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

Financial Services Institute
607 14th Street NW, Suite 750
Washington, D.C. 20005
888 373-1840 | financialservices.org

VIA ELECTRONIC MAIL

April 17, 2014

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

Re: SR-FINRA-2014-010

Dear Ms. Murphy:

On March 10, 2014 the Financial Industry Regulatory Authority (FINRA) filed a proposed rule change to adopt FINRA Rule 2243, which would establish disclosure and reporting obligations related to recruitment practices (Proposed Rule)[1]. The Proposed Rule would apply to advisors who receive recruitment compensation of $100,000 or more in upfront or future payments. These advisors would be required to provide a disclosure form specifically related to the recruitment compensation they received to any former clients who the advisor attempts to contact regarding the transfer of assets to the advisor's new firm. The disclosure would include the amount of compensation the advisor was paid upfront by the broker-dealer and/or the aggregated potential future payments they will be paid by the broker-dealer as part of the recruitment arrangement. The disclosure would also describe whether the client would incur costs to transfer their assets to the advisor's new broker-dealer. If some assets are non-transferrable this must also be disclosed. In addition, the rule would require firms to report to FINRA when an advisor receives either a $100,000 or 25% increase in their prior year's compensation as part of a recruiting arrangement. The Financial Services Institute[2] (FSI) appreciates the opportunity to comment on this important development.

<u>Background on FSI Members</u>
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 comprehensive approach to their clients' financial goals

[1] Notice of Filing of Proposed Rule Change to Adopt FINRA Rule 2243 (Disclosure and Reporting Obligations Related to Recruitment Practices), SR-FINRA-2014-010, 79 Fed. Reg. 17592 (Mar. 28, 2014).
[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 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 37,000 financial advisor members.

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.

Comments

FSI appreciates the opportunity to provide comments on this important proposal. FSI continues to support regulatory efforts that provide investors with clear and concise client disclosure, effective regulatory oversight and supervision, and "competent financial advice." We support meaningful disclosure, particularly in instances where customers must be made aware of material conflicts of interest in order for them to make fully informed investment decisions. As we have discussed in previous comment letters,[5] FSI supports a dual-tiered disclosure regime that overcomes many of the challenges clients currently face with the often lengthy and hard to understand disclosures. By providing clients a layered disclosure option that includes meaningful and easy to read information in different formats, customers are less likely to be overwhelmed with voluminous paperwork and can make better and more informed investment decisions. We understand FINRA's concerns with respect to recruitment compensation and material conflicts of interest, and we

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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.
[5] See Letter by David Bellaire to Elizabeth M. Murphy, July 5, 2013, *available at* https://www.sec.gov/comments/4-606/4606-3138.pdf.

support proposals that address the additional risks that conflicts of interest may present in the financial services industry.

We are very supportive of FINRA's efforts to improve transparency for investors, and we believe the Proposed Rule provides a good framework to further that goal. However, we also believe there are certain changes that can be made to improve the rule's effectiveness. Our suggestions include the following:

1. FSI believes the Proposed Rule's text would benefit from additional detail with respect to calculating compensation, including the direct costs that can be subtracted, and should be refined to ease compliance;
2. FSI has concerns that the proposed rule may cause advisors to violate non-solicitation agreements in instances where a client has communicated that they do not want to transfer to the advisor's new firm; we request that FINRA provide additional guidance regarding how it defines "individualized contact" that "attempts to induce the former customer to transfer assets to the member", thus triggering the disclosure requirement;
3. Finally, we encourage FINRA to apply its economic impact assessment framework to regulatory efforts like the Proposed Rule and to perform a retrospective review of the Proposed Rule

We discuss each of these concerns in detail below:

