FINANCIAL SERVICES INSTITUTE

VOICE OF INDEPENDENT BROKER-DEALERS
AND INDEPENDENT FINANCIAL ADVISORS

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VIA ELECTRONIC MAIL

May 12, 2008

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: File Number S7-06-08 - Regulation S-P

Dear Ms. Morris:

On March 13, 2008, the Securities and Exchange Commission (SEC) proposed an amendment to Regulation S-P.[1] If approved, the proposed amendment (Proposed Amendment) would set forth more specific requirements for safeguarding information and responding to information security breaches, and broaden the scope of the information covered by Regulation S-P's safeguarding and disposal provisions. It would also extend the application of the disposal provisions to natural persons associated with brokers-dealers, investment advisers registered with the SEC and transfer agents registered with the SEC, and would extend the application of the safeguarding provisions to registered transfer agents. Finally, the Proposed Amendment would permit a limited transfer of information to a nonaffiliated third party without the required notice and opt-out when financial advisors move from one broker-dealer or registered investment adviser to another. The Financial Services Institute welcomes the opportunity to comment on the Proposed Amendment.[2]

Background on FSI Members and their Customer Relationships

The IBD community has been an important and active part of the lives of American consumers for more than 30 years. The IBD business model focuses on comprehensive financial planning services and unbiased investment advice. IBD members 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, by "check and application"; take a comprehensive approach to their clients' financial goals and objectives; and provide investment advisory services through either affiliated registered investment advisor firms or such firms owned by their registered representatives. Due to their unique business model, IBDs and their affiliated financial advisors 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 98,000 independent financial advisors – or approximately 42.3% percent of all practicing registered representatives – operate in the IBD channel.[3] These financial

[1] Regulation S-P, *Privacy of Consumer Financial Information*, 12 C.F.R. Part 248, effective November 13, 2000.
[2] The Financial Services Institute 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 118 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 12,500 Financial Advisor members.
[3] Cerulli Associates Quantitative Update: Advisor Metrics 2007, Exhibit 2.04. Please note that this figure represents a subset of independent contractor financial advisors. In fact, more than 138,000 financial advisors are affiliated

advisors are self-employed independent contractors, rather than employees of the IBD firms. These financial advisors 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 advisors are typically "main street America" – it is, in fact, almost part of the "charter" of the independent channel. The core market of advisors affiliated with IBDs is clients who have tens and hundreds of thousands as opposed to millions of dollars to invest. Independent financial advisors 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. Independent financial advisors 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 advisors 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 advisors. Member firms formed FSI in 2004 to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisors play in helping Americans plan for and achieve their financial goals. FSI's primary goal is to insure 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 the compliance, operations, and marketing efforts of member firms.

The Proposed Amendment is of particular interest to FSI members. Maintaining the privacy and security of client data is an issue of great concern to IBDs. However, we believe this important policy objective must be balanced against other important concerns, including account portability and investor choice. Unfortunately, the Proposed Amendment fails to strike the correct balance of these competing concerns. As a result, FSI cannot support the Proposed Amendment as written and encourages significant revisions to improve the final version.

Detailed Comments

Recent SEC enforcement activity has sought to sanction an independent broker-dealer for facilitating the timely transfer of client accounts from one firm to another due to alleged violations of Regulation S-P.[4] According to the SEC staff's enforcement position, when a financial advisor affiliated with a firm whose privacy policy restricts the use of clients' personal information is preparing for clients' account transfers, sharing client information with the new brokerage firm without each client's prior consent is a violation of Regulation S-P. Broker-dealers may be aiding and abetting violations of Regulation S-P if they assist financial advisors in organizing their client data or in preparing account-related forms, particularly if the new firm receives any client information to do so. Once a financial advisor actually departs his or her current brokerage firm, the financial advisor's use of client information for any purpose without prior client consent is a violation—even when that information is already in the financial advisor's possession. Moreover, the SEC has also asserted that a firm violates Regulation S-P if it allows a financial advisor to retain client data when they depart the firm or, in the alternative, it fails to disclose in its privacy

with FSI member firms. Cerulli Associates categorizes the majority of these additional advisors as part of the bank or insurance channel.

