

# FINRA Proposes Desk Commentary Safe Harbor

April 27, 2017

FINRA has published a [regulatory notice](#) requesting comment on a long-awaited proposal to create a safe harbor that will exempt qualifying desk commentary from most of its equity and debt research rules. Comments on the proposal, which has been proposed for member comment but not submitted to the SEC as a rule filing, are due by May 30, 2017.

## Background

In the regulatory notice, FINRA refers to desk commentary as a type of sales material directed to institutional investors that is based on the observations of sales and trading (“**S&T**”) or principal trading (“**PT**”) personnel, and that is usually brief, focused on the near term, and prepared and disseminated quickly in response to trading events or news flashes. FINRA explicitly acknowledges that many forms of desk commentary would not be considered a “research report” under the rules – defined as any written communication that includes an *analysis* of securities or issuers and provides information reasonably sufficient upon which to base an investment decision – due to insufficient analysis. Because of the broad definition of research report, however, there has been considerable uncertainty regarding where exactly the line is drawn between desk commentary that is, and is not, a research report.

The consequences of desk commentary being deemed a research report are significant. Any employee, regardless of title or department, who prepares a research report is considered a research analyst and is subject to extensive requirements under FINRA rules, including information barriers between research analysts and investment banking (“**IB**”) and other personnel, restrictions on research analyst compensation and extensive disclosure requirements, and, in the case of equity research, specialized qualification requirements.

## Proposed Safe Harbor

The proposed safe harbor would provide firms with more certainty in classifying certain communications by S&T or PT personnel as qualifying desk commentary that is subject to a significantly narrower set of requirements under the research rules than would apply to research reports. The safe harbor would permit firms to distribute qualifying desk commentary without complying with separation requirements between desk analysts and S&T and PT personnel and various disclosure requirements. In addition, the safe harbor would exempt desk analysts from compliance with the registration and qualification requirements for equity research analysts.

The relief provided by the proposed safe harbor would be similar to the relief provided by firms relying on the existing institutional exemption from certain requirements of the debt research rule (the “**Institutional Exemption**”); however, the exemptions differ in scope. The Institutional Exemption applies to all debt research reports and not just to desk commentary produced by S&T or PT personnel. On the other hand, the safe harbor would apply to debt and equity desk commentary, rather than solely debt research. Another significant difference is that firms relying on the Institutional Exemption must typically obtain affirmative consent from certain smaller institutions, whereas firms can provide qualifying desk commentary to all eligible institutional investors based solely on negative consent.

Importantly, the safe harbor is not exclusive. In some situations, firms will be able to make a reasonable determination that specific desk commentary does not constitute a research report and, therefore, it is not subject to the research rules and reliance on the proposed safe harbor (which would still subject the firm to some of the requirements of the research rules, as summarized below) is not necessary.

FINRA's approach in the proposed safe harbor of not excluding qualifying desk commentary from the definition of "research report" may result in some ambiguities or unexpected compliance obligations for firms seeking to rely on it. For example, desk commentary on equity securities that relies upon the safe harbor but which otherwise would be a research report would, absent SEC action, continue to be subject to Regulation AC. Also, FINRA does not mention in its notice the expected interaction with FINRA Rule 5280 (Trading Ahead of Research Reports), though it would be consistent with a recent FINRA FAQ for FINRA to exclude desk commentary from that rule.

## Threshold Conditions

The safe harbor would only be available for desk commentary that meets certain author, content and recipient conditions. Specifically, the desk commentary:

- **Author:** must be produced by S&T and PT personnel (referred to herein as "**desk analysts**") who:
  - are not primarily engaged in the preparation of research reports that do not meet the safe harbor content limitation;
  - do not require registration as a research analyst pursuant to NASD Rule 1050 because their primary job function is something other than to provide investment research; and
  - do not report to research department personnel.
- **Content:** must be limited to brief observations (not including a rating, price target or earnings estimate) regarding recent, current, or near-term expected trading activity, trading ideas or opportunities, market conditions, economic statistics or company results, or regarding a recent recommendation or research report.
- **Recipient:** may only be distributed to investors that:
  - meet the definition of "institutional account" under FINRA Rule 4512(c);
  - have satisfied the requirements for reliance upon the institutional suitability exemption in FINRA Rule 2111; and
  - have received a written disclosure that the firm may provide desk commentary that is not subject to all of the independence and disclosure standards applicable to research reports prepared for retail investors, and have not objected to receiving such desk commentary (i.e., negative consent). To avoid a disruption in the receipt of desk commentary, the proposal would provide firms with a 90-day transition period following the effective date of the rule during which desk commentary eligible for the safe harbor could be sent to eligible institutional investors without negative consent.

