PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION
2415 A Wilcox Drive | Norman, OK 73069
Toll Free (888) 621-7484 | Fax (405) 360-2063
www.piaba.org

July 13, 2015

Via Email Only

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K. Street, NW
Washington, D.C. 20006-1506
pubcom@finra.org

Re: Regulatory Notice 15-19 (Comment on Revised Proposed Rule to Require Delivery of an Educational Communication to Customers of a Transferring Representative)

Dear Ms. Asquith:

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") relating to both investor protection and disclosure. Our members and their clients have a strong interest in FINRA rules relating to both investor protection and disclosure. As such, PIABA frequently comments upon proposed rule changes in order to protect the rights and fair treatment of the investing public. PIABA submits this comment because although the bar association believes the proposed rule is certainly a positive step, PIABA believes the rule should go farther in terms of education communication content and application.

Background

Pursuant to Section 19(b) of Securities Exchange Act of 1934 (SEA), before becoming effective, a proposed rule must be authorized for filing by the Board of Governors and must be filed with the Securities and Exchange Commission ("SEC") after a mandatory comment period. As such, FINRA is seeking comment on a revised proposed rule.

The prior rule proposal, filed with the SEC in March 2014, had two components: (1) a disclosure obligation to former retail customers whom the recruiting firm attempts to induce to follow a transferring registered

representative; and (2) a reporting obligation to FINRA where a transferring representative receives a significant increase in compensation. Comments included concerns about the proposal's competitive implications and operational aspects, as well as the effectiveness of the proposed compensation disclosures. FINRA withdrew the initial rule proposal to further consider the comments received.

The current proposed rule would require a member firm that hires or associates with a registered representative (recruiting firm) to provide an educational communication to former retail customers who the member, directly or through the transferring representative, attempts to induce to transfer assets to the recruiting firm or who choose to transfer assets to the recruiting firm. The educational communication would highlight the potential implications of transferring assets to the recruiting firm and suggest questions a customer may want to ask to make an informed decision. The recruiting firm would be required to provide the educational communication at or shortly after the time of first contact with a former retail customer regarding the transfer of assets to the recruiting firm.

Comments

In general PIABA supports the proposed rule because the bar association feels strongly that public investors would benefit from knowing about any potential conflicts of interest an enhanced compensation agreement may foster. However, PIABA believes the educational material, while helpful, does not go far enough. It does not require the firm to actually disclose potential or actual conflicts. It instead merely shifts the burden to investors to ask their current firm or their broker to disclose these conflicts. Moreover, the fact that the broker or current firm is not required to answer the proposed questions (listed on Attachment B) in writing as they relate the customer's particular accounts poses additional concerns regarding the accuracy of those representations and the supervision of such statements. The previous proposal would have provided a mandatory disclosure of any enhanced compensation. PIABA strongly believes that public investors should be informed if their registered representative is being paid additional "enhanced" compensation for merely bringing client assets to his new firm or for generating new commissions and fee income above the usual payout grid during his first few months or years at the firm. Obviously such arrangements may color a representatives recommendations and approach to overall account management.

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. As such, full disclosure of these potential conflicts should be required in any broker and client transfer scenario. 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

[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

representatives to “churn customer accounts, recommend unsuitable investment products or otherwise engage in investment activity that generates.[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 possible 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 advisor’s fees and conflicts of interest "to be absolutely essential." 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." PIABA applauds the revised proposed rule as a step in the right direction but is concerned that it may be too limited to address these problems adequately.

For example, the most recently proposed rule would require the educational communication to be provided to a former customer who seeks to transfer assets to an account assigned or to be assigned, to the representative at the recruiting firm absent contract (e.g., where a customer decides to transfer assets after learning from a general announcement or other sources that his or her registered representative has change firms). In such circumstances, the communication must be included in the account transfer approval documentation. While this is a positive step, the current proposal does not specify supervisory procedures to insure compliance with the mandated communications. PIABA believes that the proposed rule should include supervisory procedures rather than leaving it up to the individual firms to establish and maintain written policies and procedures to ensure compliance. PIABA does not believe it is sufficient to say that FINRA expects that firms can implement a system reasonably designed to achieve compliance with the delivery requirements through training, spot checks, certifications or other measures.[5] PIABA also believes the requirement to provide communication should continue to apply for one year from the date the registered representative begins employment or associates with the recruiting firm, as opposed to the six month application currently called for in the proposed rule.[6]

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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/p3S9971.pdf

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

[5] See FINRA Regulatory Notice 15-19 (May 2015), paragraph 2.

