Faculty Supervisors
ADELE BERNHARD
M. CHRIS FABRICANT
MARGARET M. FLINT
JILL GROSS
VANESSA MERTON
EDWARD PEKAREK

JOHN JAY LEGAL SERVICES, INC.
PACE UNIVERSITY SCHOOL OF LAW
80 NORTH BROADWAY
WHITE PLAINS, NY 10603
TEL 914-422-4333
FAX 914-422-4391
JJLS@LAW.PACE.EDU

Executive Director
MARGARET M. FLINT
Clinic Administrator
FLORIE FRIEDMAN
Staff
IRIS MERCADO
ROBERT WALKER

December 27, 2010

VIA ELECTRONIC SUBMISSION

Marcia E. Asquith
Office of Corporate Secretary
FINRA
1735 K Street, N.W.
Washington, D.C. 20006-1506

Re: Concept Proposal to Require Disclosure Statement for Retail Investors at or Before Commencing a Business Relationship; Regulatory Notice 10-54

Dear Ms. Asquith:

The Investor Rights Clinic at Pace Law School ("PIRC"),[1] operating through John Jay Legal Services, Inc., welcomes the opportunity to comment on FINRA's Concept Proposal to Require a Disclosure Statement for Retail Investors at or Before Commencing a Business Relationship as set forth in FINRA Regulatory Notice 10-54 ("Concept Proposal"). PIRC advocates for the rights of modest means investors, a constituency who would be impacted if FINRA adopted the Concept Proposal.[2]

PIRC supports the Concept Proposal generally, at least to the extent that it would require FINRA members and their associated persons to make certain disclosures to prospective retail customers, because we believe transparency benefits customers and enhances the integrity of domestic capital markets. Consistent with disclosure-based securities regulation, which has been at the center of federal securities law since the adoption

[1] PIRC, which opened in 1997, is the nation's first law school clinic in which J.D. students, for academic credit and under close faculty supervision, provide *pro bono* representation to individual investors of modest means in arbitrable securities disputes. *See* Barbara Black, *Establishing A Securities Arbitration Clinic: The Experience at Pace*, 50 J. LEGAL EDUC. 35 (2000); *see also* Press Release 97-101, Securities Exchange Commission, *SEC Announces Pilot Securities Arbitration Clinic To Help Small Investors - Levitt Responds To Concerns Voiced At Town Meetings* (Nov. 12, 1997), *available at* http://www.sec.gov/news/ press/pressarchive/1997/97-101.txt.
[2] Recent Congressional legislation defines the term "retail investor" as any "natural person, who receives personalized investment advice about securities from a broker or dealer or investment adviser; and uses such advice primarily for personal, family, or household purposes." Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 913(a), 124 Stat. 1376 (2010) [hereinafter *Dodd-Frank Act*]. *Cf.* NASD Rule 3110(c)(4) (defining an "institutional account" as any account held by a bank, savings and loan association, insurance company, investment company, registered investment advisor, or any other entity including a natural person, company or partnership with assets exceeding $50 million).

of the Securities Act of 1933,[3] Title IX of the 2010 Dodd-Frank Act has authorized the creation of "point-of-sale" disclosure requirements. We commend FINRA for acting expediently and releasing the Concept Proposal for public comment.[4] Nonetheless, we have substantial concerns about potential consequences of the Concept Proposal, the most important of which are discussed below.

Disclosure Problems for the Investing Public

Although we support the Concept Proposal disclosures as one way to decrease the informational asymmetry of a broker-customer relationship, we remain concerned about the effectiveness of disclosure, especially for retail investors of limited sophistication. The Rand Institute for Civil Justice ("RAND") conducted a study commissioned by the SEC which confirmed that the efficacy of disclosures provided currently by both investment advisers and broker-dealers is hindered by three main problems: (1) they are not easily understood by average investors; (2) financial service providers typically do not aid retail customers in understanding the disclosures; and (3) many investors do not take the requisite time and effort to fully understand the disclosures provided.[5] Thus, ensuring that the financial services industry provides comprehendible disclosures that effectively inform average retail customers, instead of confusing them, should be among FINRA's chief concerns.[6] We encourage FINRA to consider these and other problems described below when fashioning the disclosures contemplated by the Concept Proposal.

