MICHIGAN STATE
UNIVERSITY
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December 1, 2014

Via Email Only

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
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RE: Regulatory Notice 14-37: Rule Proposal to Implement the Comprehensive Automated Risk Data System

Dear Ms. Asquith,

On behalf of the Investor Advocacy Clinic at Michigan State University College of Law ("the Clinic), we write again to support FINRA's proposal to implement the 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 who cannot secure private legal representation due to the relatively small size of their claims. Additionally, students enrolled in the Clinic provide public education about investment fraud in the Michigan area. The Clinic has a strong interest in supporting measures that increase investor protection. We strongly support the implementation of CARDS because it should significantly improve FINRA enforcement by allowing for more efficient targeting of potential misconduct and more efficient use of enforcement resources.

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A. CARDS' Benefits

Currently, there is a real need for improved enforcement. In 2013, FINRA referred 660 fraud cases for prosecution, brought 1,535 disciplinary actions against registered brokers and firms, and levied 74.5 million in fines and restitution against fraudulent traders.[1] This is not unusual. In 2012 FINRA brought nearly 1,500 disciplinary actions and levied around 102 million in fines and restitution.[2] FINRA's stated mission is to ensure "investor protection and market integrity through effective and efficient regulation of the securities industry" and "to protect America's investors

[1] *About FINRA*, FINRA (2014), http://www.finra.org/AboutFINRA/.
[2] *2012: FINRA Year In Review*, FINRA, (Jan. 8, 2013), http://www.finra.org/Newsroom/NewsReleases/2013/P197624.

by making sure the securities industry operates fairly and honestly."[3] Therefore, as technological capabilities increase, FINRA not only should, but also has a duty to make use of such technology to protect investors.

CARDS should enhance regulatory surveillance by regularly collecting and efficiently processing data, allowing FINRA to intervene to protect investors earlier from potentially fraudulent and abusive behavior. CARDS will improve FINRA's ability to better understand and more quickly detect improper wholesale recommendations by observing particular concentrations of possibly unsuitable product sales. With CARDS, FINRA would be able to compare risk tolerance profiles and determine if a firm is potentially selling the same, often unsuitable, products to many customers.

It seems likely that FINRA will be able to successfully implement CARDS. FINRA has already achieved positive results identifying problematic practices and non-disclosures though its Risk Discovery and Analytic Tool ("RDAT"). RDAT was FINRA's pilot program that allowed for automatic application of analytics on data collected from a limited number of firms for a limited period.[4] More continuous use of automated analysis of brokerage activity through CARDS will likely improve FINRA's enforcement.

While we recognize the sizeable benefits of the current phase of CARDS, we encourage FINRA to expand the program. After initially establishing CARDS, FINRA should move forward with additional rulemaking to include transactions for products that are not held, custodied at, or executed through clearing firms, such as variable annuities.[5] Variable annuities are costly, complex products that are far too often sold to investors who do not need them. Common problems with annuities are unsuitable investments in subaccounts, annuity "switching,"[6] and purchase of annuities within already tax-deferred IRAs.[7] FINRA has issued an Investor Alert regarding variable annuities:

> 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.[8]

In light of the high potential for investor harm, we ask that FINRA expand the scope of CARDS to also collect data regarding variable annuities.

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[3] FINRA, *supra* note 1.
[4] *See* FINRA, Regulatory Notice 14-37, 16 (Sept. 2014), http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p600964.pdf.
[5] *See*, *Id.* at 11.
[6] Described by one commentator as, "[A]nalogous to mutual fund flipping and are highly suspect . . . [m]ost switches pay the broker significant commissions and involve the reestablishment of maximum surrender charges, while providing the investor with little benefit over their existing annuity. Craig J. McCann, et. al., *Annuities*, 4 (2005). Switching occurs when annuities are purchased with the reinvestment of the proceeds from the sale of existing annuities. *Id.*
[7] *Id.* at 1.
[8] *See* FINRA, *Variable Annuities: Beyond the Hard Sell*, Investor Alert, (Aug. 2009), http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/AnnuitiesAndInsurance/P005976.

