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December 22, 2010

VIA ELECTRONIC DELIVERY (pubcom@finra.org)

Marcia E. Asquith
Senior Vice President and Corporate Secretary
Office of the Corporate Secretary
FINRA
1735 K Street, N.W.
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 10-54; Disclosure of Services, Conflicts and Duties

Dear Ms. Asquith:

The Association for Advanced Life Underwriting (AALU) appreciates the opportunity to provide these comments on FINRA Notice 10-54, its Concept Proposal to require a member firm, at or prior to commencing a business relationship with a retail customer, to provide a written statement to the customer describing the types of accounts and services it provides, as well as conflicts associated with such services and any limitations on the duties the firm otherwise owes to retail customers.

AALU is a nation-wide organization of 2,000 life insurance agents and professionals who are primarily engaged in sales of life insurance used as part of estate, charitable, retirement, and deferred compensation and employment benefit services.

AALU supports FINRA's efforts to bring about greater customer understanding of a broker-dealer's services, conflicts, and duties. We understand that the disclosures proposed in the concept release, if and when adopted as final FINRA rules, will apply to member firms. We offer our views on this subject, based upon our experience serving our retail customers and our understanding of our customers' need for, and interest in, information about a broker-dealer's services, potential conflicts, and duties. As discussed below, we believe any additional disclosure materials provided to retail customers of a broker-

dealer must be simple, clear, and brief, and must be focused upon identified customer needs – and informed through customer surveys and testing.

Existing Disclosure and Related Requirements Applicable to Broker-Dealers

As FINRA is aware, broker-dealers already are subject to a comprehensive set of statutory, SEC, and FINRA customer protection rules, many of which prescribe or otherwise regulate disclosures to retail customers. For example, broker-dealers are subject to the antifraud provisions of the Securities Exchange Act of 1934 (Exchange Act), which prohibit misstatements or misleading omissions of material facts, as well as fraudulent or manipulative acts and practices, in connection with the purchase or sale of securities.[1] Broker-dealers must deal fairly with customers and the public under FINRA requirements to observe high standards of commercial honor and just and equitable principles of trade,[2] and engage in fair and balanced communications with the public.[3] They are required to provide timely and adequate confirmation of transactions,[4] provide account statements,[5] and disclose certain conflicts of interest.[6]

Broker-dealers also are subject to comprehensive SEC and FINRA requirements governing the recommendation and sale of securities. NASD Conduct Rule 2310 requires a broker-dealer to have a reasonable basis to believe that each securities transaction recommended by a broker-dealer is "suitable" for the client based upon very specific information that the broker-dealer is required to gather from the client and maintain, regarding the client's financial status, tax status, investment objectives and such other information used or considered to be reasonable in making recommendations to the client.[7] As the SEC staff noted in its comprehensive memorandum entitled, "Standards of Conduct Applicable to Investment Advisers and Broker-Dealers," specific suitability, disclosure, and due diligence requirements apply to certain securities products, including penny stocks, options, mutual fund share classes, debt securities and bond funds, municipal securities, hedge funds, variable insurance products, and non-traditional products, such as structured products and leveraged and inverse exchange-traded funds.[8] One such product-specific rule is FINRA Rule 2330, which sets forth extensive and detailed

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[1] *See*, *e.g.*, Exchange Act Sections 10(b) and 15(c) and SEC rules promulgated thereunder.

[2] FINRA Rule 2010; IM 2310-2.

[3] *See* NASD Rule 2210(d) (Communications with the Public).

[4] *See* Exchange Act Rule 10b-10 (confirmation of transactions) and NASD Rule 2230 (Confirmations). NASD Rule 2230 will be replaced by FINRA Rule 2232 (Customer Confirmations), but the effective date has not been determined. The new rule will streamline and combine basic customer confirmation requirements in the NASD and NYSE rules. *See* SR-FINRA-2009-058, 75 Fed. Reg. 66173, Oct. 27, 2010.

[5] *See* NASD Rule 2340 (Customer Account Statements).

[6] *See*, *e.g.*, FINRA Rule 5121 (Public Offerings of Securities with Conflicts of Interest); NASD Rule 3040 (Private Securities Transactions of an Associated Person).

[7] NASD Conduct Rule 2310, Recommendations to Customers (Suitability).

[8] *See* Memorandum, "Standards of Conduct Applicable to Investment Advisers and Broker-Dealers," from SEC staff to the SEC Investor Advisory Committee, May 17, 2010, at 13 (SEC Memorandum). The SEC Memorandum is included as Attachment A to a letter from David Stertzer, Chief Executive Officer of AALU, to Elizabeth Murphy, August 30, 2010 (AALU Letter), *available at*

Footnote continued on next page

sales practice requirements for recommended purchases or exchanges of variable annuities. [9] These include detailed disclosures about the product, including disclosures of the various features of deferred variable annuities, such as the potential surrender period and surrender charge, potential tax penalty if customers sell or redeem early, mortality and expense fees, investment advisory fees, potential charges for and features of riders, the insurance and investment components of deferred variable annuities, and market risk. We believe these types of disclosures, detailed as to the features and risks of particular types of investment products, are the most meaningful for investors. Together with information relating to costs and fees provided in confirmations, account statements and other materials, these types of disclosures enable investors to evaluate the risks of investment products and all associated fees and charges.