Investor Illiteracy Remains Persistent

Research has demonstrated repeatedly that disclosure is not the infallible investor protection measure one might suspect.[7] Many investors do not read written disclosures given to them, whether provided in paper or electronic form.[8] Moreover, studies throughout the decade have revealed the true depth of investor illiteracy: 40 million Americans are illiterate and an additional 50 million have marginal reading skills, well below what is required to parse and understand the complex industry jargon commonly found in securities disclosures.[9]

[3] The United States Securities and Exchange Commission ("SEC") has long recognized that "[f]ull and fair disclosure is one of the cornerstones of investor protection under the federal securities laws." Securities Act Release No. 7497 at 4 (1998).

[4] Dodd-Frank Act § 919 (stating that "[n]otwithstanding any other provision of the securities laws, the Commission may issue rules designating documents or information that shall be provided by a broker or dealer to a retail investor before the purchase of an investment product or service by the retail investor"). Section 919 requires that disclosures: (1) be in a summary format; and (2) contain clear and concise information on the investment objectives, strategies, costs, and risks involved as well as the compensation and financial incentive received by the broker, dealer, or any other intermediary connected to the purchase of the product. *Id.* This rule is similar to the SEC's 2010 proposed rule 15c2-3 related to mutual fund disclosures that is still open for consideration. Exchange Act Release No. 62544 (July 21, 2010).

[5] Angela A. Hung & Eric Talley, *Investor and Industry Perspectives on Investment Advisors and Broker Dealers,* at xvii (2008).

[6] *See, e.g.*, *Id.* at 28.

[7] *Id*.

[8] *See* Elizabeth MacBride, *What We All Feared: "Better" Disclosures Yields Worse Results, According to Yale Professor's Study*, RIABIZ (Sept. 27, 2010), *available at* http://www.riabiz.com/a/2322116.

[9] *Id.* Congress understood this concern in drafting the Dodd-Frank Act, providing for a "financial literacy and underserved investors" provision which increases the ability of the SEC to protect retail customers with the

As part of a 2003 study, the NASD defined "investor literacy" as "the understanding ordinary investors have of market principles, instruments, organizations and regulations."[10] The NASD studied "a wide range of investors across income, gender, size of investment portfolio and types of investments," all of which produced dismal findings of investment illiteracy, despite the fact that almost seventy percent of responding investors "described themselves as being 'somewhat knowledgeable' about investing."[11] Despite overly optimistic self-reporting, this study concluded that "fewer than one-fifth of all individual investors (in stocks, bonds, funds, or other securities) could be characterized as 'financially literate.'"[12] For example, just slightly more than one-third (35%) of the study's respondents were able to "answer[] . . . seven out of the ten of NASD's Basic Market Knowledge questions correctly."[13] Meanwhile, almost two-thirds (62%) of the surveyed investors either did not know or erroneously believed they were insured against stock market losses, and one-fifth of all investors believed such insurance was actually provided either by the SEC (16%) or the NASD (4%).[14]

TD Ameritrade, a FINRA member, funded similar investment illiteracy research in 2006 that revealed that more than half of all surveyed investors incorrectly believed that all brokers owe a fiduciary responsibility "to act in [a customer's] best interest in all aspects of the financial relationship."[15] An NASD study from the same year measured the level of senior investor illiteracy, and determined that, of the 55% of respondents who lost money on an investment,[16] almost one in five "attribute[d] the loss to being misled or defrauded[,] and 78% of those misled or defrauded did not report it."[17] These troubling findings translate into approximately 10% of all senior citizen investors being defrauded at some point—with the majority of defrauded seniors not reporting the fraud. The study also concluded that many "victims of fraud are relatively knowledgeable and active investors."[18]

The 2008 RAND study confirmed earlier findings of widespread investor confusion. It determined that almost two-thirds of surveyed investors "think brokers are legally required to act in the best interest of the client; 70% believe that brokers must disclose any conflicts of

---

creation of the Officer of the Investor Advocate. Dodd-Frank Act § 915; *see also* Edward Pekarek and Christine Goodrich, *A (Dodd-)Frank Primer of Some Imminent Regulatory Reforms*, Nov. 11, 2010, http://nysbar.com/blogs/SecuritiesLitigation/2010/11/a_doddfrank_primer_of_some_imm.html.

