# BANKERS AND BROKERS AND BRICKS AND CLICKS: AN EVALUATION OF FINRA'S PROPOSAL TO MODIFY THE "BANK BROKER-DEALER RULE"

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## *I. Introduction*

Paula P., a risk-averse individual with no investment experience and no other significant assets,[3] walked into her local bank branch recently, intending to renew her one year Certificate of Deposit (CD), seeking interest on her $20,000 in savings accumulated over a lifetime of modest employment. Pat the bank teller recommended that she talk to Joe D. who worked in the office and who may be able to help her obtain a higher interest rate on her money. Paula agreed, and Joe took her over to his cubicle, eagerly explaining that he had "something better" for her than the CD she sought to renew. Paula, pleased to learn she could earn a higher interest rate on her savings, agreed to work with Joe. After signing a few papers that Joe said were merely "red tape," they completed the transaction, and Paula left the bank a satisfied customer, not realizing that she had just purchased shares of a speculative "junk bond" mutual fund – an investment product wholly different in risk than a CD.

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[3] While Paula is a fictional character, her story is based on a typical fact pattern that the authors have heard repeatedly from clients of PIRC. Opened in 1997, PIRC is the nation's first law school clinic in which Juris Doctor students, for academic credit and under close faculty supervision, provide *pro bono* representation to individual investors of modest means in arbitrable securities disputes against broker-dealers and their associated persons. *See* Barbara Black, *Establishing A Securities Arbitration Clinic: The Experience at Pace*, 50 J. LEGAL EDUC. 35 (2000).

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This is the story of countless unsuspecting and unsophisticated banking customers who enter the seemingly "safe and sound" confines of their trusted financial institution,[4] seeking safe, insured, depository *savings* products but are lured into purchasing volatile, uninsured non-depository *investment* products they often do not understand, only to later suffer substantial losses and learn that FDIC (or FSLIC) insurance is unavailable to make them whole.[5] These customers have been victimized by a regulatory scheme that permits broker-dealers to operate on the premises of financial institutions such as banks and savings and loans, with minimal required disclosures to customers about the fundamental differences between a depository institution and a broker-dealer and the products and services each respectively markets.[6] Financial regulators repeatedly have failed to proscribe this activity, to the detriment of countless retail investors.

This article evaluates the Financial Industry Regulatory Authority's (FINRA)[7] proposal to adopt a modified version of NASD Rule 2350, known as the "bank broker-dealer rule,"[8]

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[4] Of course, the hallmark of the depository financial institution is "the presence of full faith and credit [of the United States] behind deposit insurance," unlike the uninsured non-deposit Wall Street products often pushed by affiliated brokers. Carl Felsenfeld, BANKING REGULATION IN THE UNITED STATES, p. 76, Juris Publishing (2004).

[5] *See*, *e.g.*, Richard E. Horn, Vice-President, Bank of Boston Investor Services, Inc., Regulatory Correspondence dated June 6, 1997, *available at http://www.sec.gov/rules/proposed/s71097/horn1.txt* (last visited Jan. 8, 2010), citing Gordon J. Alexander, Ph.D., *et al*., *Mutual Fund Shareholders: Characteristics, Investor Knowledge, and Sources of Information* (June 24, 1996), *available at http://comptrollerofthecurrency.gov/ftp/workpaper/wp97-13.pdf* (last visited Jan. 8, 2010); *see also* Frederick T. Furlong and Simon H. Kwan, Federal Reserve Bank of San Francisco, *Safe & Sound Banking, 20 Years Later: What was proposed and what has been adopted* (2006), *available at http://www.frbsf.org/economics/conferences/0608/kwan_furlong.pdf* (last visited Jan. 8, 2010).

