

June 29, 2009

James S. Wrona  
Associate Vice President and Associate General Counsel  
Office of the General Counsel  
FINRA  
1735 K Street, NW  
Washington, DC 20006

RE: Public Comment on Regulatory Notice 09-25, Proposed Consolidated FINRA Rules Governing Suitability and “Know Your Customer” Obligations

Dear Mr. Wrona:

I am submitting these public comments as the Editor of Investment Literacy.com. I am not a Registered Person - my website is a Blog aggregating information on Individual Investor Education, Consumer Protections and Self-Advocacy. I do not sell any investment-related products or services at this time.

My work centers on gathering content relating to the experiences that Individual Investors have working with FINRA members. My target audience is the same Retail mass market that commission-based sellers of investment products target. I started investing in the Securities Markets in 1985 and I was a Registered Representative from 1992 to 2005. I have a BA, MBA and serve as an Adjunct Professor in Finance at two Universities in Northern New Jersey. All of my NASD Series designations have lapsed.

After personally analyzing the “real-world” experiences of thousands of Retail clients during the last 17 years, I decided to start my Blog as an information clearinghouse to promote awareness of existing Investor Protections – such as Weblinks to FINRA, the SEC and State Regulators – and to illuminate wide-spread cultural practices that are well-known to employees of FINRA-member firms, but generally unknown to Public Customers. It is important for FINRA leaders to periodically remember that many of the interpersonal interactions between Public Customers and Associated Persons are actually based on learned cultural behaviors endemic to the US securities industry – behaviors that can be modified through positive incentives and negative reinforcements.

With that background introduction in mind, below are my comments on FINRA’s Proposed Consolidated Rules pertaining to Suitability and Know Your Customer (KYC) from the perspective of a typical Public Customer. Here are my principal conclusions, with the supportive details following:

1. The language and terminology used in the personal responses given by the Public Customer during the Associated Person’s Suitability/KYC interviews do not have the same literal meanings for the two parties – the average retail client often

expresses himself/herself using words and in a style that is misinterpreted and/or not fully absorbed by the Associated Person. This communication breakdown leads to many negative outcomes, unforeseen by the customer;

2. The integrity of the Sales Effort of the Associated Person is compromised by the fact that it's impossible for the Registered Representative to finitely and determinately understand every individual security and every component security embedded in the packaged investment products, such as Mutual funds or ETFs, most commonly recommended by the FIMRA-member firms. This condition becomes relevant to the Fair Dealing clause because the Associated Person often makes a Sales Presentation giving definitions of financial risks that are not technically true based on the fundamental risks of the individual securities involved. For example, an Associated Person may operate under the belief that a Corporate or Municipal Fixed-Income Mutual Fund has "little or no risk" because there are 250 different Notes and Bonds in the Portfolio, so the risk is diversified. But if all Notes and Bonds of all US issuers lose their value simultaneously because of systemic risks, lack of demand and/or change in investment dynamics, then the entire portfolio of 250 issuers loses value. 10,000 bonds may decline, making the concept of protecting principal through diversification meaningless! Human Beings often make flawed decisions because of biases, specious logic and simple lack of understanding – so the Know Your Customer Doctrine must be widened to the Customer Must Know Your Broker.
3. In order to protect the investment principal of Retail investors, and to guard Public Customers from Associated Persons who incorporate non-Scientific beliefs in their Modus Operandi, FINRA needs to devise a Standardized Classification System of all Securities that labels Risk Objectively, not subjectively. It would be similar to Standardized Classification Systems used in the USA for chemicals, foodstuffs and drugs – the manufacturers are not allowed to label their products any way they want – everything is accurately labeled based on its chemical structure and ingredients. Thus, a Public Customer who states "I don't want to lose money" could only buy Investment Products that have been labeled and classified by FINRA that the Investment Principal is NOT at risk. This protects the customer from a well-meaning but simply ignorant Associated Person who subjectively declares "it's impossible to lose money long-term when you are diversified" WHEN IT IS VERY POSSIBLE that the Public Customer's monies are not safe.

1) How Suitability, Know Your Customer, "Reasonable Basis" and Sales Practices are impacted by Misinterpreting and Incorrectly Processing the Client's Language

FINRA regulators need to step out of their own profiles of highly intelligent accomplished professionals with high functionality and high skills, and put themselves in the mindset of the Public customer. The retail client has a completely different mindset than the Professional Investment Advisor. This distinction is important because when the

Associated Person is recording the responses of during the KYC interviews, the responses are processed in the context of the world of financial jargon, dozens of asset classes, hundreds of investment managers and over 12,000 marketable securities which could be purchased on any give day. The Associated Person has become desensitized to the heightened anxiety that the new investor has to losing/risking principal.

Unfortunately this insensitivity is manifested by an absence of empathy and the desire to “train” the novice into “learning” how to lose principal, even if this is not the stated Investment Objective/Goal of the customer. It’s like, “I’m going to teach you to jump from this plane with a parachute, and you are going to like it”...more aggressive in style than the average American.

When conflicts arise between Member Firms and Public Customers, it’s often because the Registered Representative didn’t genuinely absorb or comprehend what the unsophisticated person meant when he/she said “**I want Conservative investments where I can’t lose money**”.