[10] Applied Research & Consulting LLC, *NASD Investor Literacy Research*, Executive Summary, at 2 (2003), *available at* http://www.finrafoundation.org/web/groups/foundation/@foundation/documents/foundation/p118411.pdf.

[11] *Id*.

[12] *Id.*

[13] *Id*.

[14] *Id*.

[15] TD Ameritrade Institutional, *Investor Perception Study*, at 1 (2006) *available at* http://rodgers-associates.com/files/investor-perception-study.pdf .

[16] NASD, *Senior Investor Literacy and Fraud Susceptibility Survey Executive Summary* (2006), *available at* http://www.finrafoundation.org/web/groups/sai/@sai/documents/sai_original_content/p036699.pdf.

[17] *Id*.

[18] *Id*.

interest," eclipsing the results of the 2006 TD Ameritrade study.[19] According to Jason Zweig of the *Wall Street Journal*, "the confusion is understandable, because a lot of stock brokers these days call themselves financial planners," financial advisors, financial executives and the like.[20] This use of confusingly similar titles is but one example of industry terminology that is likely to befuddle the investing public, much like the confusion that often arises when a banking customer is exposed to a sales pitch by a bank-affiliated broker within the confines of the retail deposit-taking space.[21] According to a 2009 FINRA Investor Education Foundation study, financial illiteracy is not restricted to any one cohort of the investing public and the troubling trend has actually accelerated among young adults, a vastly more financially illiterate generation than its predecessors. Over time, young adults are the group likely to be most affected by regulatory change prompted by the Concept Proposal.[22]

FINRA recently released the results of a 2010 financial capability study, developed in conjunction with the U.S. Department of the Treasury and the President's Advisory Council on Financial Literacy, which found "a significant disparity" in the financial capabilities of Americans on a state-by-state basis.[23] According to FINRA, the findings of the "unprecedented collection of data on financial behaviors across all 50 states" revealed decidedly mixed results, including the fact that the 28,000 respondents, "on average, were able to correctly answer just three of five questions about fundamental financial concepts."[24] The study "highlights how many Americans are disadvantaged by their lack of financial capability, and offers a wealth of previously unavailable information on Americans' behavior relating to how they manage their resources and how they make financial decisions."[25]

In sum, even if a retail investor does read industry disclosures, the probability of comprehension is quite low.[26] As a result, PIRC urges FINRA to consider the limited impact additional written disclosures might have on the average investor's ability to fully understand investment recommendations.

Delivery Dilemmas

The Concept Proposal calls for disclosure at, or prior to, the commencement of a business relationship between a FINRA member and its customers. Unsophisticated retail investors may not appreciate fully the importance of the Concept Proposal disclosures, especially if pressured to acknowledge receipt by signature during the account opening

---

[19] Jason Zweig, *The Fight Over Who Will Guard Your Nest Egg*, WALL ST. J. (Mar. 28, 2009), *available at* http://online.wsj.com/article/SB123819596242261401.html.
[20] *Id*.
[21] *See* Jill I. Gross & Edward Pekarek, *Banks and Brokers and Bricks and Clicks: An Evaluation of FINRA's Proposal to Modify the "Bank Broker-Dealer Rule*, 73 ALB. L. REV. 465, 472-75 (2010).
[22] FINRA Investor Education Foundation, *Financial Capability in the United States* (2009), *available at* http://www.finrafoundation.org/web/groups/foundation/@foundation/documents/foundation/p120536.pdf.
[23] FINRA Press Release, *FINRA Foundation Releases Nation's First State-by-State Financial Capability Survey* (Dec. 8, 2010), *available at* http://www.finra.org/Newsroom/NewsReleases/2010/P122538.
[24] FINRA Investor Education Foundation, State-by-State Financial Capability Survey, Survey Data, http://www.usfinancialcapability.org/survey_data.html (last visited Dec. 26, 2010).
[25] FINRA Investor Education Foundation, State-by-State Financial Capability Survey, About the Survey, http://www.usfinancialcapability.org/about_survey.html (last visited Dec. 26, 2010).
[26] *See* Gross & Pekarek, *supra* note 21, at 472-75.