[6] A financial institution must determine if undertaking various securities activities may cause it to meet the definition of "broker" in the SECURITIES EXCHANGE ACT OF 1934, or whether it falls within one of the exceptions from the broker-dealer definition offered by the Gramm-Leach-Bliley Act (GLB), the GRAMM-LEACH-BLILEY FINANCIAL MODERNIZATION ACT OF 1999, Pub. L. No. 106-102, 113 Stat. 1338 (codified in scattered sections of 12 and 15 U.S.C.). If it does not fit within an exception, the securities activity is typically "pushed-out" to a broker-dealer that is a FINRA member and registered with the SEC.

[7] FINRA was created in 2007 following the consolidation of the National Association of Securities Dealers (NASD) and the enforcement, member regulation and arbitration functions of the New York Stock Exchange (NYSE).

[8] *See* SEC Release No. 34-60475; Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change to Adopt FINRA Rule 3160 (Networking Arrangements Between Members and Financial Institutions) in the Consolidated FINRA Rulebook, 74 Fed. Reg. 41774 (Aug. 18, 2009).



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which, if approved by the SEC, would be designated as FINRA Rule 3160 within FINRA's Consolidated Rulebook (the proposed rule change).[9] The proposed rule change ostensibly seeks to prevent FINRA member firms, who offer broker-dealer products and services through contractual "networking arrangements" with financial institutions – both on and off the premises of those institutions – from undertaking certain business practices that might tend to confuse or harm financial institution customers. The proposed rule change also aims to prevent customer confusion by, *inter alia*, ensuring that certain disclosures are made to affected customers so they can understand and appreciate the distinction(s) between the financial institution's products and services and those sold by the broker-dealer affiliate.

As discussed in this article, while the proposed rule change does, to a limited extent, protect bank customers who may be solicited for the purchase of investment products and services, it does not rectify sales practices of broker-dealers affiliated with financial institutions by networking arrangements which may tend to confuse, and even mislead, unsophisticated investors of modest means who can least afford to be exposed to excessive risk. Additionally, the proposed rule change adds no meaningful new surveillance, inspection, enforcement or punitive mechanisms to prevent and/or redress insidious practices that are akin to "bait and switch" tactics, particularly effective against the unsophisticated. In fact, the proposed rule change even rolls back some key regulatory provisions, an especially unsettling retreat when one considers the lack of oversight during the recent market malaise and the contribution that such abridgement may have made to the present economic contraction as a reverse "wealth effect" impinges upon consumer behavior. In short, as demonstrated below, the proposed rule change is inadequate to sufficiently protect investors and promote genuine market integrity.

[9] *Id.*

## *II. The History of Regulating Networking Arrangements*

Prior to implementation of the "bank broker-dealer rule," the SEC governed networking arrangements between financial institutions and broker-dealers through the issuance of interpretive "no-action" letters.[10] On November 24, 1993, SEC staff issued what became known as the "Chubb Letter," which detailed SEC policy related to certain broker-dealer operational activities that occurred on the premises of financial institutions.[11] Subsequent to release of the "Chubb Letter," the four main federal bank regulators issued an "Interagency Statement on Retail Sales of Non-deposit Investment Products" (the Interagency Statement) on February 15, 1994.[12] The Interagency Statement adopted many of the Chubb Letter provisions and directed banks and savings institutions to adhere to those principles when either: 1) effecting direct sales of securities to customers; or 2) overseeing NASD members in connection with the purchase or sales of securities on their premises.

In 1994, NASD proposed new Conduct Rule 2350 ("Broker-Dealer Conduct on the Premises of Financial Institutions"), based largely on the Chubb Letter and the Interagency Statement, in order to "establish uniform and consistent standards to govern . . . the activities of

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[10] *See SEC No-Action Letter*, *Chubb Securities Corp*., Nov. 24, 1993, 1993 WL 565540. Networking arrangements typically fall into two main categories: 1) referral arrangements; and 2) standard arrangements. A referral arrangement is a written agreement by which financial institution employees refer customers to an affiliated broker-dealer, and the related sales activities of non-depository investment products and services occur outside of the confines of the financial institution. Examples of permissible referral activities include, "provid[ing] customers with the broker-dealer's promotional materials, direct[ing] them to telephones for placing orders, or provid[ing] a toll free telephone number." Standard networking arrangements are generally used for on-site sales of investment products and services, pursuant to a customer access agreement between a financial institution and a registered broker-dealer that is typically situated within the financial institution, and is often either: (i) an unaffiliated third-party; (ii) a service corporation or (iii) an affiliate. Office of Thrift Supervision (OTS), *Examination Handbook, Other Activities (Complete)*, § 710.3 (Jan. 2004), *available at* http://files.ots.treas.gov/422201.pdf (last visited Jan. 8, 2010).

