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BY EMAIL (PUBCOM@FINRA.org)

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

RE: Comment on Proposed Rule to Require Disclosure of Conflicts of Interest Relating to Recruitment Compensation Practices (Reg. Notice 13-02)

Dear Ms. Asquith:

Thank you for the opportunity to comment on FINRA Regulatory Notice 13-02, regarding the proposed rule change that would require a Recruiting Member firm to disclosure to clients the financial incentives it offers to a representative as part of his or her relationship with the new firm.

By way of background, I have represented clients on both sides of transitions. On behalf of broker-dealers I have sued brokers for violating the Protocol for Broker Recruiting, obtained temporary restraining orders, and litigated and settled hundreds of promissory note cases. I have also represented Registered Representatives by negotiating their recruitment compensation packages, advising them regarding best practices to transition their clients, defending them in injunction proceedings, and helping them resolve promissory notes owed to their former employers. I have also represented retail and institutional investors in arbitrations and in court in connection with sales practice violations.

I do not support the proposed rule because the disclosures are misleading. They provide a skewed and incomplete picture of potential compensation conflicts in the broker-client relationship. This forced partial disclosure will unnecessarily create an assumption of impropriety by the broker, while at the same time provide an advantage to the member firm attempting to retain the client without requiring that firm and its employees to disclose their own potential conflicts.

I also cannot support the proposed rule as it is far too broad in that aspects of recruitment compensation practices that provide bonuses based on asset levels do not raise any conflict issues and should be exempt from the proposed rule if it is adopted.

However, I would support an alternative approach that would advance investor protection by requiring recruiting firms to send clients a FINRA drafted pamphlet that flags issues related to transitions which have previously been adopted by the NYSE. The pamphlet should be included with all ACAT forms.

I. Analysis

a. Forced disclosure of recruitment compensation bonuses does not give the client any meaningful information especially considering the other aspects of compensation and their conflicts that are not disclosed.

Chairman Shapiro's August 31, 2009 letter focuses on the conflict created when recruiting programs offer recruits substantial inducements for "sales of investment products." She states the Commissions belief that programs designed to reward representatives for increased commissions may create incentives that could result in the churning of customer accounts, sale of unsuitable investments or other activity that would generate commissions that were not in the investors' interest.

However, since the securities acts were adopted, the compensation structure for stock brokers has always been based primarily on rewarding brokers who generate commissions. At its simplest level, a compensation structure that pays a broker a percentage of the commissions the broker generates creates an incentive for the broker to place trades.

Firms regularly offer many types of incentives for a broker to generate commissions that have nothing to do with recruitment practices, but also raise potential conflict issues[1]:

- *Standard Commission Grid Compensation.* Most member firms have a grid compensation structure that encourages the generation of commission by paying the broker increasing percentages of those commissions based upon the level of gross commission generated. The more the broker sells, the more he moves up the grid to a higher percentage payout. The Standard Grid Payout for some firms can go as high as 50% of the gross revenue generated.

[1] OnWallStreet summarized the compensation structure for all of the major wirehouses and most regional firms for 2012 and made them available online. http://www.onwallstreet.com/global/payout_grids.html. A brief review of these industry compensation summaries makes clear that all of the major firms provide increasing compensation in return for increased generation of commissions. See also, Mason Braswell and Lorie Konish, Compensation Plans Step Up to Next Level, March 4, 2013, On Wall Street. http://www.onwallstreet.com/ows_issues/23_3/compensation-plans-step-to-next-level-2683372-1.html?zkPrintable=1&nopagination=1

- *Year-Over-Year Increase Production Bonus*. Some firms encourage growth by providing bonuses for year-over-year increases in production. For example, a firm may offer a broker 7% of the broker's trailing 12 gross production if the broker was able to increase his production by 20% from the previous year.

- *Club Programs*. Some firms provide bonuses based on reaching certain fixed gross production hurdles annually. For example, at some firms, if a broker can achieve $1,000,000 in gross commission a year, the broker would be entitled to an additional $60,000 in bonus money.

- *Trainee Programs.* At many firms, trainees are required to hit certain production and asset levels every quarter. If they fail to meet these hurdles, they are terminated. Trainee Programs generally last about three years and close to 90% of trainees eventually fail. These programs can create substantial pressure on trainees to hit their mandated production levels.

- *Other incentives*: Other compensation including deferred stock/options programs, deferred bonuses, prizes, trips, titles, larger offices, and increased marketing budgets are all types of rewards given by Broker Dealers to brokers to encourage them to generate more commissions.

All of these programs are designed to reward brokers for increased commissions that can create incentives that may put brokers in conflict with the interests of their clients. These incentives are pervasive in the industry and none are regularly disclosed to clients.

