



NASAA

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**NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.**

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December 19, 2014

*Submitted electronically to rule-comments@sec.gov*

Brent J. Fields, Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

RE: Release No. 34-73622, File Number SR-FINRA-2014-047

Dear Mr. Fields:

On behalf of the North American Securities Administrators Association (“NASAA”),<sup>1</sup> I hereby submit the following comments in response to Release No. 34-73622, File Number SR-FINRA-2014-047, entitled *Notice of Filing of a Proposed Rule Change to Adopt FINRA Rule 2241 (Research Analysts and Research Reports) in the Consolidated FINRA Rule Book* filed on November 18, 2014 (“The Proposal”).<sup>2</sup> The Proposal contemplates a significant change to the regulatory framework surrounding the conflicts of interest inherently present between a firm’s investment banking and equity research analysis business. NASAA appreciates the opportunity to offer its comments.

The conflicts present between a firm’s investment banking business and its equity research department are well documented, and prior to the Global Settlement reached in 2003, were ineffectively managed by firms. In recognition of this mismanagement and the harm it dealt investors, ten of the largest firms settled disputes with several securities regulators, including state securities regulators. The 2003 Global Settlement resulted in total settlement payments of more than \$1.4 billion. In addition to the financial penalties, the firms agreed to implement significant changes in their organizational structures requiring the separation of their investment banking business and their research departments. Additionally, in light of the significant investor harm that resulted from these conflicts of interest, Congress, with the adoption of Sarbanes Oxley in 2002, required the SEC to further address these issues. In response, the NASD and NYSE (whose merger resulted in the creation of FINRA) promulgated rules, incorporating many of the requirements laid out in the Global Settlement, subjecting firms

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<sup>1</sup> NASAA is the association of the 67 state, provincial, and territorial securities regulatory agencies of the United States, Canada, and Mexico. NASAA serves as the forum for these regulators to work with each other in an effort to protect investors at the grassroots level and to promote fair and open capital markets.

<sup>2</sup> Notice of Filing of a Proposed Rule Change to Adopt FINRA Rule 2241 (Research Analysts and Research Reports) in the Consolidated FINRA Rule Book, 79 Fed. Reg. 69939 (Nov. 24, 2014).

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to a strict, proscriptive regulatory regime designed to further mitigate the conflicts of interest created when a firm's investment banking business is intertwined with its research department.

FINRA now seeks to modify these rules. While the Proposal retains many of the provisions of the current rule and proposes to add certain other restrictions, NASAA is concerned that the overall effect of the Proposal will reduce the effectiveness of this regulatory regime. More specifically, FINRA has proposed to shift this regulatory regime from a proscriptive scheme to one based on a firm's written policies and procedures. In NASAA's view, a rule with clearly stated requirements and restrictions is necessary to foster uniform practices and safeguards to protect investors. NASAA agrees that a policies and procedures approach gives firms additional compliance flexibility, which in many circumstances is appropriate and effective. However, due to the nature of the conflicts of interest between a firm's investment banking business and its research department and the industry's history of failing to mitigate or eliminate these conflicts, a proscriptive regime, in addition to a requirement that firms establish policies and procedures designed to prevent violations is required to ensure investors remain protected.

The conflicts of interest created when a firm's research department is not effectively insulated and independent from a firm's investment banking business can result in the production of unreliable research reports prepared not to present a reliable, unbiased opinion, but instead prepared to entice an issuer to engage the firm for a new issuance or other deal. Because investors look to this research when making investment decisions, it is essential that research be accurate, objective, and free from undue influence or pressure that could push an analyst to make recommendations based not on the facts, but instead to generate new business for the firm.

As FINRA explains in the Proposal, the current proscriptive scheme has been "effective in helping to restore integrity to research by minimizing influence of investment banking and promoting transparency of other potential conflicts of interest."<sup>3</sup> NASAA agrees that the current regulatory regime has reduced the harms cause by these conflicts of interest; however, as recent cases show, certain firms in the industry have continued to engage in conduct prohibited by the current rules.

For example, on October 26, 2012 and again on October 2, 2013, Massachusetts entered consent orders fining Citigroup a total of \$32 million for alleged violations of the analyst rules.<sup>4</sup> More recently, on November 24, 2014, FINRA fined Citigroup \$15 million for similar violations of the analyst rules. In that case, FINRA alleged that Citigroup's internal controls for supervising its research analysts' interactions with clients were lacking and Citigroup failed to

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<sup>3</sup> *Id.* at 69940.

<sup>4</sup> See *In Re Citigroup Global Markets, Inc.*, Docket No. 2012-0090 (Oct. 2, 2012), available at [http://www.sec.state.ma.us/sct/archived/sctciti/Citi\\_Consent.pdf](http://www.sec.state.ma.us/sct/archived/sctciti/Citi_Consent.pdf); see also *In Re Citigroup Global Markets, Inc.*, Docket No. 2013-0014 (Oct. 2, 2013), available at <http://www.sec.state.ma.us/sct/current/sctcitigroup/citigroup-consent-order.pdf>.

properly discipline violations it had detected.<sup>5</sup> Additionally, according to FINRA, Citigroup's then-existing policies and procedures did not prevent certain communications prohibited by the current rules.<sup>6</sup>

On December 11, 2014, FINRA announced another settlement with ten firms for alleged violations of the research rules. In that case, FINRA settled allegations that the firms allowed their research analysts to solicit a potential investment banking client by offering favorable research coverage. In settling the matter, the firms agreed to pay fines totaling more than \$43 million. Additionally, FINRA determined that six of the settling firms "had inadequate supervisory procedures related to research analysts' participation in investment banking pitches."<sup>7</sup>

