

# Regulatory Notice

08-16

## Third-Party Research Reports

### Member Firm Disclosure and Supervisory Review Obligations

Effective Date: April 7, 2008

#### Executive Summary

Effective April 7, 2008, an amendment to revise NASD Rule 2711(h)(13) and Incorporated NYSE Rule 472(k)(4) modifies a member's disclosure and supervisory review obligations when it distributes or makes available third-party research reports.<sup>1</sup> The rule change creates a category of "independent third-party research" and eliminates certain supervisory review requirements when a member distributes or makes available such research. The text of the amendment is set forth in Attachment A.

Questions regarding this *Notice* should be directed to Philip Shaikun, Associate Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8451; or Erika Lazar, Senior Attorney, Office of General Counsel, at (646) 315-8512.

#### Background and Discussion

NASD Rule 2711(h)(13) and Incorporated NYSE Rule 472(k)(4) (the Rules) set forth a member's disclosure and supervisory review obligations when the member distributes—*i.e.*, "pushes out"—or makes available a research report produced by a third party. The rule change makes several modifications to those requirements.

#### Definitions

Attention should be paid in this *Notice* and the Rules to the distinctions between a "third-party research report" and an "independent third-party research report." A third-party research report is defined as a research report produced by a person or entity other than a member.

April 2008

#### Notice Type

- Rule Amendment

#### Suggested Routing

- Compliance
- Legal
- Research
- Senior Management

#### Key Topic(s)

- Research Analysts
- Research Reports
- Supervision
- Third-Party Research Reports

#### Referenced Rules & Notices

- NASD Rule 2210
- NASD Rule 2711
- NYSE Rule 344
- NYSE Rule 342
- NYSE Rule 472

An independent third-party research report is defined as a research report in respect of which the person or entity producing the report (1) has no affiliation or contractual relationship with the distributing member or that member's affiliates that is reasonably likely to inform the content of its research reports;<sup>2</sup> and (2) makes content determinations without any input from the distributing member or that member's affiliates.

The second prong of the definition of independent third-party research report means that a distributing firm cannot have any input into the outcome of the research report. A member may have input into determining which companies or sectors are to be covered, but there may not be any explicit or implicit agreements, understandings or expectations as to any particular conclusions or recommendations of the resultant research reports.

### Third-Party Disclosures

The Rules require a member firm that distributes a third-party research report to accompany the report with certain current applicable disclosures (third-party disclosures) as they pertain to the firm.<sup>3</sup> Currently, the third-party disclosure requirements do not apply if a member firm makes available to its customers non-affiliate research either (1) upon request or (2) through a member-maintained Web site.

The rule change maintains those two exceptions for independent third-party research only and adds a third exception from making third-party disclosures for such research. The third exception arises when the registered representative has informed the customer, during the course of a solicited order, of the availability of an independent third-party research report and the customer requests such research report.

The disclosure requirements still pertain when a member firm "pushes out" independent third-party research reports—*i.e.*, does not meet one of the three exceptions—and to any third-party research report that does not meet the definition of independent third-party research report, irrespective of whether it is distributed or made available.

The rule change also provides that member firms may either accompany third-party research reports with the applicable disclosures or provide a Web address in the report that directs the recipient to a location where such disclosures can be found.

### Supervisory Review and Approval of Third-Party Research

The current Rules require a registered principal or a supervisory analyst, approved pursuant to NYSE Rule 344, to approve by signature or initial any third-party research distributed by a member firm and to review such research to ensure that the applicable disclosures are complete and accurate (disclosure review) and the content of the research reports contains no untrue statement of material fact or is otherwise not false or misleading (content review).<sup>4</sup>

With respect to the disclosure review requirement, in view of the volume of third-party research reports distributed by many firms, FINRA has amended the Rules to establish a more principles-based standard of review: Member firms must establish written supervisory policies and procedures reasonably designed to ensure the completeness and accuracy of all applicable disclosures. Thus, for example, a firm may employ spot-checking systems or other review mechanisms to ensure compliance with the disclosure review requirement.

