

MICHIGAN STATE
UNIVERSITY
COLLEGE OF LAW

March 21, 2014

VIA Email Only

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

RE: Regulatory Notice 13-42 FINRA's CARDS Proposal

Dear Ms. Asquith,

On behalf of the Investor Advocacy Clinic at Michigan State University College of Law (the "Clinic"), we write to support FINRA's proposal to develop a Comprehensive Automated Risk Data System ("CARDS"). The Clinic is a Michigan State College of Law clinical course in which students provide representation to public investors and public education about investment fraud in the Michigan area. We have a strong interest in supporting measures to increase investor protection. We strongly support FINRA's proposed CARDS system because it may significantly improve FINRA enforcement by allowing it to more effectively target its enforcement resources.



Legal Clinic

610 Abbot Road
East Lansing, MI 48823

517-336-8088
Fax: 517-336-8089
www.law.msu.edu/clinics

The Need for CARDS

The CARDS Proposal may protect investors and ensure market integrity by more effectively policing the market. At present, a real need for improved enforcement exists. In 2013, over 1,500 disciplinary actions were brought against firms and individuals, resulting in more than \$75 million in fines and restitution ordered.¹ These numbers were not abnormal. In 2012, FINRA brought nearly 1,550 disciplinary actions, resulting in around \$102 million in fines and restitution ordered.² These enforcement statistics reveal a real need for improved supervision. While FINRA already requires broker-dealers to maintain policies and regulations in place to prevent abuse,³ CARDS offers an intelligent way to supplement member-firm oversight through continuous data analysis, which may allow FINRA to identify problems early. Earlier regulatory intervention could substantially reduce the scope of investor damage and member liability.

¹ Brian Rubin and Andrew McCormick, *Annual Sutherland Analysis of FINRA Sanctions Shows 27% Decrease in Fines; Number of Cases Nearly Identical*, BusinessWire, <http://www.businesswire.com/news/home/20140224006363/en/Annual-Sutherland-Analysis-FINRA-Sanctions-Shows-27#.UymNSGkS6cw> (Mar. 18, 2014).

² FINRA, *2012: FINRA Year in Review*, available at <http://www.finra.org/Newsroom/NewsReleases/2013/P197624> (released Jan. 8, 2013).

³ FINRA Rule 3010.

CARDS Potential Savings Justifies Its Cost

Thus far, the cost concerns raised by other commenters have presented a one-sided accounting. Although CARDS will undoubtedly cost money to design, create, implement and maintain, those costs must be balanced against the cost-savings retail investors will experience if CARDS substantially improves FINRA's supervision and enforcement. Improved enforcement and oversight will lessen overall costs to both investors and member firms by improving enforcement effectiveness. Indeed, fear of triggering CARDS may independently deter wrongdoing. Other commenters have argued that gathering the additional information necessary to comply with CARDS' requirements will be costly. Yet these commenters fail to address the harms to customer accounts, which CARDS seeks to lessen. In any event, the cost concerns may be overblown; FINRA's proposed two-step implementation process should help spread costs over a period of years.

Data Security Concerns

Many commenters have argued that "data security is the biggest issue."⁴ Indeed, many customers and brokers have penned comments noting a fear that CARDS could compromise data security. In response, FINRA has clarified that the proposed CARDS system "will not require the submission of information that would identify [] the individual account owner, account names, account address or tax identification number."⁵ We strongly support FINRA's decision to limit the amount of information it collects to protect customer privacy and avoid creating additional data-security vulnerabilities.

Moreover, FINRA already balances these privacy considerations when it regularly examines member firms. Indeed, through CARDS, FINRA will collect the *same* information that it already collects for member-firm examinations. CARDS simply moves these ad-hoc collections to a more regular and automated form. While we support the proposed CARDS system, we strongly encourage FINRA to take every feasible measure to ensure the system's security to protect against data theft.

FINRA Should Use CARDS to Focus Examinations on Retail Investors

FINRA's proposal "envisions that the first phase of CARDS would focus on business conduct for retail accounts" and asks for comments addressing "ways in which the first phase could be structured to best achieve the goal of focusing it on business conduct for retail accounts." We strongly support FINRA's focus on retail investor protection and detail our ideas below.

Policing Variable Annuities Sales

CARDS would allow FINRA to more closely police unsuitable sales of variable annuities. Variable annuities are sophisticated, long-term investments and are far too often sold to investors who do not need them.⁶ While variable annuities may be suitable for a limited class of investors, their high fees

⁴ Dan Jameson, *Brokers Want to Thwart Finra's CARDS Plan to Collect Client Data*, Financial Advisor Magazine, <http://www.fa-mag.com/news/brokers-want-to-thwart-finra-plan-to-collect-client-data-17126.html> (Mar. 10, 2014).

⁵ FINRA, *Update Regarding Regulatory Notice 13-42-Comprehensive Automated Risk Data System*, <http://www.finra.org/Industry/Regulation/Notices/2013/P451243> (Mar. 14, 2014).

