taylor | english

January 30, 2013

By Email (pubcom@finra.org)

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

Re: **<u>FINRA Regulatory Notice 13-02; Request for Comment on Recruitment Compensation Packages</u>**

Dear Ms. Asquith:

Taylor English Duma LLP appreciates the opportunity to provide this letter in response to FINRA Regulatory Notice 13-02 ("Notice 13-02"), which seeks public comments on a proposed rule that would require specific disclosures by a recruiting member firm of the financial incentives a representative receives as part of his or her relationship with the new firm.

Taylor English Duma LLP is a full-service law firm based in Atlanta, Georgia that regularly advises issuers, financial services firms, investors and securities professionals regarding securities law matters. We submit this letter on our own behalf as attorneys who are actively engaged in securities law matters. The opinions expressed in this letter are our own and do not necessarily reflect the opinions of any of our firm's clients.

The rule proposed in Notice 13-02 (the "Proposed Rule") would require member firms to disclose to certain non-institutional customers enhanced compensation packages offered to recruit representatives under certain circumstances. In connection with our independent analysis of the Proposed Rule, we have reviewed the responsive comments previously published on FINRA's website as well as the plethora of public commentary available on the Internet and in various industry publications. One common theme is prevalent among the commentators: There is much confusion about the clear purpose and intent of the Proposed Rule as currently drafted. Respectfully, we share in this confusion, and we believe that the analysis provided by FINRA in its executive summary in Notice 13-02 identifies the root of the confusion.

On the one hand, the Proposed Rule is intended to address unscrupulous, or potentially unscrupulous, industry practices. Although the Securities and Exchange Commission (the "Commission") has yet to impose a fiduciary standard of care on broker-dealers as it is empowered to do under the Dodd-Frank Wall Street Reform and Consumer Protection Act

Taylor English Duma LLP

1600 Parkwood Circle, Suite 400 Atlanta, GA 30339 p 770.434.6868 f 770.434.7376

passed by Congress on July 15, 2010 (the "Dodd-Frank Act"), the fiduciary standard has long been the *de facto* standard imposed on broker-dealers and there is no legitimate argument that a lower standard is in the best interests of customers or the financial services industry as a whole. It is from this fiduciary standard of care that a broker-dealer and its representatives are prohibited from placing their own interests before those of their customers. The Proposed Rule is intended to address concerns that enhanced compensation packages offered by member firms incentivize recruit representatives to breach this standard of care to their customers. Whether one agrees or disagrees, this portion of FINRA's analysis and basis for the Proposed Rule is relatively straightforward and is aligned with FINRA's mission of promoting investor protection.

On the other hand, however, the actual implementation of the Proposed Rule would result in member firms being required to disclose these enhanced compensation packages offered to recruit representatives under the auspices of disclosing conflicts of interest. In our opinion, herein lies the confusion. It is our opinion that "unscrupulous" industry practices, or potentially unscrupulous industry practices, and conflict of interest disclosures to clients are two separate, albeit somewhat related, issues. Disclosure does not cure a problem if, in fact, a problem exists at all. It is also our opinion that the Proposed Rule, as currently drafted, intertwines these two issues so significantly that the ultimate goal of increasing investor protection and heightening market integrity may not be the primary, or even the secondary, end-result of implementation. Simply stated, there appears to be a significant disconnect between the stated purpose of the Proposed Rule and the mechanisms set forth in the Proposed Rule that are intended to further its purpose.

With these general considerations in mind, we respectfully offer the following specific comments in response to the issues raised in Notice 13-02:

Requiring a representative to disclose details of enhanced compensation in connection with transfer of employment/association while such representative is still at previous firm

We address this specific request for comment first because we find it to be the most difficult to reconcile with the other provisions of the Proposed Rule and other rules and regulations applicable to the industry generally.

To the extent that the Proposed Rule imposes disclosure requirements to public customers, all such requirements are imposed on the "recruiting member," not the individual representative. If a representative intends to transition from Firm A to Firm B, and Firm B has certain disclosure obligations to public customers in connection therewith, it is not possible for Firm B to fulfill its disclosure obligations through the acts of an individual who is not yet registered with Firm B and therefore not acting as an agent of Firm B.

Alternatively, Firm B could fulfill its disclosure obligations through its own registered representatives and agents prior to the representative transitioning from Firm A to Firm B. This would be a highly unusual situation. First, a public customer would be receiving this disclosure information from a firm with which neither the customer nor the customer's representative has a current relationship. Second, it is neither customary nor required for representatives to provide advance notice of resignation when transitioning to a new firm. If a public customer receives this disclosure prior to the representative transitioning to the new firm, it could very easily prompt the customer to make inquiries at the firm from which the representative is departing. Customers should always be strongly encouraged to contact anyone in management or compliance at their current firms with any questions they may have; however, one must be sensitive to the predicament this would cause for the representative. A representative's current position could be jeopardized upon the firm learning of his or her desire to transition to a new firm, and if the recruiting firm ultimately decides not to hire the representative for any reason whatsoever, the representative could suddenly find himself or herself unemployed. In turn, this would have a trickle down effect of all of the representative's customers finding themselves without a representative with whom they have a trusted history.

