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VIA E-MAIL (pubcom@finra.org)

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

Re: Comment Pursuant To Regulatory Notice 15-19 Regarding The Proposed Rule To Require Delivery Of An Educational Communication To Customers Of A Transferring Registered Representative

Dear Ms. Asquith:

This letter is in response to Regulatory Notice 15-19 (the "Notice"), which seeks comment on a "Proposed Rule" that would require a recruiting firm to provide a FINRA drafted educational communication ("Communication") to the retail customers who the recruiting firm, directly or through the transferring registered representative, attempts to induce to transfer assets or who choose to transfer assets to the recruiting firm. Our firm opposes the Proposed Rule for reasons we set forth below.

INTRODUCTION

Lax & Neville LLP has represented hundreds of registered representatives transitioning between FINRA member firms and as such, is highly familiar with the brokerage firm recruiting process, including, the way the various firms structure their recruiting packages and how registered representatives communicate to their clients that they are transitioning to a new FINRA member firm. Additionally, we also represent institutional and individual investors in FINRA arbitrations alleging sales practice abuses against registered representatives and brokerage firms. As such, we are also familiar with what information is material to customers and the mechanisms or schemes through which disreputable brokers harm their customers. Our unique position qualifies us to offer comment on the Proposed Rule.

The Proposed Rule seeks to address purported conflicts of interest, but takes an overreaching stance, which will result in more harm than good. FINRA has failed to establish that a conflict, or even a potential conflict, exists in every broker transition. Nonetheless, to remedy a presumed conflict, FINRA proposes that a Communication be provided at or shortly after the time of first contact with a customer regarding the transfer of assets to the recruiting firm. However, the Communication does not provide balanced information to customers and invites confusion, including the assumption of a conflict of interest where no such conflict of interest may exist. As such, the Proposed Rule could potentially hinder a registered representative's ability to transition between firms, disrupt the negotiating power between registered representatives and FINRA member firms, prevent smaller FINRA member firms from recruiting talent from larger firms, alarm customers when no conflict of interest exists, and thus potentially have an adverse effect on competition in the industry as a whole.

Additionally, FINRA's methodology, including the "Investor Testing" and "Economic Impacts" sections of the Notice are insufficient because they fail to consider material factors including: 1) whether any of the information contained in the Communication is material to investors' decisions to potentially transfer their assets; 2) how the Protocol for Broker Recruiting may or may not addresses issues contained in the Notice; and 3) how existing FINRA rules already protect customers from the harm addressed by the Notice. Furthermore, FINRA's failure to establish a code of conduct for how member firms should respond to customer inquiries prompted by the Communication could easily create confusion or litigation without any clear avenue for relief to the transitioning registered representative or recruiting firm. By failing to consider these issues in its methodology, FINRA has failed to perform an adequate public interest analysis for the Proposed Rule.

I. The Notice Does Not Establish That A Real Or Potential Conflict Exists In Every Transition

The Proposed Rule would require FINRA member firms to distribute a Communication to retail customers that warns of a potential conflict of interest without first establishing that a real or potential conflict exists in every transition. Nowhere in the Notice does FINRA staff show that a real or potential conflict exists in every transition. In fact, the only mention to one exists in Regulatory Notice 13-02, where FINRA Staff cited to concerns of Mary Shapiro, then Chairwoman of the Securities Exchange Commission ("SEC"), regarding how certain enhanced compensation practices may pressure registered representatives to increase their level of production in order to justify their enhanced compensation. Before making a rule to address a presumed conflict of interest, FINRA should first identify and define the conflict with particularity, its frequency, and the possible harm arising directly from it. Here, FINRA has failed to do so and as such, the Proposed Rule is entirely premature.