process. A recent Princeton University study determined that prospective customers might succumb unduly to the physical and/or social proximity of a broker, for example, during the account opening process, in a manner that could conceivably compromise customer decision-making capabilities.[27]

One potential solution to this problem might be to eliminate the portion of the Concept Proposal that calls for disclosure "at" commencement of a business relationship. Instead, FINRA could institute a "cooling off" period during which customers would be permitted to rescind any customer agreement without cost for a predetermined time period, affording customers the opportunity to consider Concept Proposal disclosures in private and perhaps consult others for insight and advice, absent any "closing" pressure.

At present, there is also no system in place to inform investors of supplemental disclosure events – *e.g.*, disciplinary actions, arbitrations and awards, criminal convictions, newly arising conflicts of interest, and the like – events which could potentially affect customers' business relationship and/or investment decisions. Although FINRA (and its predecessor, NASD) has published disciplinary actions on a monthly and quarterly basis since 1996,[28] retail customers are generally not familiar enough with the materials available on the FINRA website. With disciplinary actions specifically, many customers may not understand that what happened involving their broker qualifies as misconduct. Similarly, when customers assert complaints and/or arbitrations against FINRA members and/or associated person(s), other customers would benefit from being informed of the actions. Thus, FINRA should require member firms to provide supplemental disclosures to customers on a reasonably timely basis.

Information Overload

It is now understood that "[m]ore disclosure is hardly helpful if it produces rivers of fine print that clients will be unlikely to read or, if they do, get much value."[29] Rather than relying so heavily on written disclosures as investor protection *sine qua non*, FINRA should consider requiring verbal disclosures about product and/or strategy recommendations at the time they are made to the customer to complement written disclosures made available with a "cooling off" period. This verbal disclosure would detail: (1) financial (and/or other) incentives accruing to the firm (and/or its employees) from recommending certain products, strategies or services; (2) any conflict(s) that may arise in the servicing of a customer account; and (3) "any limitations on the duties a firm owes to its customers."[30]

Given the complexity of the industry generally and many of the compensation structures it uses to motivate associated persons, brokers should provide a detailed

---

[27] Emily Pronin, *Pitfalls of Investor Decision-Making in the Social Interaction Context* (2010), *available at* http://www.finrafoundation.org/web/groups/foundation/@foundation/documents/foundation/p122332.pdf.
[28] *See* FINRA Monthly & Quarterly Disciplinary Actions, http://www.finra.org/Industry/Enforcement/DisciplinaryActions/MonthlyActions/2010/ (last visited Dec. 23, 2010).
[29] John E. Girouard, *New Rules Mean Investment Advisors May Have a Lot of Explaining To Do*, FORBES, (Nov. 17, 2010) *available at* http://blogs.forbes.com/advisor/2010/11/17/new-rules-mean-investment-advisors.
[30] *See* Disclosure of Services, Conflicts and Duties, FINRA Reg. Notice 10-54 at 3-4 (Oct. 2010).

explanation of how an incentive may benefit them.[31] For example, disclosing that a firm is an "underwriter" or syndicate member for an offering may not provide a clear picture of what that relationship entails. It is not uncommon for brokers to frame discounts the firm receives for acting as an underwriter or syndicate member for a recommended instrument as a "commission-free" transaction. While technically true, customers have the right to know how the member firm and its associated persons benefit from the transaction, especially when brokers have a direct incentive to recommend a particular product.

