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April 7, 2014

Via Email Only

Ms. Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090
rule-comments@sec.gov

Re: SR-FINRA-2014-010—Proposed Rule Change to Adopt FINRA Rule 2243 (Disclosure and Reporting Obligations Related to Recruitment Practices)

Dear Ms. Murphy,

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by the Financial Industry Regulatory Authority ("FINRA") to govern the conduct of securities firms and their representatives. In particular, our members and their clients have a strong interest in FINRA rules relating to investor protection and disclosure.

Although we detail our reservations below, PIABA supports the proposed rule because public investors would benefit from knowing about any enhanced compensation agreement which might affect a registered representative's investment recommendations. Despite our reservations, PIABA, FINRA and the Securities and Exchange Commission (the "Commission") all agree that registered representatives' compensation arrangements may create material conflicts of interest between registered representatives' and public investors' interests.

In 2009, Mary L. Shapiro, then the Commission's Chairman, released an open letter to the chief executive officers of broker-dealer firms on the issue.[1] In her letter, Chairman Shapiro stated that enhanced compensation arrangements could motivate registered representatives to "churn customer accounts, recommend unsuitable investment products or otherwise engage in investment activity that generates

[1] SEC Chairman M. Schapiro, Open Letter to Broker-Dealer CEOs (Aug. 31, 2009), *available*: http://www.sec.gov/news/press/2009/2009-189-letter.pdf.

commission revenue but is not in investors' interest."[2] Similarly, in its October 2013 Report on Conflicts of Interest, FINRA made clear that "Financial compensation is a major source of conflicts of interest. The rewards firms offer associated persons may influence their behavior in ways that affect customer interests."[3]

PIABA wholeheartedly agrees with FINRA's observation that compensation structures may influence registered representatives' behavior and believes that greater efforts should be made to ensure that customers understand their registered representative's compensation. Far too often, retail customers do not understand their financial advisers' compensation or conflicts of interest. In 2012, the Commission released its *Study Regarding Financial Literacy Among Investors* (the *"Literacy Study")*.[4] In addition to documenting that most retail investors lack basic financial literacy, the *Literacy Study* found that retail investors consider information about an investment adviser's fees and conflicts of interest *"to be absolutely essential."*[5] The *Literacy Study* also found that retail investors want "to receive disclosure information before making a decision on whether to engage a financial intermediary or purchase an investment product or service."[6] PIABA applauds the proposed rule as a step in the right direction but is concerned that it may be too limited to address the problem adequately.

<u>Every Customer Should Know about Enhanced Compensation Agreements</u>

Despite supporting the proposed rule, PIABA believes that FINRA's proposed rule does not go far enough to combat the magnified conflicts of interest created by enhanced compensation agreements. In particular, FINRA's proposed rule only requires disclosure of an enhanced compensation agreement if a registered representative moves from one member firm to different member firm. Consistent with FINRA and the Commission's reasoning that enhanced compensation creates disclosure-worthy conflicts, PIABA believes that all enhanced compensation agreements should be disclosed to all customers, not just to the former customers of a registered representative who has changed firms.

PIABA's proposed approach would help ensure that customers receive some of the material information about recommended securities transactions and potential conflicts of interest. Under existing federal and state law, FINRA's member-firms are

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[2] *Id.*

[3] FINRA, Report on Conflicts of Interest 26 (Oct. 2013), *available:* https://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf

[4] SEC, Study Regarding Financial Literacy Among Investors (Aug. 2012), *available: https://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf.*

[5] *Id.* At xviii.

[6] *Id.* At xvii.

already required to disclose all material facts to investors.[7] This means that any fact, such as excess bonus commissions for selling a particular products, should be disclosed when it "significantly alter[s] the total mix of information made available" to an investor when evaluating a registered representative's recommendation to purchase a particular security.[8] Indeed, the Second Circuit has expressly found that the commissions broker-dealers receive on financial products "they sell to the public are relevant and must be disclosed."[9] Courts have "rejected . . . argument[s] that bonus commissions are immaterial" and found that failure to disclose commissions may even give rise to criminal liability in certain cases.[10] PIABA believes that enhanced compensation agreements should be disclosed to investors in all cases.

The old firm should be required to disclose any enhanced compensation as well. Despite the need to disclose all material information, FINRA's proposed rule focuses too narrowly on enhanced compensation for registered representatives switching firms. To put the issue in perspective, consider the events surrounding a registered representative's departure to a new firm. By switching firms, a registered representative ignites a chaotic scrum for client control. Freshly allied with a new firm, the registered representative must contact her old clients and persuade them to join her at the new firm. With an enhanced compensation agreement, her pay may depend on how many clients she convinces to switch with her. Meanwhile, the branch manager or newly assigned brokers at the old firm may receive a bonus for how many clients they convince to remain behind. FINRA's proposed rule only requires the new firm to disclose enhanced compensation while allowing the old firm to remain silent about any enhanced compensation it may pay for convincing clients to abandon the trusted financial adviser who has changed firms. If the old firm retains a significant number of clients, the transferred registered representative may need to find new clients to generate enough revenue to meet production targets under any enhanced compensation agreement at the new firm. Because this process is rife with clashing conflicts, PIABA believes that the customer should be told about *all* enhanced compensation agreements, whenever they are in place, whether they be paid by the new firm or the old.

