FINANCIAL SERVICES INSTITUTE
VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS
AND INDEPENDENT FINANCIAL ADVISORS

VIA ELECTRONIC MAIL

March 5, 2013

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 13-02, Proposed Rule to Require Disclosure of Conflicts of Interest Relating to Recruitment Compensation Practices

Dear Ms. Asquith:

On January 4, 2013, the Financial Industry Regulatory Authority (FINRA) released Regulatory Notice 13-02,[1] a request for comment on a proposed rule requiring disclosure of conflicts of interest relating to certain recruitment compensation practices (Proposed Rule). Under the Proposed Rule, a member firm that has provided financial incentives for a financial advisor to join their firm would be required to provide specific disclosures of any financial incentives received prior to transferring client accounts to the new firm. The Financial Services Institute[2] (FSI) appreciates the opportunity to comment on this important proposal.

Background on FSI Members

The independent broker-dealer (IBD) community has been an important and active part of the lives of American investors for more than 30 years. The IBD business model focuses on comprehensive financial planning services and unbiased investment advice. IBD firms also share a number of other similar business characteristics. They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of packaged products, such as mutual funds and variable insurance products; take a

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[1] Regulatory Notice 13-02 (Jan 4, 2012), *available at* http://www.finra.org/Industry/Regulation/Notices/2013/P197600.

[2] The Financial Services Institute, Voice of Independent Broker-Dealers and Independent Financial Advisors, was formed on January 1, 2004. Our members are broker-dealers, often dually registered as federal investment advisers, and their independent contractor registered representatives. FSI has well over 100 Broker-Dealer member firms that have more than 138,000 affiliated registered representatives serving more than 14 million American households. FSI also has more than 35,000 Financial Advisor members.

comprehensive approach to their clients' financial goals and objectives; and provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their registered representatives. Due to their unique business model, IBDs and their affiliated financial advisers are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.

In the U.S., approximately 201,000 independent financial advisers – or approximately 64% percent of all practicing registered representatives – operate in the IBD channel.[3] These financial advisers are self-employed independent contractors, rather than employees of the IBD firms. These financial advisers provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans with financial education, planning, implementation, and investment monitoring. Clients of independent financial advisers are typically "main street America" – it is, in fact, almost part of the "charter" of the independent channel. The core market of advisers affiliated with IBDs is comprised of clients who have tens and hundreds of thousands as opposed to millions of dollars to invest. Independent financial advisers are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities and client base. Most of their new clients come through referrals from existing clients or other centers of influence.[4] Independent financial advisers get to know their clients personally and provide them investment advice in face-to-face meetings. Due to their close ties to the communities in which they operate their small businesses, we believe these financial advisers have a strong incentive to make the achievement of their clients' investment objectives their primary goal.

FSI is the advocacy organization for IBDs and independent financial advisers. Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisers play in helping Americans plan for and achieve their financial goals. FSI's primary goal is to ensure our members operate in a regulatory environment that is fair and balanced. FSI's advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. FSI also provides our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

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[3] Cerulli Associates at http://www.cerulli.com/.
[4] These "centers of influence" may include lawyers, accountants, human resources managers, or other trusted advisers.

Comments

FSI continues to support regulatory efforts that provide consumers with access to competent investment advice, clear and concise client disclosures, and effective regulatory supervision. We support the practice of providing meaningful disclosure, particularly in instances where genuine conflicts of interest exist and need to be known for customers to make fully informed investment decisions. As have previously discussed in our comments to Regulatory Notice 10-54,[5] we support a dual-tiered disclosure regime that overcomes many of the challenges with client disclosures currently. By offering customers a layered approach that includes meaningful and understandable information in different formats, customers are less likely to be overwhelmed with voluminous paperwork and can make choices that will better position them to make fully informed investment decisions. We understand FINRA's concerns related to recruitment compensation, and do not underestimate the impact that undisclosed conflicts of interest have in the financial industry.

Our members support the disclosure of possible and potential material conflicts of interest. However, we do not believe that the Proposed Rule accomplishes that laudable goal. We find it to be simultaneously overbroad and under-inclusive, resulting in a Proposed Rule that is not well-designed to provide protection to retail customers beyond what is afforded under current rules and regulations. The Proposed Rule fails to address retention bonuses and other analogous compensation which may raise similar conflict of interest concerns. Moreover, the Proposed Rule calls for detailed disclosure of personal financial information of financial advisors, with significant consequences to the advisor, without a demonstration that the loss of privacy is outweighed by the benefit to retail customers. We are also concerned that the proposed disclosure requirements may prove counter-productive to achieving many other important goals, particularly succession planning for financial advisors.