Disclosure and Disclaimer as New Industry Shield?

PIRC is also concerned that industry members may convert what FINRA intends as protection[32] for retail investors – through the disclosures theorized in the Concept Proposal – into a liability shield.[33] FINRA should explicitly add to any new disclosure requirements that providing the written document does not automatically provide a safe harbor or affirmative defense from liability for false or misleading disclosures. Additional disclosures and disclaimers, such as those suggested by the Concept Proposal, must not provide a license for misconduct.

In the analogous context of prospectus delivery, retail brokers have contended that delivery of a prospectus alleviates their responsibility to fully inform an investor of the potential risk(s) of an investment recommendation.[34] While the securities laws do not affirmatively compel investors to read a prospectus provided in connection with an investment, some courts and arbitrators have imputed to the customer "constructive knowledge" merely for having received a prospectus, regardless of whether it was read or understood.[35] We are also concerned the industry will employ electronic delivery methods and attempt to impute information sent electronically to customers who have not read the materials, much like users who select "I agree" on a website but do not review the terms of a "clickwrap" end user license agreement.[36]

In contrast, securities regulators hold consistently that prospectus delivery is not a safe harbor from liability. Thus, the SEC has declared that "a registered representative may

---

[31] Receipt of compensation based on commission is not, in and of itself, a violation of the standard of care required by the Dodd-Frank Act. Dodd-Frank Act, § 913(g)(1) (2010). Rather, PIRC calls for a rule which makes such compensation programs and commission schemes clear to the average retail customer who lacks financial acumen.
[32] *Id.* at 2.
[33] Reg. Notice 10-54, *supra* note 30, at 4 (calling for a rule which allows broker-dealers to state the limitations of the duties owed to their customers including, but not limited to, limiting their obligation to "assure ongoing suitability of an investment or portfolio of investments").
[34] *See In re* Klein, 52 S.E.C. 1030, 1036 (1996); *In re* Foster, 51 S.E.C. 1211, 1213 n.2 (1994).
[35] *See generally*, Seth Lipner, *Do I Have to Read the Prospectus?*, FORBES (Jan. 13, 2010) *available at* http://www.forbes.com/2010/01/13/lipner-finra-sec-intelligent-investing-prospectus.html.
[36] *But see*, *e.g.*, *Specht, et al. v. Netscape Communications Corp.*, 150 F. Supp 585 (S.D.N.Y. 2001). The *Specht* court held that web site operators must take affirmative steps to prove that a web site visitor read, understood and affirmatively assented to the terms and conditions of the site before an enforceable agreement is created online. *See also* Richard G. Kunkel, *Recent Developments in Shrinkwrap, Clickwrap and Browsewrap Licenses in the United States*, 9 Murdoch U. Electronic J. L. (Sept. 2002) *available at* http://www.murdoch.edu.au/elaw/issues/v9n3/kunkel93.html

be found in violation of [FINRA's] rules and federal securities laws for failure to fully disclose risks to customers even though such risks may have been discussed in a prospectus delivered to the customers."[37] FINRA itself has made clear that delivery of prospectuses or disclosure documents does not suffice when it advised firms that "[m]embers should bear in mind . . . that providing a prospectus does not satisfy the duty to provide balanced sales materials and oral presentations."[38]

As in the prospectus delivery context, FINRA should state expressly that requiring additional disclosures to customers is not a measure intended to assist brokers in avoiding liability. Language that rejects the use of any affirmative defense(s) based on the newly required disclosures would substantially further investor protection.

Uniform Grievance Statement

At present, customer complaints have no uniformity, and thus customers who have little to no financial literacy are hard-pressed to prepare a complaint letter that describes wrongdoing that they may not completely understand. In extreme circumstances, customers may know that *something* was handled improperly, but are unable to articulate what it was without professional assistance. Considering the importance FINRA places on customer complaints and the securities arbitration process for customer-broker disputes, FINRA should consider creating a uniform grievance statement that customers may use if they allege wrongdoing in their account. FINRA should require that its members include this uniform grievance statement with any Concept Proposal disclosures.