The problem with assuming that enhanced compensation practices create a conflict of interest is that registered representatives are always incentivized to increase production, just as any person who sells a product or service. Registered representatives, who are just below the next level of a grid payout are incentivized to increase their production to reach the higher grid payout. The fact that the grid may differ from one FINRA member firm to another does not establish a measurable conflict of interest between the registered representatives and their customer because registered representatives' incentive to reach his or her performance goals is constant. Furthermore, the incentive to reach the next level of grid payout exists at all times, for all registered representatives, and is not enhanced by the mere fact of a registered representative's transition between firms. The Proposed Rule requires a Communication be sent to customers during transitions, but no FINRA rule, nor should any rule, requires a similar communication every time a registered representative is close to reaching the next grid threshold.

Here, the Proposed Rule appears arbitrary in requiring a Communication be sent to a customer in one circumstance due to a presumed conflict, but not in another related circumstance. As such, any potential conflict that could exist from enhanced compensation practices is sufficiently attenuated from a registered representative's transition between member firms. Therefore, a registered representative's transition should not be the basis for sending the Communication or the basis of a FINRA rule seeking to correct potential conflicts arising from enhanced compensation practices.

Additionally, for a registered representative with all fee-based clients, FINRA and the SEC have not identified any potential conflict of interest. Similarly, for recruiting packages that pay back-end bonuses only based upon assets under management hurdles, no potential conflicts have been identified. As such, FINRA staff has failed to establish that a real of potential conflict exists in every transition and requiring that a Communication be sent to customers in every transition is the type of overreaching rulemaking would create more harm than good.

II. <u>The Communication Does Not Provide Balanced Information</u>

The Proposed Rule is not well designed to inform investors of any potential conflict of interest and the direct and indirect impacts of transferring assets to a new firm because the Communication does not provide balanced information to customers. Specifically, the Communication invites a negative inference about the transitioning registered representative's motivation. For example, the section, "Could financial incentives create a conflict for your broker?" suggests that one already exist. Furthermore, the section contains no balancing language explaining how FINRA member firms compensate registered representatives and that the customer's registered representative may have already benefitted from enhanced compensation practices at his or her former FINRA member firm as well as at their current one. Because the Communication does not contained balanced language, it will confuse customers and make it more difficult for them to weigh the relevant information needed to decide whether they should transfer their assets to the recruiting FINRA member firm.

Additionally, it is also unclear why FINRA informs the customer to "talk with your broker or someone at your current firm" when the current FINRA member firm is in no position to comment on the recruiting firm, or the transitioning registered representative's compensation at their new firm and will simply attempt to have the customer remain at their firm. Moreover, in my experience, FINRA member firms will sometimes offer the clients discounted fees as an inducement to not follow the transitioning registered representative to the new FINRA member firm. FINRA staff has not addressed this practice in the Notice. Furthermore, the Communication provides no guidance to customers either informing them of this practice, or warning them how that practice may conflict with their long term investment goals. As such, the Communication will confuse customers by providing unbalanced information.

III. <u>The Notice's Methodology Is Flawed</u>

The Notice's purported methodology is flawed and fails to consider material information in at least three areas: 1) the Notice's "Investor Testing" section; 2) the Notice's failure to address or consider the Protocol for Broker Recruiting; and 3) the Notice's failure to consider how the purported harm it seeks to redress is already covered by other FINRA rules. Each flaw in the methodology will be addressed below.

a. The Notice's "Investor Testing" Section Is Self-Serving And Does Not Establish That Any Of The Information Contained In The Communication Is Material

The "Investor Testing" section of the Notice is self-serving and flawed. The section is self-serving because FINRA Staff only sought to ask investors whether they found the information helpful and as a result, reached the unsurprising conclusion that information is helpful. While some of the sample of investors in the section stated that the information was meaningful, the Notice does not state what that information was, and why it was meaningful. Significantly, none of the investors were asked if the information in the Communication was material to their decisions to transfer assets. Because materiality is a key issue for all communications between FINRA member firms and the public, merely stating that the information is helpful is a self-serving conclusion that fails to demonstrate the usefulness of the Proposed Rule.