If the Proposed Rule is implemented, it is our opinion that imposing a requirement for disclosure prior to a representative's transition to a new firm is impractical and potentially harmful to customers as well as the representative. We believe the trigger for the disclosure requirement should be the date upon which the representative's Form U4 is filed by the recruiting firm and no sooner. If a representative or recruiting firm wishes to disclose the information prior to the filing of the Form U4, nothing would prevent either party from doing so. However, we do not believe that an unconditional obligation to disclose prior to transition would be appropriate.

Oral versus written disclosure at the time of first individualized contact

We appreciate FINRA's consideration in the Proposed Rule that an oral disclosure of the details of enhanced compensation to customers should be permitted in lieu of written disclosure at the time of first individualized contact by the recruiting member or registered person. While this would increase the efficiency of an account transfer (or proposed account transfer), this also raises significant questions regarding adequate supervision. Unless the representative's supervisor makes the oral disclosure to the customer or personally witnesses the representative making the disclosure, a firm would have essentially no defense to a failure to supervise allegation if a question ever arose regarding the representative's statements. Would it be prudent for the firm to require the representative to make a written attestation of compliance to the firm? Is this an efficient tax on supervisory and compliance resources?

We do not have a proposed solution for the issues raised in the preceding paragraph but rather respectfully request FINRA to take them into consideration in its overall analysis of increased costs and burdens on member firms versus potential benefits to customers.

Application of the Proposed Rule for a period of one year after transition

We do not believe that a one year application period for the Proposed Rule is necessarily burdensome inasmuch as any transferring customers will likely transfer well in advance of the

1600 Parkwood Circle, Suite 400 Atlanta, GA 30339 p 770.434.6868 f 770.434.7376

expiration of the one year. However, the Proposed Rule is silent with respect to a member firm's continuing obligation to disclose enhanced compensation packages in the event that they are modified after the representative transitions to the recruiting firm. Would the recruiting firm have an obligation to update previous disclosures to transferring clients if modifications are made to the representative's initial enhanced compensation package during his or her first year of employment/affiliation?

It is our opinion that imposing a continuing obligation of disclosure on recruiting firms for modified enhanced compensation packages would be overly burdensome and unnecessary if the modification occurs subsequent to a customer transferring an account. However, we also note that absent any such continuing obligation, the Proposed Rule would create a loophole for disingenuous disclosures, i.e., purposefully scaled-back initial enhanced compensation package that could be materially modified in the future and by mutual agreement of the parties. Certainly, any such conduct, if detected by FINRA, would be considered conduct inconsistent with high standards of commercial honor and just and equitable principles of trade in violation of FINRA Rule 2010 and ripe for sanctions by FINRA. However, if a misleading disclosure is made to a customer at the time of account transfer, and presumably taken into account at the time of decision, the harm has been done. As with our previous comment, we respectfully request FINRA to take this into account in its overall cost/benefit analysis of the Proposed Rule.

Customer affirmation of receipt of the disclosure at or before account opening at the new firm

It is our belief that any requirement for a customer to affirm receipt of the disclosure of an enhanced compensation package prior to opening an account with the new firm is highly impractical, overly burdensome to the customer and could most certainly delay the account opening process. Public customers, unlike member firms and registered representatives, do not dedicate their full time to the day-to-day management of investment accounts. This is the service provided by member firms and representatives for which they are compensated. Completing new account opening documentation is an inconvenience to customers as it is, and requiring customers to engage in a two-step process of first affirming disclosure of enhanced compensation packages and thereafter completing all other new account opening documentation is impractical. If a written affirmation is required by the Proposed Rule, we believe it would be appropriate for the firm to require the affirmation as part and parcel of all required account opening documentation but not beforehand.

The $50,000 *de minimis* exception

The Proposed Rule excludes from disclosure requirements enhanced compensation packages in an amount less than $50,000. Notice 13-02 specifically requests comments regarding whether the Proposed Rule should establish an amount different from the proposed $50,000 exception for a *de minimis* exception. We will defer to member firms to provide specific comment on this issue to the extent that it calls for a quantitative analysis. We do note, however, that the $50,000 exception exceeds the actual costs to transfer registration of a representative even if such representative is registered in all 53 FINRA jurisdictions. If a different amount may be appropriate, it would be helpful for the membership to know what other "ordinary costs in the transition process" were taken into account by FINRA when earmarking $50,000 for the *de minimis* exception as stated in Notice 13-02. Absent this information, it is our opinion that $50,000 is no more or less arbitrary than any other dollar amount.