[6] Id at paragraph 3.

Despite supporting the proposal, PIABA believes the rule does not go far enough to combat the magnified conflicts of interest created by enhanced compensation agreements. In particular, FINRA's most recent proposed rule still 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 of the recruiting firm's customers, not just to the former customers of a registered representative who has changed firms. PIABA's proposed approach would help ensure that all customers receive material information about recommended securities transactions and potential conflicts of interest. Lastly, PIABA believes the new rule should include a requirement that all customers assigned to the transferring broker confirm in writing receipt of the mandated educational communication at or before establishing an account with the recruiting firm.

While the proposed educational communication requirements focus on any enhanced compensation agreements for the recruited registered representative, there are also inherent conflicts of interest when employees of the former firm are provided financial enhancements for retaining the departing broker's clients. PIABA believes FINRA's proposed rule focuses too narrowly on enhanced compensation for registered representatives switching firms. When a registered representative makes the decision to change firms, a scramble for control of the assets in his or her book of business ensues. Given incentives as well as directives from the new firm, the registered representative must contact former clients and persuade them to join him or her at the recruiting firm. With an enhanced compensation agreement, his or her pay may depend on how many clients he or she convinces to switch. There may also be additional incentives for levels of production over a certain period of time after the switch is completed ("Jump Agreements").

Meanwhile, the branch manager or newly assigned brokers at the old firm may receive a bonus or other compensation for how many of the leaving broker's clients they convince to remain at the old firm. 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 advisor 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 these recruitment and retention processes are such fertile ground for conflicts, PIABA believes that the customer should be told about all enhanced compensation agreements, 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 material information as old customers. Only then, will all clients of the transferring broker be able to make a fully informed decision as to the future management of their assets.

While the proposed rule requires the disclosure of the amount of upfront payments and potential future payments, the proposed educational communication may not adequately explain to customers what the conflict is. Customers should be told if the size of the advisor's upfront compensation is being determined by the amount of commissions generated and assets held at the representative's prior firm for the past twelve months. This is particularly important because advisors are frequently given upfront bonuses based at their trailing 12 month production at their prior firms. This arrangement could incentivize brokers contemplating switching firms to "get their numbers up" in anticipation of the move. This conflict of interest should be disclosed, even if after the fact, to customers so they can reassess the amount of commissions and fees generated from their account prior to the move.

More importantly, the customer should also be told that the advisor will only receive future bonus payments if he or she achieves certain production and/or asset targets over a certain time-frame. The future bonus payments are regularly based on several years of production and/or asset targets. The built-in incentive to hit back-end production targets exposes the customer to the most danger from conflicted financial advisors. The new rule must inform 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 properly assess their advisor's recommendations against the advisor's personal motivation to hit her back-end targets and receive the additional enhanced compensation.

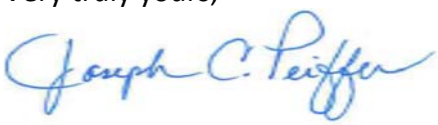
The most recent proposal, like those that came before, appears to contemplate the educational communication to be sent with the receiving firm's new account documentation package. This would permit the recruiting firm to pack an envelope with voluminous, soporific disclosures, ensuring that few of them will ever be read. PIABA believes that enhanced compensation should be disclosed in writing, on its own, and sent before any account transfer documentation to ensure that retail customers will be able to make an informed decision about whether to change firms. If the disclosures arrive with the account transfer documentation and glossy brochures about the new firm, customers may miss this important education communication. To that end, the enhanced compensation communication should be presented in a clear readable format. Moreover, the disclosure should not only include questions an investor may wish to ask, but should also give 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?
- Is any of the enhanced compensation contingent on the registered representative's production at the new firm or on convincing his or her former clients to transfer firms?
- Are fees and commissions computed differently at the new firm?

Conclusion

In summary, PIABA supports FINRA's proposed rule requiring educational communications be sent to retail customers of a recruited broker, disclosing all enhanced compensation agreements and the potential conflicts of interest inherent in such agreements. However, PIABA believes the communication rule does not go far enough and should be expanded to include disclosure of all enhanced compensation plans and should be communicated to all current, former as well as new retail clients. PIABA thanks FINRA for the opportunity to comment on this proposal.

Very truly yours,



Joseph C. Peiffer
PIABA, President