Additionally, the Notice's methodology is deeply flawed as FINRA Staff did not test a crucial aspect of the Proposed Rule. The Communication is designed to get the customer to ask questions of their new and old FINRA member firms. However, the study detailed in the "Investor Testing" section did not run any simulations where the sample of customers reached out to their hypothetical FINRA member firms for information in response to the Communication. Moreover, the "Investor Testing" section did not indicate whether the sample of investors felt more or less inclined to reach out to their registered representative, the recruiting firm, or their former FINRA member firm after receiving the Communication. As such, the Notice is critically devoid of any study showing that customers sought answers to questions arising from the Communication and after customers reached out to their new and old FINRA member firms, the customers had enough information to make an informed decision.

b. The Notice's Methodology Does Not Address The Broker Protocol Or Establish Why It Is Deficient In This Case

Established in 2004, the Protocol for Broker Recruiting ("Protocol") is an agreement between hundreds of FINRA member firms regarding registered representatives' transitions between firms. The Protocol was established with "[t]he principal goal of … further[ing] the clients' interests of privacy and freedom of choice in connection with the movement of their registered representatives between firms." Additionally, the Protocol requires "[t]he signatories to this protocol agree to implement and adhere to it in good faith."

Here, the Notice is deficient because it does not mention the Protocol and as such fails to examine: 1) how the Protocol fails to address the issues addressed by the Notice; 2) how the Proposed Rule conforms to or conflicts with a FINRA member firm's existing duties as signatories to the Protocol; and 3) what a FINRA member firm's obligation are where the new duties arising under the Proposed Rule may conflict with its duties under the Protocol. By failing to address or even acknowledge this very significant agreement, between leading industry members, to self-regulate the transition of registered representatives between FINRA member firms, the methodology of the Proposed Rule is deeply flawed.

c. The Notice Seeks To Protect Investors From Harm Already Directly Addressed Through Existing FINRA Rules

Through the Proposed Rule, the Notice seeks to indirectly protect investors from sales practice abuses that are already directly prohibited by existing FINRA rules. For example, FINRA Rule 2111 requires that "A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer." Additionally, FINRA Rule 2010 requires members to "observe high standards of commercial honor and just and equitable principles of trade" in conducting their business. Finally, FINRA Rule 2020 prohibits FINRA member firms and registered representatives from effecting "any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance." Together, these rules, along with other FINRA rules, directly prohibit the type of sales practice abuses addressed in the Notice. To the extent that these rules do not deter broker misconduct, it is unlikely that requiring delivery of the Communication will sufficiently deter that misconduct. More importantly, the Notice fails to address how the Proposed Rule will protect the public in any way that is not duplicative of these existing rules.

IV. <u>The Proposed Rule Will Create More Litigation</u>

The Protocol was drafted to establish a good faith code of conduct for signatory firms in order to limit the litigation arising from registered representatives' transitions between FINRA member firms. Here, the Proposed Rule fails because it does not establish any code of conduct to govern FINRA member firms' responses to customer inquiries prompted by the Communication. By failing to establish a code of conduct, the Proposed Rule will likely create increased litigation between transitioning registered representatives, the recruiting firm, and the former FINRA member firm. Furthermore, that litigation or the threat of litigation will have an adverse effect on competition and register representative's mobility within the industry.

The Proposed Rule will likely create increased litigation because the Communication directs customers to contact their former FINRA member firm, in order to solicit information about the recruiting firm, during a sensitive and potentially contentious time between the two firms. However, outside of FINRA Rule 2010 that establishes general conduct requirements, there is no FINRA rule explicitly stating that the former FINRA member firm's responses must be truthful, accurate, balanced or fair. As such, the Proposed Rule will potentially create litigation by establishing a grey area that invites FINRA member firms to interfere with registered representatives' transitions in an attempt to retain their customers.