Regardless of the dollar amount of the *de minimis* exception, we also question how this exception would be applied in the cases of enhanced compensation packages that include unspecified dollar amounts. Such incentives may include an accelerated payout for a period certain and the recruiting firm covering the costs of all account transfers. These incentives will have a tangible dollar value on a deferred basis; however, it will not be possible for a recruiting firm to determine the dollar amount immediately upon the representative's transition. In the case of small firms that do not have sufficient resources to offer up-front cash as a recruiting incentive, these may be the only incentives offered to representatives. Would a small firm in such a position be entitled to rely upon its reasonable belief that the ultimate aggregate dollar value of these incentives will fall within the *de minimis* exception and thus not require disclosure?

"Are the costs imposed by the [Proposed Rule] warranted by the potential harm to customers arising from the payment by member firms of recruitment compensation to incentivize representatives to change firms without disclosure of such incentives to transferring customers?"

We quote the exact language of the above-referenced request for comment from Notice 13-02 because we believe it highlights the confusion regarding the underlying purpose of the Proposed Rule as discussed above in our general opening comments. Does the "potential harm" arise from the recruiting incentive packages or the lack of disclosure thereof?

We understand the position of FINRA and the Commission that enhanced compensation packages serve as an incentive for a representative to produce increased commissions, and we agree. However, incentives in the commission-based financial services industry can and do occur in many contexts – not solely upon hiring. For example, many member firms offer step-up payout grids, bonuses and/or deferred compensation, all of which serve as incentives for a representative to continually grow his or her business while affiliated with a particular firm. We are unclear as to why FINRA is focusing on a firm transition as a triggering event for disclosure to customers. This implies that a production incentive, when coupled with a representative's decision to transition to a new firm, poses a conflict of interest substantially greater than with any other incentive offered in the ordinary course of business, thus requiring customer disclosure. We respectfully disagree that there is a sound basis for this conclusion.

A representative may choose to change firm affiliations for any number of reasons, and the payment of an enhanced compensation package as a recruiting incentive is not any indicator, in

1600 Parkwood Circle, Suite 400 Atlanta, GA 30339 p 770.434.6868 f 770.434.7376

and of itself, that such a transition is not in the best interest of the representative's customers. We find somewhat troubling the following statement in Notice 13-02:

> "These recruitment programs raise conflicts of interest that often are not disclosed when registered representatives encourage customers to move to their new firm. *Instead, many representatives typically address only the platform, products and services of the new firm*." [Emphasis added.]

A firm's platform, products and services have a direct and unquestionable impact on a customer's account and should be of primary importance to a customer when deciding whether to transfer an account to a new firm. The customer's relationship with the representative and the representative's previous handling of the account should also be of primary importance. On the other hand, the representative's overall compensation has no direct impact on a customer's account, poses a conflict of interest no different than the conflict of interest inherent in the commission-based industry and fails to serve as any indicator of the representative's competence or integrity with respect to the handling of a particular customer's account.

We have observed several public comments on the Proposed Rule from other parties that speculate with respect to unstated, ulterior purposes for the Proposed Rule. The public comments we have observed include speculation that the Proposed Rule is truly intended to encourage member firms to curtail recruiting incentive packages or, in the alternative, to discourage representatives from switching firm affiliations. While we neither endorse nor necessarily agree with these comments, we do believe that the disconnect between the stated purpose of the Proposed Rule and the text of the Proposed Rule itself lends itself to this conjecture.

Setting aside speculation about FINRA's rationale that disclosure of enhanced compensation packages will act as a preventative or curative measure for the mishandling of accounts, we instead focus on the actual impact of the Proposed Rule. While being encouraged to transfer firms by a transitioning representative, a customer would now have this disclosed information to factor into the decision-making process.

Is more information better in this instance? Does a typical customer have any context with which to evaluate the disclosure? Recruiting incentive packages are based upon the representative's overall "book of business," which includes the aggregate amount of assets, the types of products contained in the customer portfolios, the number and size of customer accounts and the solidity of the representative's relationships with his or her clients. No single customer would have access to this universe of information, so the disclosure would be made in a vacuum. Absent any context to evaluate the information contained in the disclosure, it is difficult to argue that the disclosure, standing alone, would provide any customer any additional protection or meaningful benefit.

Taylor English Duma LLP

1600 Parkwood Circle, Suite 400 Atlanta, GA 30339 p 770.434.6868 f 770.434.7376

Is the Proposed Rule well designed to reduce conflicts related to recruitment compensation packages?

From its plain language, the Proposed Rule does not reduce, or attempt to reduce, conflicts at all. Rather, it requires disclosure of them.