In written and oral statements submitted in Arbitration and Mediation cases, the Client asserted that the Member firm did NOT honor the request to be “Conservative” and “Safe”, which means DO NOT RISK THE INITIAL DEPOSIT or Investment Principal. In the practical reality of American English, these words Conservative and Safe are the most-commonly used expressions that Retail clients utilize to convey they don’t want volatility in the portfolio.

I am recommending to the Regulatory leadership of FINRA that Proposed Rules designed to protect the Retirement Savings of U.S. investors **must incorporate concrete language that powerfully communicates to the Retail Client in COLD, STARK terms the chances of losing money**. Many Suitability/KYC interviews yield undesired outcomes, with the Public Customer claiming later on in Mediation/Arbitration cases “I didn’t know I could lose so much” and “I didn’t understand that the investment he/she recommended contained so much risk to principal”.

I would like to see new terminology and descriptive words introduced to the Suitability and KYC information-gathering process **that most accurately defines the OPPOSITE of “safe” and “Conservative”**. If the Associated Person is recommending a Marketable Security or Packaged Investment Product that can lose value, it should be described as “**Unsafe**” or “**Non-conservative**” or “**Unpredictable**”, so the language really has meaning to the novice retail customer.

The nuance of American English is funny – all of us have the ability to glean different meanings based on the exact phrase employed. Since the majority of US Equities, Corporate Fixed-Income Securities and High-Yield Municipal Bond Funds and ETF’s have lost their principal value over the last 1-3-5-7 and 10 year holding periods, the authentic words to convey the Risk of losing principal is actually **perilous, dangerous and hazardous**. **The language must be “non-legalistic” in nature to have impact.**

2. The language mandating that an Associated Person (AP) must have “*a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the facts known, et al*” is sound and logical language Prima Facie.

The real-world problem for the Public Customer is when the Associated Person is pitching an investment recommendation in the client’s kitchen or living room, the legalistic Regulatory language in the FINRA manual is lost. The operating energy deployed by the AP in that given moment is the personal passion he/she believes about the purposeful nature of investing in securities. **The big problem: it CANNOT be scientifically proven that the purchase will be profitable.** The AP is also not recommending the investment securities for recreational purposes, but to earn commission dollars to increase personal income.

FINRA needs to consider that the AP/Registered Representative does not have adequate Academic training and on-site resources to ensure that the personal Suitability/KYC information disclosed by the client is matched with commensurate Investment Products that provide a good fit for the Client’s Profile. The concept of Behavioral Theory or Behavioral Economics stipulates that ALL humans make flawed decisions based on internal biases and unscientific, heuristic anecdotes that are misinterpreted to prove the original premise.

There are 650,000 Registered Representatives in the US – they don’t represent a random sampling of the population at large. They represent a positive self-selection of personalities that have the cognitive aptitudes necessary to passionately solicit investors by Persuasive Arguing. They are determined in their mission to prove the merits of their arguments – this leads them to have a bias of being “right”, i.e. winning, at all costs.

This personality bias towards winning the investment purchase argument leads to oversimplification – during the kitchen table debate - of the very complex Marketable Securities in the portfolios that are being recommended. The economic dynamics are intertwined and convoluted and it’s problematic for the Average AP to explain – as it’s problematic for the average customer to comprehend. **Therefore, the Suitability rules are superseded by the AP touting securities on the basis of misrepresentation – not motivated by bad intentions, but out of pure ignorance and biased objectives.**

- 3) I have a solution for the organic problem that FINRA faces: how can 650,000 individual Financial Advisors in the USA competently understand 12,000 complicated and volatile Investment Products that could be sold to the public, resulting in a million different Portfolio possibilities?

The answer is to protect the Member firms and Associated Persons from themselves, i.e. as human beings who can easily make mistakes. All securities that could be legally sold to Public Customers would have to be formally classified, designated by the dangers of losing money.

Once the AP has a reasonable basis to believe that the customer DOES NOT WANT TO LOSE MONEY, he/she could ONLY make investment recommendations from the category of Low Volatility/Low Risk to Principal. The Member Firm and the Client would negotiate and agree to – IN WRITING – the percentage of Classified Assets in each risk category, i.e. 70% Low Risk, 30% Not Safe.

This plain language and easy-to-understand system of choosing assets by being limited to a Suitability Grid would serve the interests of the Investment Management community, who would improve the quality of client portfolios, as well as improve the experience of Public Customers, who would stay with each firm longer and would not suffer devastating and unplanned losses of capital. It adds practical meaning and value to the Know Your Customer concept: instead of having a vague connection there would be a concrete action plan that could be implemented by the FINRA member firm.

This system also provides a built-in protection mechanism and support for individuals who don't have the aptitude or formal educational training to understand dense financial information written in unfamiliar language. Since the primary objective of the Suitability concept is to match the appropriate investment with the stated objective/personal status of the client, I envision everyone benefiting from a Securities Classification System. It would also expedite the Conflict Resolution process because there would be a model to follow to adjudicate Client Complaints.

Thank you for allowing me to comment as a private citizen who spends 40-50 hours per week thinking about methods to improve the experiences of Individual Investors in the landscape of the US Financial Services industry.

Most sincerely,

Douglas J. Klein  
Editor

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