The above examples show that even under the current proscriptive rules, firms continue in their failure to adequately mitigate the risks associated with the conflicts of interest between their investment banking business and their research departments. Given the continued violations and the risk to investors posed by a failure to address these conflicts, NASAA opposes a shift to the more flexible policies and procedures scheme contained in the Proposal without also maintaining the proscriptive nature of the current rules. In light of the continued failure by firms to address these issues, the increased flexibility allowed under a policies and procedures scheme is inappropriate. The current proscriptive regime should remain, and firms should also be required to maintain policies and procedures designed to ensure compliance.<sup>8</sup>

The Proposal also includes certain substantive changes to the rule. Some of these changes would add additional requirements, while others reduce or limit a firm's current obligations. NASAA supports the Proposal insofar as it expands the definition of a research report,<sup>9</sup> requires any recommendations to be based on "reliable information,"<sup>10</sup> expands the required disclosure requirements to those that "with the ability to influence the content of a research report,"<sup>11</sup> requires the disclosure of debt holdings,<sup>12</sup> and prevents firms from giving

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<sup>5</sup> Michael Corkery, "Finra Fines Citigroup Over Acts by Analysts," NEW YORK TIMES (Nov. 24, 2014), available at [http://dealbook.nytimes.com/2014/11/24/citigroup-fined-15-million-for-failing-to-properly-supervise-analysts/?\\_r=0](http://dealbook.nytimes.com/2014/11/24/citigroup-fined-15-million-for-failing-to-properly-supervise-analysts/?_r=0).

<sup>6</sup> *Id.*

<sup>7</sup> "10 Wall Street Firms Fined Over Conflicts in Toys 'R' Us I.P.O.," NEW YORK TIMES (Dec. 11, 2014), available at <http://dealbook.nytimes.com/2014/12/11/10-wall-street-firms-fined-over-conflicts-in-toys-r-us-i-p-o/>.

<sup>8</sup> Proposed Supplementary Material .09 indicates that any violation of a firm's policies and procedures that are developed under the newly proposed rule will constitute a violation of the rule itself. Proposed Supplementary Material .09 also indicates that if an associated person engages in any conduct that the policies and procedures developed under this rule are designed to prohibit or restrict, any such conduct will be considered a violation of the rule. Proposed Supplementary Material .09 could be read to retain the proscriptive nature of the current rules, albeit in a complex and confusing manner. In NASAA's view, FINRA's rules should be clear in their prohibition of certain conduct in this area and also be clear that firms should have policies and procedures designed to prevent that conduct.

<sup>9</sup> 79 Fed. Reg. at 69941.

<sup>10</sup> *Id.* at 69946.

<sup>11</sup> *Id.* at 69947.

<sup>12</sup> *Id.* at 69946.

certain groups advanced access to research.<sup>13</sup> While NASAA believes these additional changes will further mitigate the risks surrounding research, these changes would be more effective in a regulatory scheme that combines both the current proscriptive regime and the proposed policies and procedures approach outlined in the Proposal.

The Proposal also relaxes certain provisions of the current rule. Most notably, the Proposal eliminates or reduces the quiet periods in which a firm cannot produce research reports following its participation in an offering.<sup>14</sup> Specifically, FINRA has proposed to reduce the quiet periods following an initial public offering from 40 days to 10 days and from 10 days to 3 days following a firm's participation in a secondary offering.<sup>15</sup> FINRA also proposes to eliminate the 15-day quiet periods before or after the expiration of a waiver agreement and before or after the termination of a lock-up agreement.<sup>16</sup> FINRA argues the reducing or eliminating these quiet periods will provide investors with more information by increasing the flow of information in the markets.<sup>17</sup> FINRA also argues that other provisions in the Proposal and the requirements of SEC Regulation AC, are adequate to ensure the objectivity of research reports and justify the changes to the quiet periods.<sup>18</sup> Given the continued violations by the industry in this area, including the recent actions by FINRA discussed above in which analysts promised favorable coverage to potential clients, NASAA does not support the elimination or reduction of these quiet periods.

The Proposal also adds a provision that would allow FINRA "to . . . grant, in exceptional and unusual circumstances, an exemption from any requirement of the proposed rules for good cause shown."<sup>19</sup> FINRA's rationale for this authority is that "the scope of the rule's subject matter and the diversity of firms, sizes structures and research business and distribution models" is so broad that this authority would be "useful and appropriate."<sup>20</sup> Without additional justification or examples of what circumstances would justify such an exemption, NASAA cannot support this provision.

Given the risks posed by the conflicts of interest present between a firm's investment banking business and its research department and the industry's continued failure to effectively address them, as evidenced by the recent violations, NASAA does not support the Proposal's shift to a policies and procedures based approach alone as a means of mitigating these risks. In NASAA's view, the proposed policies and procedures should be added to the existing proscriptive regime, and the Proposal's enhancements should be incorporated into the existing framework. NASAA appreciates the opportunity to offer its comments on the Proposal, and should you have any questions about these comments, please contact NASAA's Acting Executive Director and General Counsel, Joseph Brady, at [jb@nasaa.org](mailto:jb@nasaa.org).

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<sup>13</sup> *Id.* at 69948.

<sup>14</sup> *Id.* at 69943.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.* at 69944.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at 69950.

<sup>20</sup> *Id.*

Brent J. Fields  
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Sincerely,

A handwritten signature in black ink, appearing to read "William Beatty". The signature is fluid and cursive, with a large initial "W" and a long, sweeping tail.

William Beatty  
NASAA President  
Washington Securities Administrator