Second order impacts

Disclosure as a tool to dissuade customers to act in their best interest

It is not uncommon for firms to reassign customers of a departing representative to other representatives who, in turn, will contact the customers in an effort to persuade them to remain with the firm. This practice, in and of itself, can be uncomfortable for customers because it may result in the customers receiving competing and conflicting information from two different sources, causing confusion.

If the Proposed Rule is implemented, it is predictable that a newly assigned representative of the "departing firm" would ask a customer about the details of the disclosed recruiting incentive package as an initial matter. If the customer shared such information, which he or she would be free to do, the representative would have a new tool to persuade the customer that the departing representative transitioned to a new firm for self-serving purposes and did not act in his or her clients' best interests. In all likelihood, the newly assigned representative would have the same insufficient context as the customer to evaluate the disclosed information because the newly assigned representative likely would not have intimate knowledge of the departing representative's overall "book of business." Perhaps the departing representative transitioned to a new firm because it truly offered enhanced products and services and would unquestionably be in the best interest of the representative's customers notwithstanding any incentive package.

Interestingly, in this context, the Proposed Rule would give rise to a new conflict of interest. The disclosure would be made in the interest of informing a customer of the departing representative's conflict of interest. Who will inform the customer that a newly assigned representative using the same information to persuade the client to remain with the firm is a separate, and possibly greater, conflict of interest?

The Proposed Rule versus Regulation S-P

Upon reviewing the Proposed Rule, we note an interesting side-by-side comparison with Regulation S-P that was adopted by the Commission in 2000 to implement certain provisions of the Gramm-Leach-Bliley Act and the Fair Credit Reporting Act ("Reg S-P"). In adopting Reg S-P, the Commission addressed a customer's interest in protecting his or her nonpublic personal information. Specifically, Reg S-P requires firms regulated by the Commission to adopt security measures to protect customers' nonpublic personal information and to inform customers about the applicable firms' privacy policies and practices. Reg S-P also limits when firms may disclose nonpublic personal information to any nonaffiliated third party without first giving the customer an opportunity to opt out of the disclosure.

On the other hand, the Proposed Rule, if implemented, would concurrently and explicitly require brokers and dealers to disclose certain nonpublic personal information of its representatives to nonaffiliated third parties. We recognize that Reg S-P is intended to protect customers, and while representatives may also be customers of their employing firms, we do not suggest that representatives should fall within the same class of "customers" contemplated by Reg S-P. We also recognize that Reg S-P would not apply to representatives if the Proposed Rule is implemented because member firms would disclose this information in order to comply with "federal, state or local laws, rules and other applicable legal requirements," which is an explicit exception to Reg S-P.

However, we believe that the diametrically opposed positions of Reg S-P and the Proposed Rule warrant further consideration. Specifically, we note that disclosures under the Proposed Rule essentially would be made to the public at large inasmuch as once the information is disclosed to a public customer, the customer would have neither an obligation to safeguard the information nor any restrictions on how the information could be used or with whom it could be shared. The Proposed Rule suggests that a representative's desire to control the use and dissemination of his or her nonpublic personal information carries such little weight when compared to a customer's interest in receiving a disclosure of a conflict of interest that potentially could, but not necessarily will, result in a representative failing to act in the customer's best interest, that a firm's disclosure of the representative's nonpersonal public information is not only permitted, but it is required.

"How will the [Proposed Rule] change business practices and competition among firms with respect to recruiting and compensation practices? Will these impacts differentially affect small or specialized broker-dealers?"

We again quote a particular request for comment from Notice 13-02 verbatim to highlight the confusion surrounding the purpose of the Proposed Rule. The above-quoted request for comment assumes that the Proposed Rule will, in fact, change business practices of member firms. If this is the intended outcome of the Proposed Rule, then we respectfully suggest that FINRA clarify this and re-examine the mandates of the Proposed Rule. The Proposed Rule, as written, merely requires disclosure of conflicts of interest. Nothing in the Proposed Rule, as currently written, requires any firm to change any of its business practices, other than incorporating new disclosures to customers.

If the true intent of the Proposed Rule is to reduce conflicts by curtailing recruiting incentive packages, then we believe it would be more efficient and effective for FINRA to address the enhanced compensation packages themselves, as opposed to requiring firms to disclose them to public, non-institutional customers with the hope that the second order impact will be for firms to change their business practices.

*　　*　　*　　*　　*

Please do not hesitate to contact Dianne L. Trenholm (678.336.7144) if you have any questions regarding the issues addressed in this letter.

Respectfully submitted,

TAYLOR ENGLISH DUMA LLP

By: /s/ Dianne L. Trenholm

Taylor English Duma LLP

1600 Parkwood Circle, Suite 400 Atlanta, GA 30339 p 770.434.6868 f 770.434.7376