Firms relying on the safe harbor would also be required to establish policies and procedures reasonably designed to ensure that desk commentary subject to the safe harbor is made available only to eligible institutional investors.

## Requirements that Apply to Desk Commentary

### Conflict Management Requirements

The proposed safe harbor would provide relief for qualifying desk commentary from some – but not all – of the conflict management requirements contained in FINRA's equity and debt research rules. Specifically, a firm relying on the safe harbor would need to establish, maintain and enforce written policies and procedures reasonably designed to:

- prevent the use of desk commentary or desk analysts to manipulate the market;
- prohibit prepublication review by IB personnel and subject companies;

- establish information barriers or other safeguards reasonably designed to ensure that desk analysts are insulated from pressure by IB personnel or other persons who might be biased in their judgment or supervision;<sup>1</sup>
- prohibit retaliation against desk analysts for unfavorable desk commentary that may adversely affect the firm's business interests;
- prohibit explicit or implicit promises of favorable desk commentary as inducement for the receipt of business or compensation;
- restrict or limit desk analyst activities that can reasonably be expected to compromise their objectivity, including participation in pitches and other solicitations of IB transactions and participation in road shows and other marketing on behalf of an issuer related to an IB transaction;
- prohibit IB personnel from directing a desk analyst to engage in sales or marketing efforts related to an IB transaction and directing a desk analyst to communicate with a customer about an IB transaction; and
- prohibit desk analysts from communicating with a customer in the presence of IB personnel or company management about an IB transaction.

In addition, firms would still need to comply with applicable provisions of FINRA Rule 2210 (Communications with the Public), the anti-fraud provisions of the federal securities laws and FINRA rules, and the requirement to establish written procedures reasonably designed to prevent the dissemination of material nonpublic research information, such as through the selective early disclosure of ratings.

### **Additional Requirements for Equity Desk Commentary**

Firms distributing desk commentary regarding equity securities would be required to have policies and procedures reasonably designed to (i) prohibit persons engaged in IB activities from supervision or control of desk analysts, including influence or control over desk analyst compensation evaluation and determination; (ii) limit determination of the research department budget to senior management, excluding senior management engaged in IB activities; and (iii) prohibit compensation based upon specific IB transactions or contributions to a firm's IB activities.

### **Disclosure Requirements**

The proposed safe harbor would require desk commentary to carry a "health warning" stating that the document is intended for institutional investors and is not subject to all of the independence and disclosure standards applicable to research reports prepared for retail investors.

An additional disclosure would be required for any firm that either maintains a proprietary trading desk or trades for customers on a discretionary basis:

"Clients should assume that this document is not independent of [Firm's] proprietary interests. [Firm] trades, and will continue to trade, the securities covered in this document for its own account and on a discretionary basis on behalf of certain clients. Such trading interests may be contrary to or entered into in advance of this document."

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<sup>1</sup> FINRA noted that it would not interpret this condition as requiring physical separation between a desk analyst and other S&T or PT personnel; however, in the absence of such physical barriers, FINRA would expect firms to implement other policies and procedures to achieve compliance with this anti-pressuring requirement.

## Timing

Any safe harbor would not become effective until filed with and approved by the SEC, following an SEC comment period. As a result, even if FINRA ultimately moves forward and formally files the proposed safe harbor with the SEC as a proposed rule change, the rule will likely not become effective until sometime in 2018.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

<b>Annette L. Nazareth</b>	<b>202 962 7075</b>	<a href="mailto:annette.nazareth@davispolk.com">annette.nazareth@davispolk.com</a>
<b>Lanny A. Schwartz</b>	<b>212 450 4174</b>	<a href="mailto:lanny.schwartz@davispolk.com">lanny.schwartz@davispolk.com</a>
<b>Hilary S. Seo</b>	<b>212 450 4178</b>	<a href="mailto:hilary.seo@davispolk.com">hilary.seo@davispolk.com</a>
<b>Zachary J. Zweihorn</b>	<b>202 962 7136</b>	<a href="mailto:zachary.zweihorn@davispolk.com">zachary.zweihorn@davispolk.com</a>
<b>Jeffrey T. Dinwoodie</b>	<b>202 962 7132</b>	<a href="mailto:jeffrey.dinwoodie@davispolk.com">jeffrey.dinwoodie@davispolk.com</a>
<b>Mark A. Sater</b>	<b>212 450 3142</b>	<a href="mailto:mark.sater@davispolk.com">mark.sater@davispolk.com</a>

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