The rule change eliminates the content review requirement when a member firm distributes independent third-party research. It also codifies FINRA's interpretation regarding the scope of the content review to provide that a member firm's approval of third-party research reports shall be based on a review to determine that the report does not contain any untrue statement of material fact or any false or misleading information that (1) should be known from a reading of the report or (2) is known based on information otherwise possessed by the member.

FINRA intends for the amendment to the Rules to promote the availability of independent third-party research—a valuable source of independent analysis for investors that can be compared with or supplement a firm's own research. At the same time, the amendment maintains member supervisory review in those circumstances where the firm's relationship with the research provider is such that the research is not wholly free from the control or influence of the member firm.

## Endnotes

- 1 See Securities Exchange Act Release No. 57279 (February 6, 2008); 73 FR 8089 (February 12, 2008); Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of Proposed Rule Change as Modified by Amendment No. 1 to Amend NASD Rule 2711 (Research Analysts and Research Reports) and NYSE Rule 472 (Communications With The Public) Regarding a Member's Disclosure and Supervisory Review Obligations When it Distributes or Makes Available Third-Party Research Reports; File No. SR-FINRA-2007-011.
- 2 For the avoidance of any doubt, FINRA staff wish to make clear that the first prong of the definitional test of independent third party research is meant to be read as excluding from the definition all research produced by (1) an affiliate; and (2) all other parties that have a contractual relationship with the distributing member firm or that firm's affiliates that is reasonably likely to inform the content of its research reports.
- 3 A distributing member firm must disclose the following, if applicable: (1) If the member firm owns 1 percent or more of any class of equity securities of the subject company; (2) if the member firm or any affiliate has managed or co-managed a public offering of securities of the subject company or received compensation for investment banking services from the subject company in the past 12 months, or expects to receive or intends to seek compensation for such services in the next three months; (3) if the member firm makes a market in the subject company's securities; and (4) any other actual, material conflict of interest of the research analyst or member firm of which the research analyst knows or has reason to know at the time the research report is distributed or made available.
- 4 Incorporated NYSE Rule 472(k)(4) requires a supervisory analyst approved pursuant to NYSE Rule 344 or a qualified person, designated pursuant to NYSE Rule 342(b)(1), to approve by signature or initial any third-party research distributed by a member organization and to complete the disclosure and content reviews.

## Attachment A

New language is underlined. Deleted language is bracketed.

### 2700. SECURITIES DISTRIBUTIONS

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#### 2711. Research Analysts and Research Reports

(a) through (g) No Change.

##### (h) Disclosure Requirements

(1) through (12) No Change.

##### (13) Third-Party Research Reports

(A) Subject to paragraph (h)(13)(B) of this Rule, if a member distributes or makes available any third-party research report[ that is produced by another member, a non-member affiliate of the member or an independent third party], the member must accompany the research report with, or provide a web address that directs the recipient to, the current applicable disclosures, as they pertain to the member,[ that are] required by paragraphs (h)(1)(B), (h)(1)(C), (h)(2)(A)(ii) and (h)(8) of this Rule. Members must establish written supervisory policies and procedures reasonably designed to ensure the completeness and accuracy of all applicable disclosures.

(B) The requirements of paragraph (h)(13)(A) of this Rule shall not apply to independent third-party research reports[ prepared by an independent third party that the member makes] made available by a member to its customers:

(i) [either ]upon request;

(ii) in connection with a solicited order in which a registered representative has informed the customer, during the solicitation, of the availability of independent research on the solicited equity security, and the customer requests such independent research; or

(iii) through a member-maintained web site.

(C) Subject to paragraph (h)(13)(D) of this Rule, [A]a registered principal (or supervisory analyst approved pursuant to Rule 344 of the New York Stock Exchange) must approve by signature or initial [any]all third-party research reports distributed by a member. The approval of third-party research shall be based on a review [All third-party research distributed by a member must be reviewed ]by the designated principal (or supervisory analyst approved pursuant to NYSE Rule 344) to determine that [the applicable disclosures required by Rule 2711 are complete and accurate, and] the content of the research report, pursuant to Rule 2210(d)(1)(B), contains no untrue statement of material fact or is otherwise not false or misleading. For the purposes of this Rule only, a member's obligation to review a third-party research report pursuant to Rule 2210(d)(1)(B) extends to any untrue statement of material fact or any false or misleading information that:

a. should be known from reading the report;

or

b. is known based on information otherwise possessed by the member.