At a minimum, such a uniform grievance form could: i) isolate and identify basic information that customers should readily have available on their account statements (*e.g.*, account number, broker-dealer, associated person, supervisor, etc.); and ii) provide customers with a descriptive list of common forms of sales practice violations, to allow customers to better articulate whatever misconduct they contend took place in their brokerage account. Such a form could also provide a section for customers who wish to provide a more detailed description of the account activity with ample opportunity to express concerns with a narrative.

Disclosure Must Not Supplant Fiduciary Duty Considerations

While increased disclosure-based securities regulations are laudable, these disclosures must not supplant the recent call for an explicit broker-customer fiduciary duty – a duty which an overwhelming majority of investors already believe protects them. Section 913 of the Dodd-Frank Act authorized the SEC to conduct a study to determine "the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers" in order to determine whether reform is needed.[39] SEC Chair Mary Schapiro stated in 2009 that

[37] *See* Dep't of Enforcement v. Reynolds, 2001 NASD Discip. LEXIS 17, at *35 (June 25, 2001).
[38] NASD Notice to Members 03-07, *NASD Reminds Members of Obligations When Selling Hedge Funds*, at 49 (Feb. 2003).
[39] Dodd-Frank Act § 913(b)(1).

"investors would rationally say that they prefer fiduciary duty as the standard of care. And they are entitled to have their interests come first, always . . . ."[40]

However, other industry players, including the Securities Industry and Financial Markets Association ("SIFMA"), have concluded "the proposed disclosure is very similar to what [SIFMA] suggested as an alternative to extending the 1940 Act's fiduciary duty to the brokerage industry."[41] Moreover, the way in which the Concept Proposal frames the fifth proposed disclosure – "[l]imitations on the duties a firm owes to its customers"[42] – has the potential to provide broker-dealers with a means to circumvent duties through disclosure and/or disclaimer.

Disclosure-based securities regulation should not be an "alternative" to expressly imposing a fiduciary duty on brokers, but rather should be used in conjunction with the promulgation of a uniform standard of care: requiring brokers to act "in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice."[43] FINRA should consider including language in the fifth provision to emphasize that broker-dealers may not rely on that provision to circumvent or dilute their duties and responsibilities recognized under current law.

Conclusion

Congress enacted the Dodd-Frank Act, in part, to determine "whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for brokers, dealers, investment advisors, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute."[44] Unsophisticated retail customers, far more so than other investors, lack understanding of financial terminology, market structure and a broker-dealer's existing legal obligations. Thus, any disclosure rule FINRA promulgates must protect the "average customer."

In drafting a rule that requires additional broker-dealer disclosures, we urge FINRA to seriously consider the depth of investor illiteracy amongst average retail customers. A decade of research has irrefutably established that retail investors have only marginal understanding of today's complex financial markets. Prudential regulation by FINRA calls for, *inter alia*, the recognition that additional precautions are warranted to afford maximum protection to the investing public. Similarly, any new regulations resulting from the Concept Proposal should include an express elimination of any new industry shields from liability through affirmative defenses and/or liability disclaimers. We support the Concept Proposal

[40] Jason Zweig, *The Fight Over Who Will Guard Your Nest Egg*, WALL ST. J. (Mar. 28, 2009), *available at* http://online.wsj.com/article/SB123819596242261401.html.
[41] Malini Manickavasagam, *FINRA Seeks Comment on Raising Broker-Dealers Retail Disclosure Obligations*, BNA SEC. REG. & L. REP. (Oct. 28, 2010).
[42] *Id.* at 4.
[43] Dodd-Frank Act § 913(g)(1).
[44] *Id.*, § 913(b)(2).

to the extent stated above, and urge FINRA to adopt additional measures that genuinely protect the interests of modest means investors.

Respectfully submitted,

Jill I. Gross
Director, PIRC

Edward Pekarek
Assistant Director, PIRC

Christopher Bloch
Law Graduate Assistant, PIRC