As discussed above, some FINRA member firms will seek to retain the clients of a departed registered representative by offering discounted, or even no fees for a set period of time. This practice will almost certainly create litigation. For example, assume that a registered representative ("RR") leaves broker-dealer 1 ("BD1") for broker-dealer 2 ("BD2") and provides his customers with a copy of the Communication as provided by the Rule. BD1 reassigns RR's customer account to a new registered representative (the "New RR"). When RR's customers contact BD1 at FINRA's advice, they are put in contact with the New RR who says "RR charged you too much in the past, we'll waive your fees for the next year if you stay with our firm." This statement is arguably defamatory and as such, RR could pursue a claim against BD1 through arbitration.

Additionally, because there is no FINRA rule directly prohibiting this conduct, aggrieved parties may have difficulty prosecuting their rights through FINRA arbitration. Again, assume that RR leaves BD1 for BD2 and provides his customers with a copy of the Communication as provided by the Rule. RR's customers call BD1 as suggested by the Communication and BD1's branch manager makes false, unfair, or unbalanced oral statements regarding BD2, but nothing regarding RR. Here, RR may not have a direct cause of action against BD1 because BD1 did not make any defamatory statement against him or her. Furthermore, BD2 may have difficulty prosecuting a claim in arbitration because the alleged inflammatory statements may be truthful yet misleading or unbalanced.

Enacting the Proposed Rule will either result in increased litigation costs associated with transitioning between firms or stifle competition in the industry, or both. The Proposed Rule will increase litigation costs because it invites FINRA member firms to interfere with registered representatives' transitions between firms. In turn, registered representatives and recruiting firms will seek to enjoin that practice or to recover the damages arising from it. However, due to the fact that there is no clear pathway to relief, some registered representatives may turn down favorable recruitment offers, which could benefit the registered representative and their customers, out of an apprehension that their current firm will interfere with the transition. Finally, some smaller firms may be hesitant to recruit talent from larger firms because they may not be able to incur the costs associated with such litigation. As such, the Proposed Rule has significant direct and indirect costs that will differentially affect FINRA member firms, and ultimately stifle competition in the industry.

V. Because FINRA Has Failed To Consider Many Relevant Factors, The Notice's "Economic Impacts" Section Contains An Inadequate Public Interest Analysis

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act"), FINRA must submit to the SEC a "concise general statement of the basis and purpose" of any proposed rule. Section 15A(b)(9) of the Act requires the SEC to determine that FINRA rules "do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of [the Act]." When reviewing a proposed FINRA rule, the SEC is required to consider whether an action is necessary or appropriate and as part of its public interest analysis under Section 3(f) of the Act, the SEC must "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." To aid the SEC in its consideration of rule proposals, the SEC's Form 19b-4 requires each FINRA rule filing to include a statement regarding the burden on competition.

FINRA maintains that it meets these requirements by performing economic impact assessments that provide "a formal way of organizing the evidence on the key effects, good and bad, of the various alternatives that should be considered in developing regulations." *See* Office of Management and Budget, Circular A-4 (September 2003). However, the economic impact assessment in the Notice only addresses the compliance costs associated with establishing a written supervisory procedure reasonably designed to insure compliance with the Proposed Rule and delivery of the Communication. Notably missing is an analysis on the economic impact of the increased litigation that will follow the Proposed Rule and the affect that litigation will have on competition. Furthermore, balancing these costs against the benefits of the Proposed Rule is impossible at this time because the "Investor Testing" section of the Notice contains an insufficient analysis as well. Without these assessments the Notice likely fails to perform an adequate public interest analysis under Section 3(f) of the Act.

CONCLUSION

The Proposed Rule is not well designed to reduce alleged conflicts relating to enhanced recruitment compensation practices and instead could harm registered representatives' interests with no practical purpose. Before any action is taken, FINRA should identify and narrowly define the specific conflict it seeks to redress, draft a communication that provides balanced information to customers, establish a code of conduct for FINRA member firm communications to customers in response to inquiries arising from the Communication, perform a full and complete analysis of how effective the Communication is, as well as an economic impact assessment of potential litigation costs associated arising from the communication and its effect on competition in the industry.

Very truly yours,

/s/ Brian J. Neville
Brian J. Neville, Esq.