The Proposed Rule appears primarily concerned with recruitment compensation packages that pay financial advisors a multiple of their trailing 12-month revenue production. The Proposed Rule raises concerns that this type of enhanced compensation incentivizes financial advisors to place their clients in unsuitable investments or to churn their accounts in order to maximize the payout arrangement's benefits to the advisor.[6] We understand

[5] *See* Comments by Financial Services Institute (Re: Regulatory Notice 10-54); *available at* https://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/noticecomments/p122722.pdf.

[6] *See* Open Letter to Broker-Dealer CEOs from SEC Chairman Mary L. Schapiro, dated August 31, 2009, *available at* http://www.sec.gov/news/press/2009/2009-189.htm.

this concern; however, we believe this perspective is flawed for several reasons which are described in this comment letter.

Our comments are not designed to downplay the risks associated with conflicts of interest in our industry; rather, we hope to highlight areas where FINRA must proceed cautiously and with greater attention to the complexities and unintended consequences inherent in the provisions of the Proposed Rule.

The Proposed Rule is not Well-Designed to Provide Additional Protection to Retail Customers

For a variety of reasons, FSI concludes that the Proposed Rule is not well-designed to provide additional protections to retail investors. We describe these concerns in greater detail below.

- Further Regulatory Action Should Be Postponed Until FINRA Completes Its Ongoing Conflicts of Interest Review - One troubling aspect of the Proposed Rule is that it has been introduced while FINRA is undertaking a review of the procedures firms use to manage and identify conflicts of interest.[7] Firms have processes in place to identify and assess whether business practices put a firm or representative's interests ahead of a customer's, and we commend FINRA for initiating a review to better understand the steps that firms take to protect investors. Rather than waiting for the results of this review, however, FINRA has decided to forge ahead with a proposal that incorrectly assumes that all compensation offered to transitioning representatives over $50,000 raises genuine conflict of interest concerns. We believe this assumption is misguided. Compliance programs are capable of managing the potential conflicts of interest related to recruitment by internally flagging customer accounts connected to a financial advisor who has received certain enhanced compensation package. Firms can monitor these accounts to identify potentially offending behavior and work with the representative and customers to remedy the issue.

- Existing Regulations Address Potential Abuses Arising From Conflicts of Interest - An advisor who churns customer accounts or recommends investments unsuitable for a client would be in clear violation of FINRA and SEC rules. The Proposed Rule, therefore, assumes bad faith on the part of advisors who accept recruitment compensation and implies that a transferring customer should view their financial advisor's advice apprehensively. If a financial advisor does in fact move a customer

[7] See Targeted Examination Letter Re: Conflicts of Interest (July 2012); available at http://www.finra.org/Industry/Regulation/Guidance/TargetedExaminationLetters/P141240.

into unsuitable investments or churns an account then FINRA should not hesitate to bring an enforcement action to discipline the advisor. However, the proposed disclosure of an advisor's recruiting bonus will give customers the mistaken belief that their financial advisor's advice should now be viewed suspiciously. Because penalties already exist to punish advisors, the disclosure will only serve to unnecessarily interfere with the relationship an advisor has built with their clients.

- The Monetary Threshold is Arbitrarily Set at $50,000 - The Proposed Rule presumes that recruitment compensation always results in a conflict of interest for the recruited financial advisor. This is simply not the case. In fact, a variety of enhanced compensation arrangements are offered by firms to recruit financial advisors, many of which do not create improper incentives. The Proposed Rule insists that a firm offering transition assistance to registered persons creates conflicts of interest, but does not explain how a recruiting firm that offers to cover the clients' ACAT transfer fees, pay for new advertising materials, letterhead and business cards, or reimburse a financial advisor for lost revenues during the transition period creates incentives for advisors to churn accounts or place clients in unsuitable investments. Firms will often cover moving expenses, the cost of leasing space, purchasing furniture, paying staff overtime, and the termination fees associated with moving accounts. Similarly, many firms will offer a forgivable loan that is not tied to production, but instead forgives portions of the loaned amount based on the length of time the advisor stays with the new firm. None of these types of recruitment compensation arrangements create incentives for financial advisors to engage in activities that conflict with their clients' best interests.

  Rather than assessing qualitative factors that more accurately indicate conflicts of interest, the Proposed Rule concludes that, so long as the total amount conferred to a financial advisor is in excess of $50,000, firms must disclose that the compensation raises potential conflicts of interest. This sets an arbitrary nominal threshold and fails to adequately address the problem that it attempts to remedy. The result of FINRA's targeted exam letters and meetings with firms will hopefully shed more light on this issue. Because firms offer a variety of recruitment compensation to transferring advisors, it may be most prudent for FINRA to assemble a Working Group to collect additional information related to the use of recruitment bonuses in the industry. By assessing the prevalence of various recruitment bonuses, the amounts typically offered, and other relevant facts, FINRA can then make a well informed decision about how best to proceed in order to achieve its intended goals.