[4] See *In re NEXT Financial Group, Inc.*, Exchange Act Release No. 56316 (Aug.24, 2007), http://www.sec.gov/litigation/admin/2007/34-56316.pdf, and Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 (Aug. 24, 2007) (alleging violations of the notice and opt out provisions of Regulation S–P and the safeguards rule in connection with recruiting registered representatives), http://www.sec.gov/litigation/admin/2007/34-56316-o.pdf.

notice that financial advisors are allowed to continue using client information when they depart the firm.[5] This strict enforcement position came as a surprise to many independent contractor broker-dealer firms and their affiliated financial advisors who believed that the client relationship belongs to the advisor, not the broker-dealer firm. This position also came as a surprise to clients who expected to continue working with their chosen advisor even if he or she changed broker-dealer firms.

FSI has been actively pursuing regulatory relief from the SEC's interpretation of certain provisions of Regulation S-P because of the significant negative impact on portability of customer accounts and investor choice. The consequences of the SEC staff's enforcement position have been substantial delays in the account transfer process and unnecessary interference with an investor's choice of financial advisor. In order to achieve compliance with the SEC's current interpretation of Regulation S-P, each client of a firm with a restrictive privacy policy must be individually contacted and his or her consent must be documented before client information can be shared outside the current firm. Preparation of client communications and forms by anyone outside the current firm cannot start until that client's consent has been received. Adding the time and cost of these additional steps to today's account transfer process dramatically slows the processing and adds significant costs for staffing and communications. Ironically, the SEC staff's view allows the current firm to share the client's information with a complete stranger, within the broker-dealer firm, without the client's prior consent while precluding the information's use by the financial advisor who received it from the client in the first place. Technology used to merge data with required account transfer forms is largely useless as nothing can be done for a client until his or her consent is obtained. While the account transfer process is pending, clients are often unable to access their accounts or, in many cases, have their current financial advisor service their accounts. The biggest impact has been upon smaller accounts, which are often the lowest priority. Some smaller accounts have even been abandoned as the result of an unduly costly and cumbersome account transfer process.

FSI has actively advocated for regulatory relief that would allow broker-dealers to facilitate the timely transfer of client accounts between firms. Efficient transfers allow investors choice regarding the financial advisor with whom they do business. The Proposed Amendment addresses some of these concerns by attempting to strike a balance between protecting investors from identify theft and preserving account portability and investor choice. The Proposed Amendment does this by providing a limited exception from the notice and opt-out provisions otherwise required by Regulation S-P before information can be shared. While the Proposed Amendment represents a significant step forward, it nevertheless suffers from significant shortcomings that will severely limit its effectiveness in achieving its stated objective.

The Proposed Amendment would allow firms with departing financial advisors the option to share limited customer information with the advisors' new firm if the following conditions are met:

- The information shared relates to clients to whom the financial advisor personally provided a financial product or service at the prior firm and is limited to the client's name, address, telephone number, e-mail information, and a general description of the type of account and products held within the account;
- The information does not include any client's account number, Social Security number, or securities positions; and

[5] For a full discussion of genesis of this issue, please see FSI's Member Briefing entitled *SEC Staff Recommends Enforcement Action under Regulation S-P Dramatically Affecting Customer Transfers When Financial Advisors Change Firms* at http://www.financialservices.org/MediaLibrary/FSIMemberBriefing_RegS-P.pdf.

- The broker-dealer or investment adviser requires the departing financial advisor to provide a written record of the information that will be disclosed pursuant to this exception. The written record must be provided to their former broker-dealer no later than the financial advisor's date of separation from employment with that firm.[6]

The SEC acknowledges that allowing this limited information sharing is unlikely to put an investor at risk for identity theft and will promote investor choice and account portability. We could not agree more. Unfortunately, the Proposed Amendment would allow a broker-dealer the option of denying a departing financial advisor even the most basic contact information about their clients. All the firm has to do is decide not to take advantage of the exception. Departing financial advisors would be unable to utilize the information necessary to facilitate the transfer of the accounts of those clients who choose to follow them to the new firm. The Proposed Amendment would, therefore, allow the financial advisor's former broker-dealer the ability to deny investors the very benefits the Proposed Amendment is supposed to provide by simply choosing to deny the financial advisor continued access to basic information concerning his or her clients.

