SHEARMAN & STERLING LLP

FINANCIAL INSTITUTIONS ADVISORY & FINANCIAL REGULATORY

CLIENT PUBLICATION

October 6, 2015

FINRA Publishes FAQs Regarding Research Conflicts of Interest in the Offering Process

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

Region

Charles S. Gittleman
New York
+1.212.848.7317
cgittleman@shearman.com

Russell D. Sacks
New York
+1.212.848.7585
rsacks@shearman.com

Jenny Ding
New York
+1.212.848.5095
jenny.ding@shearman.com

Oliver Linch
London
+44.20.7655.5715
oliver.linch@shearman.com

Jennifer D. Morton
New York
+1.212.848.5187
jennifer.morton@shearman.com

Steven Blau
Toronto
+1.416.360.2154
New York
+1.212.848.8534
steven.blau@shearman.com

SHEARMAN.COM

In late May, FINRA published a set of Frequently Asked Questions regarding FINRA's equity research rule,[1] which addresses interactions between issuers, research analysts and investment bankers in various stages of the offering process (the "Research FAQs" or the "FAQs").[2]

The Research FAQs appear in part designed to provide guidance regarding FINRA's views in light of recent enforcement actions in which FINRA found certain conduct violative of:

- FINRA's prohibition on analyst participation in efforts to solicit investment banking business; and,
- FINRA's prohibition on the offer of favorable research as consideration or inducement for the receipt of investment banking business.[3]

The guidance provided in the Research FAQs breaks down the offering process into three distinct stages,and indicates that FINRA believes that analyst issuer communications carry more or less risk of violating FINRA's equity research rules depending on the stage of the offering at which the communication is made. Despite this, the Research FAQs eschew bright lines prohibiting or permitting communications during the different stages, with FINRA instead noting that the context and content of the communication is essential to determining the degree of risk it carries.

1 FINRA's revised equity research rule, FINRA Rule 2241, is discussed in our client publication issued today, FINRA's New Fixed-Income Research Rule and Modifications to Equity Research Rule. The Research FAQs refer to the provisions of NASD Rule 2711 — those provisions remain unchanged in its successor, FINRA Rule 2241, which provisions will go into effect on December 24, 2015.

2 The FAQs are available at http://www.finra.org/industry/faq-research-rules-frequently-asked-questions-faq.

3 In the new equity research rule, FINRA Rule 2241, these prohibitions are found, respectively, at 2241(b)(2)(L) and 2241(b)(2)(K).

I. Overview: The Three Stages of the IPO Process Under the FAQs

The Research FAQs address the issue of analyst issuer communications during IPOs by focusing on three stages of an offering: (1) a pre IPO period, (2) a solicitation period and (3) a post mandate period.[4] The solicitation period begins when "the issuer makes known that it intends to proceed with an IPO and ends when there is a bona fide awarding of the underwriting mandates."[5] The solicitation period would end for a particular firm when it learns that it has been awarded a role in the offering or been rejected for a role. The FAQs state that there is a "sliding scale of attendant risks" for analyst issuer communications, which scale is based on the stage of the offering in which the communication takes place.

FINRA believes that the greatest risk of rule violations occurs with respect to communications by a research analyst with an issuer during a solicitation period. In contrast, FINRA states that such communications pose less risk of rule violations when they occur during a pre IPO period or a post mandate period. The FAQs make clear that this classification does not create periods during which communications are absolutely prohibited or absolutely permitted; instead, they are meant to serve as guideposts, and ultimately the inquiry relies heavily on the context and content of the communication.

II. The Pre IPO Period

The FAQs state that the risk of improper communications between analysts and issuers is generally lower in a pre IPO period than in a solicitation period, and that the risks inherent in analyst issuer discussions regarding the issuer's competitors, the IPO market and an issuer's readiness for an offering can effectively be managed through policies and procedures during this period. However, FINRA underlines that the pre IPO stage is not a safe harbor that shields all communications between analyst and issuer during this period.

In particular, FINRA sees risk in an analyst answering questions relating to how the analyst would value or position the issuer. FINRA sees risks in those questions even in a true pre IPO period, and cautions that the questions themselves may suggest that an IPO determination has already been made. FINRA suggests that firms' policies and procedures should address circumstances where issuer questions suggest that an IPO determination has already been made.

III. The Solicitation Period

1. Analyst Issuer Communications

FINRA considers communications by a research analyst with an issuer during a solicitation period, other than bona fide vetting or due diligence communications by the member, to carry significantly elevated risk. The FAQs recognize that analysts are allowed to engage in bona fide vetting and due diligence communications, which enable the analyst to assess

[4] The Research FAQs note that although the principles of the Research FAQs also apply to follow-on offerings, FINRA believes that the risks associated with analyst-issuer communications during the solicitation period in connection with a follow-on offering carry less risk and can be effectively managed by policies and procedures.