The rule should be extended to include new customers who are subject to the same risks. Surely, a registered representative's new customers deserve the same amount of information as old customers. Indeed, as the Commission's *Literacy Study* found, retail investors desire this information before hiring a financial advisor. While PIABA believes that no good reason for excluding new customers exists, FINRA's proposal defends its decision to deny disclosure to new customers by asserting that old customers warrant special

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[7] *See* Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988).
[8] *Id.* (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).
[9] Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 756 F.2d 230, 242 (2d Cir. 1985).
[10] United States v. Laurienti, 611 F.3d 530, 541 (9th Cir. 2010) (affirming criminal convictions for failure to disclose extra commissions and markups in a pump and dump scheme).

treatment. FINRA argues that old customers must consider the costs of bringing their account to the new firm. Although sensible sounding, the costs to transfer an account are relatively *de minimus* compared to the potential costs to any customer, old or new, of receiving advice from a conflicted financial advisor. Further, to the extent that transfer fees are an issue, a new customer's assets must come from some other place before being transferred to the control of one of FINRA's member-firms. Accordingly, PIABA believes that FINRA should adopt a broader rule extending the same protections to new and old customers alike. Moreover, PIABA believes that enhanced compensation agreements should always be disclosed, not merely during the first year of their existence.[11]

The Conflicts involved in Enhanced Compensation Need to be
Explained to Customers in the Disclosure

While the proposed rule requires the disclosure of the amount of upfront payments and potential future payments, the Recruitment Disclosure Form does not adequately explain to customers what the conflict is. Customers should be told that the size of the advisors upfront compensation is being determined by the amount of commissions generated and assets held at her prior firm for the past twelve months. More importantly, the customer should also be told that the advisor will only receive future bonus payments if she achieves certain production and/or asset targets over a certain time-frame. The built-in incentive to hit back-end production targets exposes the customer to the most danger from conflicted financial advisors. Presently, the proposed Recruitment Disclosure Form's check-the-circle explanation is inadequate.

The new rule fails to tell customers how long their commissions may be used to calculate their advisors' back-end compensation. As noted above, the SEC and FINRA both believe that enhanced compensation creates disclosure-worthy conflicts. Therefore, customers must be told how long those enhanced compensation programs will last in order to be vigilant and properly weigh their advisors' recommendations against the advisor's personal motivation to hit her back-end targets and receive the additional bonus money.

The Purported *De Minimis* Exception Is Not *De Minimis*

When FINRA first proposed this rule, it contained a so-called *de minimis* exception to exempt disclosure for enhanced compensation of less than $50,000. FINRA's current

[11] In public comments, others noted that other forms of special compensation agreements may exist without disclosure, such as year-over-year production bonuses, club programs, trainee programs and other special incentive programs. PIABA believes that public customers should be told about any enhanced compensation agreement, not merely ones put in place in instances where a registered representative changes firms.

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proposal has doubled this amount to $100,000. Only on Wall Street could such an amount on compensation be considered *de* minimus. Black's Law Dictionary defines *de minimis* as "trifling; minimal" or "so insignificant that a court may overlook it in deciding an issue or case."[12] To put this in perspective, the 2012 median annual wages for a person providing securities and commodity contracts intermediation, *i.e.* a registered representative, came to $99,940.[13] The proposed rule would consider it trifling and unworthy of mention when the median registered representative received a full year's salary in enhanced compensation. As we stated in our initial letter, PIABA believes that, at least $250,000 would be an appropriate amount for a *de minimis* exemption.

<u>Enhanced Compensation Disclosures Should Be in Writing and Delivered Early</u>

As we stated in our initial letter, PIABA believes that enhanced compensation should be disclosed in writing and as close as practicable to the time of initial contact with the investor. As the *Literacy Study* made clear, retail investors need information about conflicts when making their decision about whether to use a particular financial intermediary. If the information arrives weeks later, bundled with transfer authorization documents, the disclosure may not serve its intended purpose and the investor may not be able to take the information into account when making her decision.

The current proposal all but ensures that any enhanced compensation disclosures will be bundled with account transfer approval documentation. FINRA's proposed rule states that the written disclosures must be "sent within 10 business days from [initial] oral contact *or with the account transfer approval documentation, whichever is earlier.*" (emphasis added). This rule sets the stage for FINRA's member-firms to pack an envelope with voluminous, soporific disclosures, ensuring that few of them will ever be read. PIABA believes that enhanced compensation should be disclosed in writing, on its own, and sent before account transfer documentation to ensure that retail customers will be able to make an informed decision about whether to change accounts. If the disclosures arrive with the account transfer documentation and glossy brochures about the new firm, customers may miss this important disclosure.

To ensure efficacy, the enhanced compensation disclosures should be presented in a clear readable format. The disclosure should include answers to at least the following questions:

- What is the registered representative's stated rationale for changing firms?
- Is the registered representative receiving enhanced compensation, and if so, for how long?

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[12] DE MINIMIS, Black's Law Dictionary (9th ed. 2009).

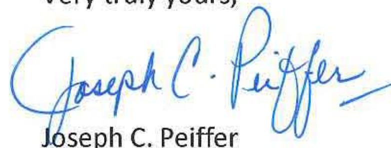
[13] Bureau of Labor Statistics, Occupational Outlook Handbook, *available:* http://www.bls.gov/ooh/sales/securities-commodities-and-financial-services-sales-agents.htm#tab-5.

- Is any of the enhanced compensation contingent on the registered representative's production at the new firm or on getting her former clients to transfer firms?
- How are fees different at the new firm?

Conclusion

In summary, PIABA supports FINRA's proposed rule but believes that it does not go far enough to ensure and explain adequate disclosure. PIABA thanks the Commission for the opportunity to comment on this proposal.

Very truly yours,



Joseph C. Peiffer