interested in the securities.

Rule 137 also requires that the issuer may not be, nor have been in the past three years:

- a blank check company;[35]
- a shell company;[36] or
- a penny stock issuer.[37]

Independent research prepared by a broker-dealer not participating in an offering, but paid for by a broker-dealer participating in the offering, will be considered distributed by an offering participant and thus will not satisfy the Rule 137 safe harbor; however, subscription payments in ordinary course by those receiving the research reports are permitted.

Source: Securities Act Rule 137

What is Rule 138 under the Securities Act?

Rule 138 under the Securities Act applies to broker-dealers participating in the distribution of a *different security* from that being discussed in the research reports. Rule 138 permits a broker-dealer that is participating in the distribution of an issuer's securities to publish and distribute research reports that either:

- relate solely to the issuer's common stock, debt securities, or preferred stock convertible into common stock, where the offering involves solely the issuer's non-convertible debt securities or non-convertible non-participating preferred stock; or
- relate solely to the issuer's non-convertible debt securities or non-convertible, non-participating preferred stock, where the offering involves the issuer's common stock, debt securities, or preferred stock convertible into common stock.

In order to take advantage of Rule 138, a broker-dealer must regularly report on the types of securities that are the subject of the research report. The issuer involved must not be a blank check company, shell company or penny stock issuer *and* be *either:*

- a reporting company (foreign or domestic) and current in its Exchange Act filings; or
- a foreign private issuer that meets all of the registrant requirements of Form F-3 (other than the reporting history provisions of General Instructions I.A.1 and I.A.2(a) to Form F-3) *and either*:
  - satisfies the $75 million minimum public float threshold in General Instruction I.B.1. of Form F-3; *or*
  - is issuing non-convertible securities other than common equity and meets

[35] A blank check company is a development stage company that has no specific business plan or purpose or has indicated its business plan is to engage in a merger or acquisition with an unidentified company or companies, other entity, or person. Securities Act Rule 419(a)(2).

[36] A shell corporation is a company that serves as a vehicle for business transactions without itself having any significant assets or operations. Securities Act Rule 405.

[37] A penny stock issuer is a very small issuer of low priced speculative securities. Since penny stocks are difficult to accurately price, there are specific SEC rules that must be satisfied prior to a broker-dealer selling penny stock, and the SEC does not allow an issuer to use certain exemptions from the registration requirements when selling their securities. Exchange Act Rule 3a51-1.

the provisions of General Instruction I.B.2. of Form F-3 – *and either:*

- has its equity securities trading on a "designated offshore securities market" as defined in Rule 902(b) under the Securities Act and has had them trading for at least 12 months; *or*
- has a worldwide public float of $700 million or more.

Source: Securities Act Rule 138(a)(2)

What is Rule 139 under the Securities Act?

Rule 139 under the Securities Act applies to broker-dealers participating in the registered distribution of the *same security* as that discussed in their disseminated research reports. The broker-dealer must:

- publish or distribute research reports in the regular course of its business; and
- such publication or distribution cannot represent either the initiation of publication or the re-initiation of publication.

The issuer may not be a blank check, shell or penny stock issuer, *and* must:

- have filed all required Exchange Act reports during the preceding 12 months;
- meet all the registrant requirements of Form S-3/F-3 (other than the reporting history provisions of General Instructions I.A.1. and I.A.2(a) to Form F-3), *and either*:
  - satisfies the minimum public float threshold in General Instruction I.B.1. of Forms S-3/F-3;
  - is or will be offering non-convertible securities other than common equity and meets the threshold pursuant to General Instruction I.B.2 of Form S-3/F-3; or
  - is a "well-known seasoned issuer" as defined in Rule 405 under the Securities Act or is a foreign private issuer that satisfies the same requirements as for Rule 138 under the Securities Act (as described above).

Source: Securities Act Rule 139(a)

When dealing with industry-specific reports, certain conditions must be satisfied. The broker-dealer:

- must publish or distribute research reports in the regular course of its business; and
- at the time of publication or distribution, must include information about the issuer or its securities similar to that contained in similar research reports about other issuers.

The issuer must be either a reporting company or meet the foreign private issuer requirements described above with respect to issuer-specific research reports. The research reports:

- must contain similar information with respect to a substantial number of issuers in the industry or sub-industry;
- must contain a comprehensive list of securities (not just industry-specific) currently recommended by the broker-dealer;
- cannot give materially greater space or prominence to the analysis regarding the issuer or its securities, compared to the

analysis regarding other issuers or securities; and

- may include projections, provided that:
  - the broker-dealer has previously regularly published or distributed projections in its research reports;
  - it is publishing or distributing projections with respect to that issuer at the time of the current publication or distribution; and
  - the projections cover the same or similar periods with respect to either a substantial number of issuers in the industry/sub-industry or substantially all the issuers represented in the comprehensive list of securities included in the research report.