⁶ Craig J. McCann, *et. al*, *Annuities*, Securities Litigation & Consulting Group ("With apologies to Winston Churchill, we can say this about tax-deferred variable annuities: never in the field of financial products has so much been sold to so many when

incentivize brokers to oversell them. CARDS would allow FINRA to easily red flag potentially unsuitable sales by filtering for account type and investor age.

As FINRA has observed, variable annuities may be less suitable for retail investor's retirement accounts. FINRA has issued an Investor Alert on the issue:

Investing in a variable annuity within a tax-deferred account, such as an individual retirement account (IRA) may not be a good idea. Since IRAs are already tax-advantaged, a variable annuity will provide no additional tax savings. It will, however, increase the expense of the IRA, while generating fees and commissions for the broker or salesperson.⁷

To its credit, FINRA has been policing this tax issue for over a decade. In 1999, it issued a Notice to Members explaining that variable annuities "provide no additional tax deferred treatment of earnings beyond the treatment provided by the tax-qualified [account] itself."⁸ CARDS may effectively focus FINRA enforcement on potentially unsuitable variable annuities within IRA accounts.

Variable annuities may also be less suitable for investors with shorter time-horizons because their benefits take decades to materialize.⁹ FINRA may use CARDS to focus on this issue by scrutinizing variable annuities sold to seniors and retirees. FINRA may use their relatively advanced age as a proxy for inferring shorter time-horizon.

Oversold Alternative Investments

CARDS should also be used to identify instances where member-firms or associated persons sell high concentrations of alternative investment products. With respect to these products, Brad Bennett, FINRA's Enforcement Chief, commented that "most mom-and-pop investors 'don't understand the risks they're taking.'"¹⁰ Despite this, alternative investment sales are booming. A total of \$59 billion were poured into alternative mutual funds during the first six months of 2013.¹¹

CARDS positions FINRA to target enforcement resources whenever a member firm sells an abnormally high concentration of alternative investment products. Under FINRA's suitability rule, "a broker's recommendations must be consistent with his customers' best interests."¹² As FINRA has observed, alternative investments are unlikely to be suitable for everyone because "only a very narrow band of investors [may be] capable of evaluating and being financially able to bear"¹³ the risks associated

⁷ See FINRA, *Variable Annuities: Beyond the Hard Sell*, Investor Alert.

⁸ NASD Notice to Members 99-35, *The NASD Reminds Members of Their Responsibilities Regarding the Sales of Variable Annuities* (May 1999).

⁹ See McCann, *supra* note 6.

¹⁰ James Sterngold, 'Alternative' Investments Draw Flak, *Wall Street Journal*, <http://online.wsj.com/news/articles/SB10001424127887323455104579014893143233748> (Mar. 18, 2014).

¹¹ *Id.*

¹² *In re Sathianathan*, Admin. Proc. File No. 3-12245, 2006 SEC LEXIS 2572, at *21 (Nov. 8, 2006); see also *In re Epstein*, Admin. Proc. File No. 3-12933, 2009 SEC LEXIS 217, at *40 n.24 (Jan. 30, 2009) ("In interpreting the suitability rule, we have stated that a [broker's] 'recommendations must be consistent with his customer's best interests.'").

¹³ NASD Notice to Members 03-71, *NASD Reminds Members of Obligations When Selling Non-Conventional Investments* (Nov. 2003).

with alternative investments. CARDS may allow FINRA to infer that a member firm may not be performing suitability analyses in instances where a product suitable for a few has been sold to many.


Asset Class Overconcentration

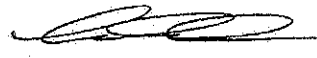
CARDS may also be used to identify troubling asset overconcentration. Asset allocation matters. As "most investors haven't studied financial economics, read financial economic journals, or read books on modern portfolio theory, they don't understand how many stocks are needed to build a well-diversified portfolio."¹⁴ Brokers and broker-dealers may recommend only suitable investments. Recommendations which cause overconcentration are not suitable. By observing overconcentration, FINRA can infer a probability of unsuitable recommendations.

Conclusion

We strongly support FINRA's ambitious CARDS proposal. This innovative approach to oversight should be applauded because it will give FINRA a significant analytical tool. We thank FINRA for the opportunity to comment on this proposal.

Respectfully submitted,


Casey Gonyea
Law Student Clinician


Michala Welch
Law Student Clinician

Michigan State University College of Law
Investor Advocacy Clinic
Legal Clinic
610 Abbot Road
East Lansing, Michigan 48823
(517) 336 – 8088, Option 6
(517) 336 – 8089 Fax
securities.clinic@law.msu.edu

¹⁴ Larry Swedroe, *Why don't stock investors diversify?*, Money Watch, available at <http://www.cbsnews.com/news/why-dont-stock-investors-diversify/> (May 1, 2012).