1. **Calculating Costs and Compensation**: FSI is encouraged by FINRA's decision to increase the threshold level within the rule to $100,000. In addition, FSI appreciates that the Proposed Rule permits members to net out costs directly incurred by a representative in connection with a transfer to the recruiting firm. We request additional guidance (and flexibility) be provided to firms and advisors with respect to calculating costs for the purposes of disclosure. The rule text also should clarify what is acknowledged in the rule filing, which is that two separate thresholds -- one for upfront compensation and one for potential future payouts -- exist for purposes of triggering the disclosure requirement. While the filing uses the specific example of an advisor who received $75,000 in upfront compensation and $75,000 in potential future payments without triggering the disclosure requirement, the rule text itself is not explicit on this fact.[6] The disclosure requirement would be triggered, according to the rule text, "if the registered person has received or will receive $100,000 or more of either (A) aggregate upfront payments or (B) aggregate future payments…"[7] We suggest that FINRA add Section 2243(a)(1) to the rule to clarify this issue, stating::

    - *"if the registered person has received or will receive (A) $100,000 or more of aggregate upfront payments or (B) $100,000 or more of aggregate future payments, in connection with transferring to the member;"*

    FSI also believes this rule may be improved if FINRA were to provide further clarity with respect to the definition of "increased costs incurred directly" that may be netted out of the compensation calculation according to Supplementary Material .04 of the proposed

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[6] *Id.* at 87
[7] *Id.* at 347.

rule text.[8] For example, we suggest that FINRA provide guidance on whether costs to advisors, such as moving expenses, lease or rental costs, new overhead costs, costs incurred in repapering accounts, the loss of revenue when transferring firms, overtime and bonuses paid the advisors' employees, or the cost of temporary employees are also to be included in this calculation.

In addition, we suggest that FINRA provide additional clarity with respect to recruitment compensation arrangements paid to ensemble practices. In the ensemble practice model, multiple advisors form a team similar to the partner structure of law firms, and may include junior advisors who are groomed for a future senior partnership role. The clients are supported by an entire team rather than a single point of contact. Ensemble practices may also have the benefit of subject matter experts to provide services such as tax, insurance, and estate planning. Depending on the recruiting arrangement, a senior advisor may be paid the full amount upfront or through future payments, however, this would be distributed to other partners of the practice such as junior advisors. The disclosure requirement in this case may be triggered on the individual senior advisor under the rule when in reality the compensation arrangement does not exceed the individual's de minimis threshold.

Finally, we suggest that FINRA provide additional clarity in the rule text regarding the higher commission schedule payouts received by advisors that occur when they transfer to an independent broker-dealer. Independent broker-dealers provide higher payouts to advisors to offset the fact that advisors are not salaried employees as is the case in the traditional wirehouse model. Rather, advisors in the independent model are independent contractors responsible for all their expenses and taxes related to their practice, which is their own small business. The filing states in a footnote[9] that this increased compensation arising from the payouts in the independent channel would not be included in either category of required recruitment compensation disclosure, however the rule texts leaves this ambiguous by referring only to "special commission schedules" paid on commission basis beyond "what is ordinarily provided to similarly situated registered persons."[10] This language on its own does not clearly explain that the higher commission schedule payouts received by a transferring representative, as often occurs when a representative transfers to an independent broker-dealer, would not be included in the disclosure calculation. We suggest having the rule text specifically state that higher commission schedule payments received by a transferring representative shall not be included in the calculation of "aggregate upfront payments" or "aggregate future payments."

2. **Non-Solicitation and guidance regarding "attempts to induce":** Under the proposed rule, if an advisor orally contacts a former customer regarding transfer of assets to the advisor's new firm, such contact must be followed by written disclosure sent within 10 business days, even if the client communicates a preference to remain with their existing firm.[11] This contact would occur against the wishes of the client despite the fact that the mailing of the disclosure is required by the Proposed Rule. The requirement may also violate contractual non-solicit agreements that the advisor enters into with their former firm. Some firms will require advisors to sign non-solicitation agreements with firms which

[8] *Id*. at 350.
[9] *Id*. at 10 note 8.
[10] *Id*. at 351.
[11] *Id*. at 85.

only allow them to announce their departure from the firm so that clients are aware of the change. Under these agreements, advisors are not allowed to encourage a client to transfer their assets but clients may do so if they wish. While the announcement that the advisor is leaving their current firm does not violate a non-solicitation agreement, the Proposed Rule would define the announcement as an "inducement" and require that the announcement be followed-up with the disclosure, which may violate the terms of the non-solicitation agreement. This puts advisors into a situation where they may become the subject of allegations by the firm of violating their non-solicitation agreement as a result of following the requirements set forth in the Proposed Rule. We believe additional guidance is needed regarding how FINRA defines "individualized contact" that "attempts to induce the former customer to transfer assets to the member," thus triggering the disclosure requirement.