Therefore, FSI recommends that Regulation S-P be amended to require broker-dealers and investment adviser firms to share limited customer information with their former financial advisors' new firm if he or she complies with the following conditions:

- The information shared by the financial advisor relates only to clients to whom the financial advisor personally provided a financial product or service at the prior firm and is limited to the client's name, address, telephone number, e-mail information, and a general description of the type of account and products held within the account;
- The information shared by the financial advisor does not include any client's account number, Social Security number, or securities positions; and
- The departing financial advisor provides the broker-dealer or investment advisor a written record of the information that will be disclosed pursuant to this exception. The written record must be provided to their former firm no later than the financial advisor's date of separation from that firm.

FSI has the following additional concerns about the proposed exception to allow the limited transfer of information to a nonaffiliated third party without the required notice and opt-out when financial advisors move from one broker-dealer or registered investment adviser to another:

- The exception does not address the need for financial advisors to obtain customer information to respond to regulatory inquiries or to defend themselves against customer complaints made while at their old firms. We recommend that Regulation S-P be amended to require a broker-dealer or investment adviser to provide a former financial advisor access to customer information necessary to respond to such regulatory inquiries or customer complaints.
- The exception establishes the date of "separation from employment" as the deadline for the departing financial advisor to provide his broker-dealer a written record of the information that will be disclosed to the new firm under the exception. This language must be changed to "separation from affiliation" so that it accurately reflects the independent contractor status of financial advisors associated with independent broker-dealer firms.

[6] See Section 15(o)(8) of the Proposed Amendment at Release, 733 Fed Reg. 13716.

- The exception only applies to information use and sharing when representatives are transferring between broker-dealers and SEC-registered investment advisers, but not to or from state-registered advisers. FSI believes that clients of state-registered advisers should also be guaranteed portable accounts and their choice of financial advisor. We understand that correcting this problem would require Congressional action because the SEC does not have regulatory jurisdiction over state registered investment advisers. Therefore, we urge the SEC to seek Congressional support to correct this problem.

In addition to these account portability and investor choice issues, FSI has concerns about the Proposed Amendment's attempt to set forth more specific requirements for safeguarding information and responding to security breaches. The relevant provisions of the Proposed Amendment are described briefly below:

- Safeguarding Policies and Procedures - The Proposed Amendment would require broker-dealers, registered investment advisers, and other industry participants to develop, implement, and maintain a comprehensive information security program appropriate to their size and complexity, the nature and scope of their activities, and the sensitivity of any personal information they utilize.
- Responding to Data Security Breaches - The Proposed Amendment would require broker-dealers, registered investment advisers, and other industry participants to develop written policies and procedures for responding to unauthorized access to or use of personal information.
- Application of Safeguards and Disposal Rules - The Proposed Amendment would extend the coverage of the Safeguards and Disposal Rules to associated persons of a broker-dealer, supervised persons of a registered investment adviser, and other industry participants. The Proposed Amendment would also extend the Safeguards and Disposal Rules to protect personal information, which would encompass any record containing either non-public personal information or consumer report information. It also would include information identified with any consumer, employee, investor, or security holder who is a natural person.
- Maintaining Records of Compliance - The Proposed Amendment would require registrants to document compliance with the proposed information security program requirements, and to maintain other detailed compliance records.