Existing disclosure and other customer protection requirements are buttressed by the requirements for a daily suitability review by a registered, qualified principal of the broker-dealer of all recommended transactions effected by a broker-dealer – a review that is heightened for products that present higher risks. Moreover, as FINRA is well aware, these internal supervisory and audit procedures are further buttressed by a robust examination program by the SEC and FINRA, as well as state securities regulators. The frequency and intensity of FINRA audits of broker-dealers means that many potential problems will be detected and corrected through the examination process; the anticipation of a near-term examination also has a deterrent effect on adverse behavior and creates a strong incentive for broker-dealers to continuously monitor and adhere to regulatory requirements, including the various disclosure requirements mentioned above. The regulatory, supervisory, and examination requirements applicable to broker-dealers are discussed at length in AALU's comment letter filed with the SEC to inform its Study Regarding Obligations of Brokers, Dealers, and Investment Advisers.[10]

We believe existing disclosure and related customer protection requirements for securities recommendations by broker-dealers – particularly when coupled with the robust internal supervisory procedures required by the SEC and FINRA and their regulatory oversight of broker-dealers – currently provide protection for customers of broker-dealers that is superior to the regulation of other financial services providers, such as investment advisers.

Addressing Potential Investor Confusion over the Legal Requirements Applicable to Investment Professionals

Notwithstanding the disclosure and other customer protection requirements for customers of registered broker-dealers discussed above, we are aware of the substantial attention focused on the issue of potential investor confusion about the specific legal role in which a financial advisor may be operating in today's very diverse financial marketplace. For example, a 2008 report by the RAND

Footnote continued from previous page
http://www.sec.gov/comments/4-606/4606-2631.pdf. The AALU letter, with the SEC Memorandum, is included also with this submission to FINRA.

[9] FINRA Rule 2330.

[10] AALU Letter, *supra* n. 8.

Institute for Civil Justice (RAND Report),[11] which was based upon a survey of investor and industry perspectives on the role of broker-dealers and investment advisers, summarized its findings as follows:

> Overall, we found that the industry is very heterogeneous, with firms taking many different forms and offering a multitude of services and products. Partly because of this diversity of business models and services, investors typically fail to distinguish broker-dealers and investment advisers along the lines that federal regulations define.[12]

However, the RAND report did not identify any investor harm that has occurred as a result of confusion. Indeed, the RAND Report also found:

> Despite their confusion about titles and duties, investors express high levels of satisfaction with the services they receive from their own financial service providers.[13]

The RAND Report's finding of some investor confusion nonetheless has been used by some to call for legislative or regulatory changes to address this issue through "harmonized" standards for financial professionals serving retail investors. Congress responded in Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) by mandating a study of the effectiveness of existing legal or regulatory standards of care for brokers, dealers and investment advisers when providing personalized investment advice about securities to their retail customers and requiring that the study identify any gaps, shortcomings or overlaps in legal or regulatory standards in the protection of retail customers related to the standard of care. Section 913 also directed the SEC to facilitate simple and clear disclosures of material conflicts by both broker-dealers and investment advisers. The statute also gave the SEC discretionary authority to write rules to adopt a uniform "best interest" or "fiduciary" standard for brokers, dealers and investment advisers, but, unlike earlier provisions of the reform legislation, did not mandate that the SEC do so.[14]

AALU members believe our customers fully understand the role in which our members operate. Indeed, if there is any concern about the current level of disclosures, we believe many customers feel buried under the weight of required disclosure and account-related documents. Nonetheless, we support FINRA's efforts to develop better and clearer disclosure for customers of broker-dealers. Indeed, we believe the FINRA process offers the potential to give thoughtful consideration to the types of disclosures that investors would find most useful in making investment decisions and to simplify and pull together in a document provided at the beginning of a customer relationship information about the roles, conflicts and services provided by a broker-dealer.

On this issue, the RAND Report also offers some critical insight, referencing the "questionable value of disclosures" and reporting that a majority of those interviewed by RAND's researchers

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[11] Angela A. Hung *et al*., Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, RAND Institute for Civil Justice, *available at* http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf (RAND Report).

[12] *Id.* at xiv.