However, rules already exist which are designed to mitigate the impact of potential conflicts thereby protecting investors. For example FINRA's Suitability Rule 2111 requires a broker to make only suitable recommendations regardless of the broker's compensation.

By mandating the disclosure of Recruitment Compensation, FINRA is essentially asking the client to reexamine the suitability of the broker's recommendations in light of only one of many unknown potential conflicts. However, the client is not in a position to evaluate the recommendation or the potential conflict with only partial information. It is the member firms and broker's responsibility to determine and recommend only suitable investments. That obligation should not be shifted to the clients.

A client has no way of analyzing a recruitment incentive bonus when the customer does not know anything about the rest of the broker's day-to-day compensation. For example, a client has no ability to determine whether a broker's $100,000 bonus is a significant sum of money. It depends, in part, on what other compensation the broker is receiving which is information the client has not been given.

b. The proposed rule gives clients misleading and incomplete information, because it does not require the broker's former firm to disclose the incentives it offers its brokers and managers to prevent clients from transferring their accounts.

The proposed rule also only addresses the potential conflicts of enhanced compensation packages for the transitioning broker during a transition. The Retaining Broker at the former firm who has been assigned to attempt to keep the clients may receive additional compensation if he is successful. In some instances, the Retaining Broker is offered enhanced compensation above the grid to keep a client with the firm. Some firms even offer branch managers enhanced compensation based on their retention rate of clients of departing brokers.[2]

By not disclosing these potential conflicts as well, a client is left with an unbalanced picture which makes it appear as if the departing broker has done something wrong or unethical.

c. Aspects of Recruitment Compensation Practices that provide bonuses based on asset levels do not raise any potential conflict issues and should be exempt from the proposed rule.

Clearly if the form of the recruitment compensation does not present a potential conflict, there is no reason to disclose it. Asset based compensation does not encourage any sort of trading and therefore should be exempt from the proposed rule.

Many firms structure their back-end loans so that they are based upon an increase in the representatives' assets under management, and not based on an increase in commissions generated. Such practices eliminate any incentive to churn accounts, while at the same time meet member firm's legitimate objectives of encouraging brokers to grow their business.

Respected Recruiter Howard Diamond recently noted that most firms have already moved away from commission based back-end compensation and questioned the need for disclosure of asset based bonus payments:

> While there is a back-end bonus portion to many of the recruiting bonuses that are paid today, most are based upon the increase in assets under management and not increase in revenues. Why should an advisor come

[2] For example, branch managers may be paid a bonus 6 – 9 months after a broker leaves the firm based on the amount of assets that did not follow the departing broker.

> under scrutiny for trying to build his business and gather assets? Back-end bonus payments based upon the growth of an advisor's assets under management would clearly not lend itself to the "conflicts" argument.

Howard Diamond, *Should FAs Disclose Recruiting "Bonuses" to Clients, as FINRA Proposes? A Recruiter's Perspective*, Jan. 14, 2013, WealthManagement.com[3].

Moreover, some firms have already taken steps to address potential conflicts of interest raised by back end bonuses as recognized by FINRA in its Notice.[4] This is the appropriate way to deal with potential conflicts of interest through firm's adopting supervisory procedures that ensure compliance with existing rules.

II. Unintended Consequences.

The information gained by the proposed disclosure will eventually be obtained and aggressively used by a broker's former firm as a tool to try to persuade clients not to follow their brokers to their new firms. Firms may imply that the only reason a broker left the firm was because they were greedy.

In addition, many firms have had difficulty retaining brokers over the past few years and are net-losers in the recruitment wars. Some of these firms put in place retention compensation plans to try to stem the loss of brokers to rivals. These plans are scheduled to wind-down within the next two years. I believe these firms will likely be the biggest beneficiaries if the proposed rule is adopted, not the clients.[5] If brokers are required to disclose their recruitment compensation to clients, the brokers may be less likely to move firms even though a change of firms may ultimately be to the benefit of the client.

It is also possible that the disclosure of recruitment compensation will mislead some clients into thinking that the size of the compensation package is a measure of the new firm's endorsement of the broker because of incomplete information—"your broker is so great, we gave her a $150,000 sign-on bonus."

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[3] http://wealthmanagement.com/rias/should-fas-disclose-recruiting-bonuses-clients-finra-proposes-recruiter-s-perspective

[4] Some firms who still use revenue hurdles as a trigger to pay back-end bonuses have addressed the conflict issue by including contract language making clear that the broker is not entitled to the back-end bonus if the turnover rate/velocity in the client account is above a certain low level, (i.e. 1.5). This takes away any added incentive for the broker to churn customer accounts and provides customers with an additional level of protection.

[5] It is also very interesting to note, that of all the client-broker conflicts described herein, the proposed rule only seeks disclosure of the one conflict which will have severe anticompetitive results for departing brokers.