[is consistent with all applicable standards regarding communications with the public.]

(D) The requirements of paragraph (h)(13)(C) of this Rule shall not apply to independent third-party research reports distributed or made available by a member.

(E) For the purposes of this Rule, "third-party research report" shall mean a research report that is produced by a person or entity other than the member and "independent third-party research report" shall mean a third-party research report, in respect of which the person or entity producing the report:

(i) has no affiliation or business or contractual relationship with the distributing member or that member's affiliates that is reasonably likely to inform the content of its research reports; and

(ii) makes content determinations without any input from the distributing member or that member's affiliates.

(i) through (k) No Change.

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## Rule 472. Communications With The Public

(a) through (k)(3) No Change.

### (k)(4) Third-Party Research Reports

(i) Subject to paragraph (k)(4)(ii) of this Rule, if a member organization distributes or makes available any third-party research report[s produced by another member organization, a non-member organization affiliate of a member organization, such as a foreign or domestic broker-dealer or investment adviser, or an independent third party], the member organization must accompany the research report with, or provide a web address that directs the recipient to, the current applicable disclosures, as they pertain to the member organization, [that are] required by paragraphs (k)(1)(i)c, (k)(1)(i)a, (k)(1)(i)b and (k)(1)(iii)d of this Rule. Member organizations must establish written supervisory policies and procedures reasonably designed to ensure the completeness and accuracy of all applicable disclosures.

[a. A supervisory analyst qualified under NYSE Rule 344 must approve, pursuant to Rule 472(a)(2), by signature or initial any third-party research distributed by a member organization; and

b. A supervisory analyst or qualified person designated pursuant to Rule 342(b)(1) (e.g., a person who has taken and passed the Series 9/10, or another examination acceptable to the Exchange which demonstrates competency relevant to assigned responsibilities, including the Series 24 if taken and passed after July 1, 2001) must review third-party research distributed by a member organization to determine that the disclosures required by Rule 472(k)(1)(i)c, (k)(1)(i)a, (k)(1)(i)b and (k)(1)(iii)d are complete and accurate, and that the content of the research report is consistent with all applicable standards regarding communications with the public.]

(ii) The requirements in paragraph (k)(4)(i) of this Rule shall not apply to independent third-party research reports [prepared by an independent third party that the member organization makes] made available by a member organization to its customers:

a. [either ]upon request;

- b. in connection with a solicited order in which a registered representative has informed the customer, during the solicitation, of the availability of independent research on the solicited equity security, and the customer requests such independent research; or
- c. through a member organization-maintained website.

(iii) Subject to paragraph (k)(4)(iv) of this Rule, a supervisory analyst, qualified under NYSE Rule 344, or a qualified person, designated pursuant to Rule 342(b)(1), must approve by signature or initial all third-party research reports distributed by a member organization. The approval of third-party research shall be based on a review by the designated supervisory analyst or qualified person to determine that the content of the research report, pursuant to Rule 472(i), contains no untrue statement of material fact or is otherwise not false or misleading. For the purposes of paragraph (k)(4) of this Rule only, a member organization's obligation to review a third-party research report pursuant to Rule 472(i) extends to any untrue statement of material fact or any false or misleading information that:

- 1. should be known from reading the report; or
- 2. is known based on information otherwise possessed by the member organization.

(iv) The requirements of paragraph (k)(4)(iii) of this Rule shall not apply to independent third-party research reports distributed or made available by a member organization.

(v) For the purposes of this Rule, "third-party research report" shall mean a research report that is produced by a person or entity other than the member organization and "independent third-party research report" shall mean a third-party research report, in respect of which the person or entity producing the report:

- a. has no affiliation or business or contractual relationship with the distributing member organization or that member organization's affiliates that is reasonably likely to inform the content of its research reports; and
- b. makes content determinations without any input from the distributing member organization or that member organization's affiliates.

**(l) through (m)** No Change.

Supplementary Material .10 through .140 No Change.

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