[13] *Id.*

[14] *See* Pub. L. No. 111-203 (2010), § 913.

expressed the view "that disclosures do not help protect or inform the investor, primarily because few investors actually read the disclosures."[15] Many participants in the survey apparently complained that "[t]he way [disclosures] are written is not easily understandable to the average investor, and the information in disclosures is not sufficient."[16] Of course, we know that both the SEC and FINRA have heard this complaint year after year, over many decades, and yet regulators to date have been unable to write the kind of rules that would result in the type of simple, brief, "plain English" disclosures investors want and need. We believe this underscores the need for FINRA, together with the SEC, to develop and implement investor testing and investor education as part of the process of developing any new disclosure rules in this area.

Subjects for Requested Comments

Application of new disclosure rules to "retail customers," as defined. Before commenting on the specific areas of disclosure outlined in the release, we note that the release provides that the term "retail customer" with respect to whom broker-dealers would be required to provide the new disclosures would mean a customer that does not qualify as an institutional account under NASD Rule 3110(c)(4). To the extent that this FINRA initiative is intended, as stated in the release, to respond in part to the Dodd-Frank Act requirement that the SEC facilitate simple and clear conflicts disclosures, we suggest that FINRA utilize the same definition of "retail customer" set forth in Section 913 of the Dodd-Frank Act.[17] It makes no sense for FINRA rules to apply to investors in a manner inconsistent with rules that may be written by the SEC.

Scope of services, products, limitations and fees. The release states that FINRA is considering disclosures regarding the types of brokerage accounts and services a firm provides to retail customers, including the scope of services and products and any limitations on those services and products, and the fees associated with those services (including whether they are negotiable). As FINRA is aware, broker-dealers offer multiple levels of services and types of products. Some may offer only proprietary products and limit those products to a particular class (*e.g.* mutual funds). Some may offer a wider range of products from a broad range of issuers. While we believe most investors can readily assess the range of products and services offered by a broker-dealer, we would like to see FINRA, through investor surveys and consumer testing, assess whether this information can be delivered to investors in a clearer and more efficient manner. In our view, the ideal form of delivery would be through a brief, general document with hyperlinks or website references to more detailed information, but we emphasize that the particular form and scope of disclosure should be dictated by customer needs and preferences.

Disclosures of incentives for firms to make recommendations. The release also states that FINRA is considering disclosures as to the financial or other incentives that a firm has to recommend certain products, investment strategies, or services over similar ones. These types of disclosures would

[15] Hung *et al.*, 19.

[16] *Id.*

[17] Section 913 of the Dodd-Frank Act defines "retail customer" as "a natural person, or the legal representative of such natural person, who–(1) receives personalized investment advice about securities from a broker or dealer or investment adviser; and (2) uses such advice primarily for personal, family or household purposes."

include arrangements in which the firm receives any economic benefit from an issuer or product manufacturer in connection with providing a particular product, compensation for customer referrals from or to any individual firm, and differential payments or compensation that are likely to incentivize the offering of one product over another.

Incentive compensation and fees paid by an issuer to a broker-dealer for the sale of the issuer's securities are described in the prospectus, but we agree that prospectus disclosure can be cumbersome and unread. In analogous contexts, short, simple written disclosures have been required to be provided to retail customers by broker-dealers that provide services on bank premises,[18] and by broker-dealers and others that solicit and refer clients to investment advisers.[19]

As in the category above, we would like to see FINRA utilize investor surveys and testing to assess the particular information investors believe would be most helpful and the method of presentation. In this connection, we note that the SEC in 2004 proposed, then in 2005 revised and reproposed, and then apparently shelved for the past five years a proposal that would have required broker-dealers to provide their customers with information, at the point of sale and in transaction confirmations, regarding the costs and conflicts of interest that arise from the distribution of mutual fund shares, 529 college savings plan interests, and other financial products.[20] We understand that, in revising the proposed rules, the SEC also engaged the assistance of a consultant to assist in conducting investor testing.[21] Although the SEC did not complete its rulemaking, we suggest that FINRA may also wish to review the SEC's record to identify the type of information investors viewed at that time as most relevant, to assist FINRA in developing the most user-friendly types of disclosures preferred by investors.

In view of the multitude of different investment products provided by many broker-dealers, a requirement to provide detailed disclosures related to each and every product at the beginning of a customer relationship would overwhelm investors. We therefore suggest that FINRA explore developing requirements for broker-dealers to provide a brief, general document describing the range and types of incentives, with hyperlinks or website references to more detailed information about particular products that may be deemed useful and relevant following investor testing and analysis.

Conflicts disclosures. The release further states that FINRA is considering disclosures as to the conflicts that may arise between a firm and its customers, as well as those that may arise in meeting the competing needs of multiple customers, and how the firm manages such conflicts. Existing SEC and FINRA rules address numerous areas of conflicts and require disclosures of those conflicts. For example, the confirmation rules require disclosure of the capacity in which a broker-dealer is acting in effecting a customer's securities transaction and associated fees received,[22] and special disclosures are

[18] FINRA Rule 3160(a)(3).