B. Adequate Protection To Ensure Data Security

FINRA's current privacy protection measures appear adequate. In response to previously-raised privacy concerns, FINRA has developed systems and procedures to adequately protect the data. First, FINRA announced on March 4, 2014 that it would not require firms to submit information sufficient to identify individual account holders, namely account names, account addresses, or tax identification numbers.[9] These exclusions should significantly reduce the potential danger that hackers' could determine the identity of an account's owner. Second, FINRA has emphasized that all data will be encrypted both in transmission and after receipt, such that no one could "interpret the data without the proprietary encryption keys."[10] These encryption requirements should provide an additional layer of security. Third, FINRA made clear that access to the data will be limited to a few full-time technical employees and that their access will be carefully traced and monitored.[11] Fourth, FINRA emphasized that it operates a comprehensive security program to ensure cyber security and compliance with applicable data privacy regulations and laws.[12] Lastly, FINRA has vowed to obtain reports testing the integrity of its system relating to security and confidentiality prior to implementing CARDS. Taken collectively, these measures more than adequately address the privacy concerns raised by the proposal's critics.

Moreover, no good reason exists to doubt FINRA's ability to competently protect investor privacy. FINRA has consistently taken the steps necessary to protect the information it has received from firms over the years. Our research has not revealed any instances of a data breach. As noted in Regulatory Notice 14-37, "FINRA has been maintaining high security standards and safely hosting highly confidential broker data for decades."[13] There is no reason to believe that this will not continue. While we believe FINRA has taken appropriate steps to protect data collected through CARDS, we hope and fully expect that FINRA will continue to monitor its systems and make appropriate changes to protect against a potential security breach. Ultimately, the benefit provided to investors in enhanced protections outweighs the potential risks associated with a breach of data security, which appears quite low.

C. Economic Impact of CARDS

Critics have also expressed concerns about costs associated with implementing and maintaining CARDS. To be sure, CARDS will cost money to implement and maintain; however, these costs appear justified due to the increased potential for the industry to have more efficient and thorough FINRA supervision and enforcement. At the least, the costs identified in the Regulatory Notice do not appear to outweigh the benefits.

[9] *Update Regarding Regulatory Notice 13-42—Comprehensive Automated Risk Data System*, FINRA, (Mar. 2014), http://www.finra.org/Industry/Regulation/Notices/2013/P451243.
[10] FINRA, *supra* note 4, at 5.
[11] *Id.*
[12] *Id.*
[13] *Id.*

While CARDS will undoubtedly create costs, it should be offset by lowering many other costs. CARDS will lower costs through the elimination of intermittent and extensive information requests for the information CARDS covers.[14] Furthermore, FINRA posited that costs would be saved by an increased capability to more effectively target firms engaged in misconduct, thereby reducing the number of unnecessary firm wide-sweeps.[15] CARDS should also reduce costs by allowing streamlined review of firms that pose low risks.[16] To further reduce costs, FINRA made clear that introducing firms that do not automate their recording of suitability information would be able to use a web interface provided by FINRA to submit the CARDS information directly.[17] Also, CARDS' implementation may allow other systems to be eliminated to avoid duplicative reporting requirements.[18] Lastly, FINRA's phased approach for CARDS should be viewed as a systematic approach to lessen the costs associated with complying with CARDS. FINRA is requiring carrying, clearing, and self-clearing firms to submit automated, standardized format specific information regarding to their customers' accounts. This requirement allows the firms to make data delivery simpler for the firms and for FINRA. The burden on firms has also been lessened by listing out exclusions (Select Account Profile Data) to the CARDS requirement because FINRA understands that that particular data is not always part of a firm's books or records for the accounts that the firm carries or clears for others on a fully-disclosed basis.

Critics predict that the increasing regulatory costs will likely be passed down to their clients. However, increased regulatory costs are necessary and beneficial for those who want the best investing environment for their customers. Furthermore, FINRA's chief economist is currently engaging with small firms to fully understand the costs and benefits for the second phase of CARDS.[19] This shows that FINRA is currently, and is likely to continue, monitoring the costs associated with implementing CARDS and will make changes accordingly. The potential savings discussed above, coupled with enhanced and more efficient investor protections make CARDS a desirable and much needed investor protection.

Conclusion

We strongly support FINRA's proposed implementation of CARDS and believe that the economic impact will not be as burdensome as some industry professionals posit. FINRA's efforts to provide investors and firms with a fair and efficient financial environment should be commended. We thank FINRA for the opportunity to comment on this proposal.

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[14] *Id.* at 4.
[15] *Id.*
[16] *Id.*
[17] *Id.* at 12.
[18] *Id.* at 15.
[19] *FINRA Assessing Costs for Second Phase of CARDS Affecting Broker-Dealers*, INVESTMENT NEWS (Oct. 6, 2014), http://www.investmentnews.com/article/20141006/FREE/141009944/finra-assessing-costs-for-second-phase-of-cards-affecting-broker.

Very Truly Yours,

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