

Disclosure of Services, Conflicts and Duties

FINRA Requests Comment on Concept Proposal to Require a Disclosure Statement for Retail Investors at or Before Commencing a Business Relationship

Comment Period Expires: December 27, 2010

Executive Summary

FINRA requests comment on a concept proposal to require member firms, 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.

Questions concerning this *Notice* should be directed to:

- Philip Shaikun, Associate Vice President, Office of General Counsel, at (202) 728-8451.

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by December 27, 2010.

Member firms and other interested parties can submit their comments using the following methods:

- Emailing comments to pubcom@finra.org; or
- Mailing comments in hard copy to:

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

October 2010

Notice Type

- Request for Comment

Suggested Routing

- Compliance
- Legal
- Operations
- Registered Representatives
- Senior Management

Key Topics

- Conflicts of Interest

Referenced Rules & Notices

- NASD Rule 3110
- Regulatory Notice 09-34

To help FINRA process and review comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA website. Generally, FINRA will post comments on its site one week after the end of the comment period.¹

Before becoming effective, a proposed rule change must be authorized for filing with the SEC by the FINRA Board of Governors, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.²

Background and Discussion

Even as the legislation that became the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was being developed, FINRA staff considered how it might implement a heightened standard of care with respect to broker-dealers. The staff determined that no matter how the ultimate contours of such a standard would be concluded, retail customers would benefit from an upfront disclosure document that sets forth in plain English a firm's accounts and services, its associated conflicts of interest and any limitations on duties owed to the customer. The staff conceived of a document similar in purpose to Form ADV, which is required under the Investment Advisers Act to be provided to each advisory customer. The staff believed that such a document would not only provide useful information to a retail customer, but also would help clearly define the scope of the duties owed to that customer.

With the enactment of Dodd-Frank, the staff believes the concept is even more appropriate, if not an outright necessity. The legislation requires the SEC to conduct a study of the obligations of broker-dealers and investment advisers, and authorizes subsequent SEC rulemaking to establish a fiduciary duty for broker-dealers. Notably, the study must consider the regulatory gaps between broker-dealer and investment adviser regulation, and the SEC has asked for comment as to how such gaps may be closed. Additionally, the legislation requires the SEC to facilitate simple and clear disclosures of material conflicts by both broker-dealers and investment advisers. Accordingly, in anticipation of satisfying any resultant rulemaking mandates and to enhance retail investors' understanding of the business, relationships and conflicts of their brokers, FINRA staff is seeking comment on the contours of a proposal that would require each firm to timely provide to retail customers a statement of services, conflicts and duties. Firms would continue to provide the more particularized sales practice disclosures currently required in interactions between registered representatives and customers.

As conceived by FINRA staff, a possible new rule proposal would require a firm, at or prior to commencing a business relationship with a retail customer, to provide to the customer a written statement that sets forth the types of brokerage accounts and services the firm provides to retail customers and the conflicts associated with such services. A “retail customer” would mean a customer that does not qualify as an institutional account under NASD Rule 3110(c)(4). The definition of “institutional account” under that rule consists of a bank, savings and loan, insurance company, registered investment company, registered investment adviser or any entity (which includes natural persons) with total assets of at least \$50 million.

FINRA staff further conceives that the document would include the following characteristics and subject matter:

- **The types of brokerage accounts and services the firm provides to retail customers, such as research, underwriting and recommendations of securities, products and strategies.**
- **Disclosures that are reasonably designed to permit existing and prospective retail customers of the firm to evaluate:**
 - the scope of services provided by the firm to its retail customers and any limitations on the scope of the services offered (e.g., that the universe of research covered may be limited or influenced by the issuers with which the firm maintains an investment banking relationship or the securities for which the firm acts as a market maker or otherwise engages in proprietary trading);
 - the scope of products offered to the firm’s retail customers;
 - to the extent applicable, that the firm may not offer all products of a certain class or type and that it or its affiliates may be the sponsor or originator of certain products and may determine in some cases to act as a distributor or placement or sales agent for a fee from the issuer or sponsor of the product; and
 - all fees associated with each brokerage account and service offered to retail customers, a specific description of the service provided for each fee and whether fees are negotiable presented in a manner to allow customers to make comparisons between broker-dealers.

- **Disclosures as to financial or other incentives that a firm or its registered representatives have to recommend certain products, investment strategies or services over similar ones, including:**
 - in the case of investment company securities, the information required by proposed FINRA Rule 2341(l)(4);³
 - any arrangement in which the firm receives any economic benefit (including cash, revenue sharing, commissions, equipment, research or non-research services) from any person, including an issuer or product manufacturer in connection with providing a particular product, investment strategy or service to a customer;
 - any arrangement in which the firm compensates or receives any economic incentive for customer referrals from or to any individual or firm; and
 - any arrangement in which a registered representative receives different payouts or other rates of compensation for certain products or services that are reasonably likely to provide an incentive for the registered representative to offer that product in lieu of similar products offered by the firm.
- **Disclosure of 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.**
- **Limitations on the duties a firm owes to its customers; for example, that the firm:**
 - does not assure the ongoing suitability of an investment or portfolio of investments;
 - takes no responsibility for the propriety of unsolicited orders, other than to discharge its best execution obligation; or
 - may execute any transaction on a principal basis, absence instructions to act only in an agency capacity.

Request for Comment

FINRA staff welcomes all comments on the concept proposal. Among other things, FINRA staff is interested in comments on the following:

- Scope:** Is the proposal either overbroad or too narrow in the products, services and conflicts requiring disclosure?
- Delivery method:** Should the disclosure statement be delivered in writing in hard copy or made electronically available or both?
- Form and content:** How detailed should the disclosures be? How best to ensure meaningful disclosure without overwhelming retail investors? Should there be two-tiered disclosure, such as a general disclosure document with hyperlinks or website references where investors can obtain more detailed disclosures of a firm's products, services and attendant conflicts and limitations?
- Timing:** How often should a firm update and provide the disclosure statement to retail customers?

Endnotes

- 1 FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. *See NASD Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.
- 2 Section 19 of the Securities Exchange Act of 1934 (SEA or Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. *See* Exchange Act Section 19 and rules thereunder.
- 3 *See Regulatory Notice 09-34* (June 2009).

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