The filing states: "FINRA believes that any action taken by a recruiting firm directly or through a representative that attempts to induce former customers of the representative to transfer assets to the recruiting firm should trigger disclosures. As such, under the proposed rule change, actions by the recruiting firm or the representative that do not involve individualized contact, such as tombstone advertisements, a general announcement, or a billboard, would be considered an attempt to induce former customers to move their assets. In these circumstances, if a former customer subsequently decides to transfer assets to the recruiting firm without individualized contact, the proposed rule change would require the recruiting firm to provide the proposed disclosures to former customers with the account transfer approval documentation."[12] Under this interpretation, any individualized contact by an advisor that consists solely of an announcement that the advisor is leaving the firm would be considered an "attempt to induce former customers to move their assets." This would trigger the disclosure requirement even if the client said that they do not want to transfer their assets to the new firm. Advisors would not be violating a non-solicitation agreement by providing the announcement, but the rule would require him or her to provide the disclosure. FSI suggests that FINRA alter the language of the proposed rule to indicate that, if at the point of contact a client indicates a preference to not transfer to the advisor's new firm, no subsequent written disclosure needs to be provided. FSI suggests the following language be added to FINRA Rule 2243(b)(1):

- *"… unless a former customer indicates a preference to not transfer an account to transfer assets to the member."*

3. **Cost-Benefit Analysis:** FSI has long supported cost-benefit analysis in agency rulemaking and was encouraged by the release of FINRA's economic impact assessment framework in September 2013.[13] FINRA's goal with this framework is to help ensure that rules are "better designed to protect the investing public and maintain market integrity while minimizing unnecessary burdens."[14] The Framework outlines several key principles and approaches that can ensure this goal, including: 1) consulting with key stakeholders in the development of rules; 2) providing clarity about the objectives and potential impacts of rule proposals and alternatives considered; and 3) obtaining supporting evidence where

[12] *Id.* at 14.
[13] See Framework Regarding FINRA's Approach to Economic Impact Assessment for Proposed Rulemaking (September 2013); available at http://www.finra.org/web/groups/industry/documents/industry/p346389.pdf.
[14] *Id.*

practical.[15] FINRA also indicated that significant future rule will address the following questions:

- o What is the problem, issue, or practice that necessitates regulatory action?
- o What is the objective of the regulatory action?
- o What is the baseline against which to measure the likely economic consequences of the proposed regulatory action?
- o What is the proposed solution and how does it address the problem?
- o What are the reasonable alternative options available?
- o What are the anticipated economic impacts associated with the options, including the costs and benefits and distributional impacts, in particular as to efficiency, competition, and capital formation?

FSI believes that rules like this one are good candidates for FINRA to conduct in-depth and robust cost-benefit analysis for addressing the above questions. Although FINRA does discuss some of these questions in this rule filing, there were missed opportunities to provide empirical evidence and quantitative data (e.g., the number of sales practice violations involving recruitment compensation arrangements) that could have assisted commenters in responding. Further discussion and analysis of potential unintended consequences would also be welcome when assessing the impacts of this rule proposal as the requirements as proposed create some operational and supervisory challenges.

We encourage FINRA to utilize the economic impact assessment framework and to obtain and provide supporting evidence where practicable. Furthermore, FINRA should engage in a retrospective review of the finalized rule after it has been in effect for a sufficient period of time (we recommend five years) in order to determine whether the rule addressed the problems it was intended to mitigate, whether implementation of the rule had unanticipated economic impacts and whether the dollar threshold chosen was set at an appropriate level.

Conclusion

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

Thank you for your consideration of our comments. Should you have any questions, please contact me at [redacted]

Respectfully submitted,

David T. Bellaire, Esq.
Executive Vice President & General Counsel

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[15] *Id.*