- The Proposed Rule Fails to Address Similarly Activities that May Raise Conflicts - Enhanced compensation related to retaining, as opposed to recruiting, financial advisors may raise the same types of conflicts of interest depending on the payment arrangement, yet the disclosure of retention bonuses is not covered by the Proposed Rule. There is no reasonable rationale for including recruitment compensation while excluding retention bonuses within this proposal. This lack of consistency underscores the problem discussed earlier -- arbitrarily setting a nominal $50,000 threshold does not provide firms the flexibility to use qualitative factors when determining whether conflicts of interest need to be disclosed. Inconsistencies and gaps in the regulatory framework are a predictable result of substituting FINRA's judgment for the firm's. We believe placing the burden on firms to develop and comply with comprehensive policies and procedures related to conflicts identification and disclosure will better serve the industry and investors.

Impact on Business Practices

We believe the Proposed Rule will have significant unintended consequences for the business practices of financial advisors and broker-dealers. Our concerns are described below:

- Financial Privacy – The Proposed Rule threatens the financial privacy of advisors in a manner that is unfair and needlessly intrusive. As the country continues to recover from the worst financial crisis since the Great Depression, and millions of Americans remain out of work, the Proposed Rule would force financial advisors to reveal their personal financial condition to their clients which may jeopardize the relationships they have developed in their communities. The SEC recognized the importance of protecting personal financial information when it adopted Regulation S-P, which requires firms to ensure their customers' financial privacy. While Regulation S-P would likely not apply to an advisor who is required to disclose enhanced compensation to former clients, the principle of protecting personal financial information should remain consistent regardless of whether the individual is a financial advisor or a customer. The safety of advisors may even become endangered if the disclosure of their personal financial condition makes them an attractive target for robbery, extortion or other criminal activity.

- The Required Disclosure Threatens Advisors' Succession Planning - The Proposed Rule may also have the unintended consequence of complicating a financial advisor's succession plan. This succession plan may involve working with another representative to ensure that clients are adequately protected after the retirement of their financial advisor. It is not uncommon for a financial advisor involved in a succession plan to entrust his customers to a competent colleague in the industry who does not share the same broker-dealer affiliation. In those cases, the retiring financial advisor's firm will often offer transition assistance to the succeeding representative advisor to assist the new advisor while he transfers his broker-dealer affiliation and becomes familiar with the new broker-dealer and the outgoing representative's financial advisor's clients. This practice is to the benefit of investors and everyone in the industry; however, the Proposed Rule would create a disincentive to engaging in this advance planning practice. The new financial advisor, just beginning his relationship with the new clients, now appears potentially conflicted when the only activity he or she has engaged in is to accept transition assistance in order to implement an adequate succession plan. The proposed disclosure requirement in the Proposed Rule may in fact threaten the beneficial efforts by firms to incentivize succession planning. With the aging of the financial advisor population, this would be a very unfortunate unintended consequence of the Proposed Rule.

- Inconsistent Rules Will Lead to Additional Movement Toward Under-Regulated Business Models - Because of the regulatory gap that exists between broker-dealers and investment advisors, we have concerns that 13-02 will serve as yet another reason to move away from FINRA's regulatory jurisdiction. As the compliance burden increases on financial advisors with broker-dealer affiliations, some may feel drawn toward the registered investment advisor business-model which does not apply the same proscriptive rules-based approach. This movement toward a less regulated environment introduces competitive concerns and, more importantly, increases the risks that investors face in the marketplace. The proposed disclosure is another example where inconsistent regulatory oversight places investors at additional risk.

Development of an Improved Recruitment Compensation Disclosure

In order to improve its effort to disclose recruitment compensation to investors, FSI suggests that FINRA form a Working Group to continue to analyze this issue thoroughly. The Working Group should be tasked with collecting and reviewing qualitative information regarding the different types of recruitment compensation in the financial services industry. The Working Group should look to the differences between transition assistance and other types of compensation to determine whether distinctions should be made with regard to disclosure. In addition, recruitment disclosures should be integrated with other pre-engagement client disclosures considered by

FINRA in Regulatory Notice 10-54 to enhance their effectiveness and limit information overload. We also suggest focus group testing to determine whether a general disclosure of recruitment compensation practices will provide the same level of protection to clients as specific financial disclosures while still preserving the privacy of advisors.

In the end, we believe FINRA will conclude that allowing firms to identify and reasonably disclose the general details of conflicts of interest that arise in their own recruitment compensation practices as part of a concise, consolidated, pre-engagement disclosure document will prove to be the best approach to this issue.

Conclusion

We are committed to constructive engagement in the regulatory process and, therefore, welcome the opportunity to work with FINRA on this and other important regulatory efforts.

Thank you for your consideration of our comments. Should you have any questions, please contact me at 202 803-6061.

Respectfully submitted,

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Executive Vice President & General Counsel