[19] 17 C.F.R. § 275.206(4)-3(b).

[20] *See* Exchange Act Release No. 49148, 69 Fed. Reg. 6438 (Feb. 10, 2004) and Exchange Act Release No. 51274, 70 Fed. Reg. 10521 (Mar. 4, 2005).

[21] 70 Fed. Reg. 10521, 10522.

[22] 17 C.F.R. § 240.10b-10.

required for margin lending,[23] day trading,[24] analyst reports,[25] and in connection with the offering of securities of issuers affiliated with a member firm or in which the member firm has an interest.[26]

We know that some believe that the sale of products based on commission presents an inherent conflict and, therefore, that fee-based services are somehow better for investors. However, actual investor surveys, such as the survey recently reported by Charles Schwab of its customers, clearly debunk this notion. Most investors report that they want to be charged only for what they purchase, and they prefer and are well aware that they are paying commissions for their securities purchases. Moreover, as noted above, the SEC's confirmation rule and related FINRA rules already require disclosures of, among other things, the capacity in which a broker-dealer is acting in effecting a customer's securities transaction, the type of compensation received, and the source of the compensation.[27]

Nonetheless, we encourage FINRA to conduct investor testing and surveys, in order to develop the types of conflicts disclosures that would optimize investor understanding.

Limitations on duties. FINRA also is considering disclosures of limitations on the duties a firm owes to its customers in areas such as whether the firm has ongoing suitability obligations, its responsibility for the propriety of unsolicited orders, and whether the firm may execute transactions on a principal basis. We believe a clear and candid discussion of the limitations on duties owed by a firm to its customers is always helpful in order to assure investor understanding. In this area, as in those discussed above, we suggest surveying and testing investors to determine the scope and appropriate method of delivery of this information.

Delivery Method. While we believe the method of delivering these new disclosures also should be the subject of investor survey and testing, we reiterate our view that a brief disclosure document (prepared in hard copy or electronically, as a particular customer may request), with website references or hyperlinks, is the optimum method of delivery.

Timing. Information should be updated periodically, which underscores the need to deliver most of the contemplated disclosures in electronic, website format.

Additional Comments and Conclusion

Broker-dealers are subject to extensive disclosure and customer protection rules imposed by the SEC and FINRA; they are subject to licensing, supervisory, books and records, and regulatory examination requirements that support and enforce these disclosure and customer protection

[23] FINRA Rule 2264.

[24] FINRA Rule 2270.

[25] Regulation AC, 17 C.F.R. § 242.500 *et seq.*; NASD Rule 2711(h).

[26] FINRA Rules 2262, 2269, 5121, 5122.

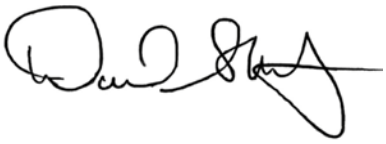
[27] 17 C.F.R. § 240.10b-10; NASD Rule 2230. As noted in footnote 4, NASD Rule 2230 will be replaced by FINRA Rule 2232 (Customer Confirmations), but the effective date has not been determined.

requirements. AALU supports FINRA's efforts to develop improved disclosures, not because we believe more is better, but because we believe this initiative offers an opportunity to determine the types of disclosures most useful for investors.

We also believe the effort to develop clear and simple role and conflicts disclosure for broker-dealers addresses what has been the driving policy rationale for adopting an amorphous "fiduciary duty" as a uniform standard of conduct for all broker-dealers and investment advisers who advise retail customers. As our comment letter to the SEC in its study on broker-dealer and investment adviser regulation provides in great detail, any inadequacy in customer protection is on the adviser side. The SEC's inspection cycle for advisers, occurring once every 10 years, is woefully inadequate; there is no self-regulatory organization to pick up the slack; there are few rules of conduct for investment advisers; there are no specified supervisory or review procedures to assure associated persons are following the rules; and there is no private right of action under the Investment Advisors Act for customers of advisers to recover damages based on adviser misconduct.

Therefore, if there is a need for uniformity in customer protection, we believe the SEC needs to address the inadequacy on the adviser side, before imposing any new duties on brokers and dealers. At the same time, we support and will make every effort to work with FINRA as it develops clearer and simpler disclosures of the roles and responsibilities of broker-dealers.

Sincerely,



David J. Stertzer
Chief Executive Officer

Attachment:
AALU Letter from David Stertzer, CEO to Elizabeth Murphy, SEC, August 30, 2010

cc: Richard G. Ketchum, Chairman and Chief Executive Officer, FINRA
Thomas M. Selman, Executive Vice President, Regulatory Policy, FINRA
Howard M. Schloss, Executive Vice President, Corporate Communications and Government Relations, FINRA