The proposed changes will create significant burdens for independent broker-dealer firms and require the allocation of considerable resources to review and revise existing privacy and data security policies and procedures. In fact, the SEC estimates smaller firms would have to spend 2 to 80 hours and an average of $18,560 initially to adopt the enhanced procedures.[7] Larger firms are expected to spend between 40 and 400 hours and an average of $172,732 to adopt and implement the new procedures.[8] Of course, the cost of compliance does not end there. Annual compliance for small firms is estimated by the SEC to involve 12 to 40 hours and an average annual cost of $10,764.[9] Meanwhile, larger firms are expected to need 32 to 100 hours for compliance annually, at an estimated average yearly cost of $51,084.[10] Many firms indicate that these figures are at the low end of their expected range of charges in light of the technical nature of the work and the substantial ongoing monitoring required. Whatever the specifics, the consensus opinion is that the compliance costs will be substantial.

[7] See Release, 73 Fed Reg. at 13711. "Smaller institutions" are defined as entities with no more than 10 employees.
[8] Id. "Larger institutions" are defined as entities with 10 or more employees.
[9] Id.
[10] Id.

FSI believes these costs could be substantially reduced without significantly affecting the investor protections sought by the SEC if the following issues are addressed as we recommend:

- Threshold for Client Notification is Too Low – The Proposed Amendment requires only that misuse be "reasonably possible" and that there be a significant risk of "more than trivial financial loss" or "expenditure of effort" or "loss of time" to trigger the notification requirements. In fact, notification requirements are triggered even if data is encrypted or otherwise unreadable. The SEC appears to have set the threshold too low. The Proposed Amendment will thus result in unreasonable cost to firms and unnecessarily alarmist notifications to clients. FSI recommends that the threshold be raised by eliminating the compromise of encrypted or unreadable data and requiring misuse to be "likely" of resulting in "significant risk of financial loss."
- State Security Breach Laws May Conflict with the Proposed Amendment – At least 39 states have adopted their own security breach notification statutes.[11] Introducing a new federal requirement may result in the duplication of notifications to clients who reside in states who have substantially different requirements than those imposed by the Proposed Amendment.[12] The patchwork of conflicting notification requirements will likely increase costs to firms and result in confusion for investors. In light of the disparate federal and state requirements, it would be appropriate for Congress to preempt state law in this area. We urge the SEC to seek Congressional support for such preemption.
- Private Cause of Action – The Proposed Amendment may give rise to a private cause of action for a firm's failure to have an Information Security Program that meets the requirements or if the firm fails to follow the terms of their program. This would create a new opportunity for plaintiff's attorneys to bring costly class action or other litigation against broker-dealers doing their best to comply with Regulation S-P. The Proposed Amendment must be changed to clearly state that there is no private cause of action.
- Creates Individual Liability – The Proposed Amendment creates individual liability for violations by expanding the safeguard rules to associated persons of broker-dealers and supervised persons of investment advisers. This substantially increases the liability exposure for broker-dealer employees and financial advisors who will look to their firm for higher compensation or insurance coverage to offset the risk. These costs will be passed on to clients. In light of fact that even the best security systems are vulnerable, this individual liability appears unreasonable and should be eliminated.
- Difficulty Evidencing Compliance with Information Security Program – The Proposed Amendment's requirement that firms document in writing the proper disposal of personal information is simply unworkable within the independent broker-dealer model. Under its terms, firms would be required to document in writing compliance with the disposal requirements each time an employee or independent financial advisor replaces a computer or cell phone. The same would appear to apply when customer files or other similar information is disposed of in a branch or home office. These requirements are overly expansive and simply unreasonable. We urge the SEC to adopt more reasonable recordkeeping requirements.

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[11] See National Conference of State Legislatures, State Security Breach Notification Laws at http://www.ncsl.org/programs/lis/cip/priv/breachlaws.htm.

[12] The SEC recognizes this concern in the Release. See Release, 73 Fed Reg. 13708.

Conclusion

We are committed to constructive engagement in the regulatory process and, therefore, welcome the opportunity to work with you further improve investor understanding through more concise and effective disclosure.

Thank you for your consideration of our comments. Should you have any questions, please contact me at 770 980-8487.

Respectfully submitted,

Dale E. Brown, CAE
President & CEO