III. Responses to Some Specific Requests for Comments.

a. Alternative Approach.

The Notice asks for specific comment on "an alternative approach that would require a general upfront disclosure by the recruiting member or registered person that the registered person is receiving, or will receive, material enhanced compensation in connection with the transfer of securities employment (or association) to the recruiting member and that additional specific information regarding the details of such compensation is available."

As discussed above, I do not believe the details—dollar amounts—of the recruitment compensation should be systematically provided to the clients, as clients do not have the information necessary to properly put that information in perspective in the context of total compensation and other potential conflicts. However, I would be in favor of a rule requiring the publication of an educational bulletin flagging potential issues that a client should consider when considering moving accounts to a new firm.

In 2006, NYSE Regulation published a bulletin as part of their "Informed Investor" series entitled, If Your Broker Changes Firms, What Do You Do?[6] The bulletin provides a list of questions that clients should ask their brokers, among other questions of interest to the clients, when evaluating whether or not they want to move their accounts to their broker's new firm:

- Why is the broker changing firms?
- How will the change affect your account?
- Will certain products or services that you like be available at the next firm?
- Can your existing investments be transferred to the new firm?
- How are fees different at the new firm?
- Will you have to pay any fees to the old or new firm to make the change?
- Are there any tax consequences if you are asked to sell any of your existing products?

[6] https://usequities.nyx.com/mkt-equities-regulation/informed-investor-series

- Are there elements of the broker's transition package that relate to the commissions, fees or costs associated with your account?

I believe FINRA should create a comparable updated disclosure that should be attached to all ACAT forms. With this information, clients can make their own determination as to what information they consider important in evaluating whether they should follow their broker to a new firm. To the extent a client wants additional information, a client can ask their broker for it.

b. The proposed rule is not well designed to eliminate conflicts.

The Notice also asks, "Is the proposed rule well designed to reduce conflicts related to recruitment compensation and practices?" The answer is "no." The rule does not prevent or reduce any conflicts because it does not prohibit any action. The proposed rule merely provides an incomplete disclosure of one of many potential conflicts. However, as discussed above, the way to avoid potential conflicts is to enforce existing rules rather than through forced incomplete disclosure.

IV. Requests for More Information.

In order to allow more thoughtful discussion and comment, I ask FINRA to make publicly available any evidence or statistics it has that demonstrates that current Recruitment Compensation Practices have been problematic. Without such evidence, it seems that the supervisory processes and rules already in place address FINRA's concerns. Forced disclosure without any demonstrated need for the disclosure will only damage relationships between the client, the broker and the firm.

I also ask FINRA to clarify how some firms have already changed their Recruitment Compensation Practices to eliminate potential conflicts. The Notice points out that in response to the Chairman's letter, "many firms restructured the recruiting compensation arrangements to avoid incentivizing such activity." However, FINRA gave no guidance as to how these firms modified their practices and satisfied the SEC's concerns. Such information will help commentators suggest ways to more narrowly tailor the rule to the perceived problem.

V. Final Comments.

A broker's decision as to where he or she chooses to work is based on many factors and is usually not limited to transition compensation. Considerations include a comparison of firms' reputations, relationship with the branch manager, technology, office location, platform, culture, fee structure and products. Firms compete for these brokers and their customers through constant innovation. This competition prevents stagnation in the industry and ultimately benefits clients by providing better customer support, resources and pricing. The adoption of the proposed rule will make it more difficult for brokers to switch firms and will eventually dampen innovation and harm the customer.

By forcing disclosure of recruitment compensation, clients will be given a false sense that they have been given complete information when, in fact, they have only been shown a sliver of the truth. This partial disclosure of a piece of a very large complex compensation package is misleading to clients and will distract them from asking more relevant questions. Clients should not be focusing on how a broker's pay or bonuses are derived from the broker's entire book of business, but instead the clients' focus should be on issues that more directly relate to that client's accounts. FINRA should empower investors by giving them a guideline of questions they may want to ask when considering following their broker to a new firm.

Finally, I think it is illustrative to contrast the proposed mandatory recruitment compensation "conflict" disclosure to attorneys' ethical and fiduciary obligations owed to their clients. When lawyers move from one law firm to another, they usually ask their clients to join them at their new firm. However, the Rules of Professional Conduct do not require the attorneys to detail to clients the "lucrative financial incentives" they were offered by the new law firm, such as increase in salary, the firm's formula for granting bonuses, or the new firm's requirements to make equity partner. The proposed rule would make brokers' disclosure obligations to their clients more stringent than attorneys' fiduciary obligations owed to theirs. That seems unreasonable.

Very truly yours,

<u>/s/ Brent A. Burns</u>