FINRA Seeks Comments on Potential Safe Harbor from Research Rules for Desk Commentary

Last week, the Financial Industry Regulatory Authority (FINRA) announced that it is seeking comment on a potential safe harbor for “desk commentary,” in what will likely be viewed by the industry as a welcome development. Desk commentary has generally not been treated as a “research report” under FINRA’s rules because commentary does not “include an analysis of” the relevant security “that provides information reasonably sufficient upon which to base an investment decision.” Typical examples of desk commentary would be an email or message from a trader to institutional investors regarding the trader’s observations about recent market events. However, until now, FINRA had never explicitly recognized a desk commentary exception to the broad definition of a research report. Recently, the common industry understanding had been questioned during FINRA examinations and investigations. FINRA exam staff, for example, have taken the position that desk commentary relating to either debt or equity securities could be considered a research report even if it contained only a very limited discussion about the fundamentals of an issuer or security.

If approved, the safe harbor would shield some desk commentary from the requirements relating to research regarding equity and debt securities imposed by FINRA Rules 2241 and 2242. According to FINRA, the proposed safe harbor would have no effect on the operation of the institutional-debt research exemption in Rule 2242(j).

The proposed safe harbor would only be available to communications that meet specific conditions regarding the author, the content of the communication and the recipient of the communication. Each limitation reflects FINRA’s stated objective to ensure that retail investors retain the full protections of the research rules and that any safe harbor does not cause firms to move their research function to the trading desk to avoid Rules 2241 or 2242.

- **Authorship:** To qualify for the safe harbor, the author must be part of “sales and trading” or “principal trading personnel” whose primary job functions do not involve investment research, who are not required to register as a research analyst under NASD Rule 1050 and who do not report directly or indirectly to personnel in the firm’s research department.

- **Content:** The safe harbor covers only communications that are “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.”
Recipients: The safe harbor would apply only to communications distributed to institutional accounts (as defined by Rule 4512(c)) that have satisfied FINRA’s institutional suitability standards and that consent to receiving the desk commentary. According to FINRA, it would be sufficient for a firm to notify an institutional investor that it may receive desk commentary and is not subject to all of the independence and disclosure standards applicable to research reports prepared for retail investors is the negative consent of an investor. Unless the investor opts out, it could then be sent desk commentary. FINRA indicated it would provide a “transition period” of up to 90 days after the effective date of the proposed amendments during which a firm could send desk commentary to an institutional account without first engaging in this negative consent process.

Health Warning: As an added measure to ensure that desk commentary is not improperly distributed to retail investors, the safe harbor would require firms to apply a health warning similar to the warning required by Rule 2242(j).

As FINRA’s notice makes clear, FINRA has concerns that some firms have sought (or may seek) to evade the requirements of FINRA’s research rules by simply re-labeling research reports as desk commentary. At the same time, FINRA acknowledged the value of trader commentary for institutional buy-side clients and its proposal reflects its appreciation that firms must have some clarity regarding how the rules will be applied. Accordingly, FINRA has underscored that the proposed safe harbor is “intended to create a feasible and effective supervisory framework that will provide firms more compliance certainty.”

Under the proposed release, a firm that seeks to rely upon the safe harbor would still have to establish, maintain and enforce written policies and procedures that are reasonably designed to address potential conflicts of interest, potential influence by the firm’s investment banking business and potential dissemination of material nonpublic information. In its release, FINRA identified specific aspects that a firm’s policies and procedures must address concerning conflicts or influence from the investment banking business, including information barriers, pre-publication review and potential retaliation for negative commentary. Additionally, a firm’s policies and procedures must be designed to prohibit, consistent with Rule 2241, improper influence on desk commentary regarding equity securities by a firm’s investment banking business. These requirements would require firms to establish information barriers that may not currently exist between trading desks that provide desk commentary and investment banking.

In contrast, traders who provide desk commentary that meets the safe harbor would not need to comply with certain provisions of Rules 2241 or 2242 concerning the separation of research from sales and trading personnel or the need to meet the requirements of NASD Rule 1050.

Importantly, the safe harbor would be non-exclusive. Therefore, under the proposed amendments, desk commentary that does not satisfy the safe harbor would still be allowed, so long as it is not actually a research report. As FINRA explained, this approach would permit firms to make “their own considered determination that desk commentary does not constitute a research report and therefore is not subject to the rules.” At the same time, FINRA has cautioned that “[d]esk commentary that meets the definition of research report but falls outside of these conditions—e.g., fundamental research or research distributed to retail investors—would be subject to the full scope of the applicable research rules.” In such a circumstance, where a firm “produces desk commentary that rises to the level of a research report but fails to satisfy the conditions of the proposed safe harbor,” the firm “could be found to have violated the research rules.”
FINRA’s proposed amendments underscore its stated desire to work with member firms to increase regulatory certainty while still effectively protecting market participants. Notably, the desk commentary safe harbor proposal was accompanied by a request for comment on the impact of a number of rules, including Rules 2241 and 2242, on broker-dealer activities related to raising capital. See Regulatory Notice 17-14. Given the growing uncertainty over the reach of Rules 2241 and 2242, FINRA’s proposed safe harbor could be welcome relief to traders and compliance officers who are forced to walk an increasingly fine line regarding the appropriateness of desk commentary. Nevertheless, even if the proposed amendments are adopted, member firms who plan to rely on the safe harbor should proceed carefully. As proposed, the safe harbor would only apply to a trader’s “brief observations” and only if the trader is “insulated from pressure” – requirements that could be interpreted in more than one way. Because of this flexibility, a member firm that intends to comply with the safe harbor may learn too late that FINRA examiners or enforcement attorneys take a comparatively narrow view of what traders may say and which traders may say it. As a result, if the proposals are enacted as written, member firms must continue to be mindful of the line that separates desk commentary from a research report.

Any comments are due by May 30, 2017. See Regulatory Notice 17-16.

If you have any questions regarding this Sidley Update, please contact the Sidley lawyer with whom you usually work, or

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1 Along with Rules 2241 and 2242, FINRA specifically sought comment on the effect of Rules 2310, 5110, 5151, 5122, 5130, 5131, 5141, 5150, 5160, 5190, 5250, 6432, rules regarding Capital Acquisition Brokers, rules regarding Funding Portals and FINRA’s Trading Activity Fee. FINRA also indicated that it welcomed comments on how any other rules might impact capital formation.