Source: Securities Act Rule 139(a)(2)

To what types of offerings do Rules 137, 138 and 139 under the Securities Act apply?

The safe harbors of Rules 137, 138 and 139 under the Securities Act are available to registered offerings, as well as offerings covered under Rule 144A and/or Regulation S under the Securities Act. Under Rule 144A, publication of a research report will not be considered an offer for sale or an offer to sell a security, general solicitation, or general advertising. Under Regulation S, publication of a research report will not constitute "directed selling efforts" nor will it be inconsistent with the "offshore transaction" requirement.

Source: Securities Act Rules 137(b)(c), 138(b)(c) and 139(b)(c)

To what types of reports do Rules 137, 138 and 139 under the Securities Act apply?

For purposes of Rules 137, 138 and 139 under the Securities Act, a research report means a written communication, including graphic communications,[38] that includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision.

Source: Securities Act Rules 137(e), 138(d) and 139(d)

Additional Materials

For further information on the requirements regarding the separation of research and investment banking personnel, including detailed analysis of FINRA Rules 2241 and 2242, please see the following materials prepared by Morrison & Foerster:

- FINRA's Final Equity Research Rules Go Effective; Final Debt Research Rules' Effective Date Quickly Approaching, Morrison & Foerster LLP Client Alert, Jan. 25, 2016 (available here)
- Line by Line Comparison of FINRA Proposed Rule 2241 (Equity) Versus FINRA Proposed Rule 2242 (Debt) (available here)

[38] Graphic communications include all forms of electronic media, including, but not limited to, audiotapes, videotapes, facsimiles, CD-ROM, electronic mail, Internet websites, substantially similar messages widely distributed (rather than individually distributed) on telephone answering or voice mail systems, computers, computer networks and other forms of computer data compilation. *See* Securities Act Rule 405.

- Research Quick Guide to Offerings (available here)

By Anna T. Pinedo, Partner, and
Ze'-ev D. Eiger, Partner,
Morrison & Foerster LLP

APPENDIX A

Comparison Between FINRA Rules 2241 and 2242		
Provision	**Included in FINRA Rule 2241**	**Included in FINRA Rule 2242**
Definitions	✓	✓
Identifying and Managing Conflicts of Interest	✓	✓
Content and Disclosure in Research Reports	✓	✓
Disclosure in Public Appearances	✓	✓
Disclosure Required by Other Provisions	✓	✓
Termination of Coverage	✓	✗
Distribution of Member Research Reports	✓	✓
Distribution of Third-Party Research Reports	✓	✓
Exemption for Members with Limited Investment Banking Activity	✓	✓
Exemption for Good Cause	✓	✓
Exemption for Limited Principal Trading Activity	✗	✓
Exemption for Research Reports Provided to Institutional Investors	✗	✓
Supplementary Materials		
Efforts to Solicit Investment Banking Business	✓	✓
Joint Due Diligence	✓	✓
Restrictions on Communications with Customers and Internal Personnel	✓	✓
Information Barriers Between Research Analysts and Trading Desk Personnel	✗	✓
Disclosure of Non-Investment Banking Services Compensation	✓	✗
Disclosure of Compensation Received by Affiliates	✗	✓
Submission of Sections of a Draft Research Reports for Factual Review	✓	✓
Beneficial Ownership of Equity Securities	✓	✗
Distribution of Member Research Products	✓	✓
Ability to Influence the Content of a Research Report	✓	✓
Obligations of Persons Associated with a Member	✓	✓
Divesting Research Analyst Holdings	✓	✓
Distribution of Institutional Debt Research During Transition Period	✗	✓

✗ Provision not contained in FINRA Rule

✓ Provision contained in FINRA Rule

APPENDIX B

May Research Personnel…	Pre-JOBS Act	Post-JOBS Act	
	All Issuers	EGC	Non-EGC
Publish research reports concerning the securities of an issuer immediately following its IPO?	Prohibited	Permitted	Prohibited
Publish research reports concerning issuers that are the subject of *any* public offering of common equity securities (even if the firm is participating in the offering)?	Prohibited	Permitted	Prohibited
Publish research reports concerning the securities of an issuer within 15 days before and after the expiration, waiver or termination of any lock-up agreement?	Prohibited	Permitted	Permitted
Participate in meetings with representatives of an issuer, attended by investment banking personnel?	Prohibited	Permitted	Prohibited
Contact potential investors in an issuer's IPO?	Prohibited	Permitted	Prohibited
Make public appearances concerning the securities of an issuer?	Prohibited	Permitted	Prohibited
Solicit business for investment banking personnel?	Prohibited	Prohibited	Prohibited
Engage in communications with potential investors in the presence of investment banking personnel?	Prohibited	Prohibited	Prohibited
Share price targets and ratings with an issuer prior to the launch of a deal?	Prohibited	Prohibited	Prohibited
Be compensated based on investment banking revenue?	Prohibited	Prohibited	Prohibited