[5] FINRA notes that: "While typically a solicitation period will commence with a request for proposal from an issuer or other communication that will expressly indicate an intent to proceed with an IPO, firms must carefully assess the context and content of a request for information from an analyst by an issuer during an ostensible pre-IPO period. For example, where an analyst has indicia either from the type of information being requested by the issuer or from other reliable sources that the issuer has already determined to proceed with an IPO, the analyst should consult with legal and compliance personnel to make a reasonable determination whether a solicitation period has begun before complying with the information request."

the issuer for purposes of the underwriting commitment process and to share the analyst's views with the banking team and to gather information on behalf of investors. FINRA seems to generally view the flow of information from an issuer to the analyst as appropriate, but seems to see significant risk in the sharing of analyst opinions with the issuer in this period — in particular FINRA calls out the sharing of analyst views regarding valuation with an issuer, and an analyst making "positive statements to an issuer" in the solicitation period. FINRA notes that vetting and due diligence communications must be managed carefully to ensure they serve only their permitted purpose, and that any particular communication must be analyzed in its specific context.

As an example of a communication during the solicitation period that carries low risk, the FAQs imagine a research analyst "sharing his or her industry views at a previously scheduled conference during a solicitation period where the issuer may be in attendance." This, according to FINRA, is probably an acceptable communication, because it is unlikely that the analyst intends the remarks to induce the issuer to provide business or compensation, and it is equally unlikely that the issuer sees the remarks that way. However, gesturing toward recent enforcement actions, FINRA states that unmanageable risk is present when an analyst shares their view with the issuer after an issuer suggests that the selection of underwriters will be based on the views of a research analyst.

2. Analyst Banking Communications

The FAQs also address the interactions between analysts and banking teams, which interactions were also treated in recent enforcement actions. The FAQs state that it is not inconsistent with the equity research rule for investment bankers to consult with analysts during the solicitation period to get analyst views regarding valuation. However, bankers may not convey to the issuer that a valuation is either the research analyst's valuation or a joint valuation of the bankers and research analyst. Moreover, where there has been a request from the issuer or tacit understanding that the valuation of the bankers and research analyst will be aligned or that any valuation presented will reflect the analyst's views, any valuation provided by bankers to the issuer must affirmatively repudiate the overture and note that any valuation provided presents the bankers' views only and that the firm is not making any representation about the views of the research analyst. That repudiation must be documented.

FINRA notes that any communications between investment bankers and research analysts during a solicitation period regarding valuation or the research analyst's views present heightened risks that investment bankers will influence the research analyst's views and must be managed carefully.

3. Provision of Previously Published Research Reports to Issuers

The FAQs provide that investment bankers may provide (or arrange for others to provide) to an issuer during a solicitation period previously published research reports (or electronic access to those reports), upon request by the issuer, provided that the request is made to the investment bankers and not the research analyst, is unsolicited and the research reports have been previously published and generally made available to investing clients of the firm. The FAQs state that if an investment banker were to provide only its selection of reports or to comment on the reports, these actions would carry an elevated risk of being viewed as impermissible conduct.

IV. Post Mandate Period

The FAQs state that analyst issuer communications during a post mandate period pose less risk than during a solicitation period. FINRA notes that in a post mandate period, it would generally be appropriate for an analyst to communicate with the issuer their views about valuation, pricing and structuring of the transaction, even if the valuation or pricing assessment is positive.

The FAQs acknowledge that even after the awarding of mandates for a transaction, an issuer may still be determining the final roles or economics for the firms that have been selected to participate in the offering. But the FAQs state that the risks of analyst issuer communications can be effectively managed in this period by policies and procedures.

Again, however, FINRA makes clear that the context and content of a communication are the critical factors determining the degree of risk it carries, and that a post mandate period is not a safe harbor. For example, where an issuer indicates that final roles or economics will be based on the highest valuation given by a firm's research analyst, analyst issuer communications, in that context, would carry a heightened risk of constituting a promise of favorable research.

V. Issuer Conduct

The FAQs note that FINRA rules apply only to FINRA members, and as such, FINRA has no jurisdiction over conduct of non member issuers that invite, request or demand that FINRA members violate the principles set forth in the FAQs.

VI. Conclusion

In light of recent enforcement actions, the Research FAQs may serve as a welcome clarification of FINRA's views regarding specific types of analyst and banking communications during the offering process.

As discussed above in footnote 1, in addition to the Research FAQs, firms will also need to revisit their policies and procedures in respect of FINRA's revised equity research rule and establishment of a fixed-income research rule. The changes to NASD Rule 2711 will mostly go effective on December 24, 2015, although some changes, including changes to the quiet periods mandated by the rule, went into effect on September 25, 2015. The fixed-income research rule will be effective on February 22, 2015. Our client publication, FINRA's New Fixed-Income Research Rule and Modifications to Equity Research Rule, further discusses the changes.

ABU DHABI | BEIJING | BRUSSELS | DUBAI |FRANKFURT | HONG KONG | LONDON | MENLO PARK | MILAN | NEW YORK | PARIS
ROME | SAN FRANCISCO | SÃO PAULO | SAUDI ARABIA* | SHANGHAI | SINGAPORE | TOKYO | TORONTO | WASHINGTON, DC

599 LEXINGTON AVENUE | NEW YORK | NY | 10022-6069