[11] *See Chubb Letter*, *supra* note 10.

[12] Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), Federal Reserve Board (FRB) and Federal Deposit Insurance Corporation (FDIC), *Joint Interpretations of the Interagency Statement on Retail Sales of Non-deposit Investment Products*, Sept. 12, 1995, *available at http://www.occ.treas.gov/ftp/release/95-94.txt* (last visited Jan. 8, 2010).

NASD members that are conducting broker-dealer services on the premises of a financial institution where retail deposits are taken."[13] Three years later, on November 4, 1997, the SEC approved Rule 2350, also known as the "bank broker-dealer rule."[14] .

On November 12, 1999, through "the culmination of a $300 million lobbying effort by the banking and financial-services industries,"[15] Congress passed GLB, repealing key provisions of the Glass-Steagall Act of 1933[16] and eliminating the long-standing separation of insurance, banking and securities businesses.[17] GLB did nothing to enhance investor knowledge or awareness, yet it permitted, and even fostered, the blending of seemingly secure depository savings institutions with the high-flying speculative culture of investment banking.[18]

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[13] *See* SEC Release No. 34-39294, File No. SR-NASD-95-63, 1997 WL 685310 (1997).

[14] *Id*.

[15] Joseph E. Stiglitz, Ph.D., *The Economic Crisis - Capitalist Fools*, VANITY FAIR, Jan. 2009, *available at http://www.vanityfair.com/magazine/2009/01/stiglitz200901* (last visited Jan. 8, 2010).

[16] THE BANKING ACT OF 1933, popularly known as the GLASS-STEAGALL ACT, is codified in various sections of title 12 of the United States Code.

[17] *See*, *e.g*., *Investment Co. Institute v. Camp*, 401 U.S. 617, 623 (1971), citing 12 U.S.C. §§ 24, 378(a); *see also Securities Industry Ass'n v. Board of Governors of Federal Reserve System*, 839 F.2d 47, 57 (2d Cir. 1988); *Mergers in the Financial Services Industry: Hearing Before the H. Comm. on the Judiciary*, 105th Cong. 2 (1998) (statement of John M. Nannes, Deputy Assist. Att'y Gen., Antitrust Div., U.S. Dep't of Justice), *available at http://www.usdoj.gov/atr/public/testimony/1787.htm* (last visited Jan. 8, 2010); Daniel Gross, *Shattering Glass-Steagall: Lehman's failure marks the end of an era*, NEWSWEEK, Sept. 15, 2008, *available at http://www.newsweek.com/id/159092* (last visited Jan. 8, 2010).

[18] Joseph E. Stiglitz, Ph.D., Columbia University Economics Professor and 2001 recipient of the Nobel Memorial Prize in Economic Sciences, attributes the 2008 economic collapse largely to the repeal of the Glass-Steagall Act:

> The most important consequence of the repeal of Glass-Steagall was indirect—it lay in the way repeal changed an entire culture. Commercial banks are not supposed to be high-risk ventures; they are supposed to manage other people's money very conservatively. It is with this understanding that the government agrees to pick up the tab should they fail. Investment banks, on the other hand, have traditionally managed rich people's money—people who can take bigger risks in order to get bigger returns. When repeal of Glass-Steagall brought investment and commercial banks together, the investment-bank culture came out on top. There was a demand for the kind of high returns that could be obtained only through high leverage and big risk[-]taking.

Stiglitz, *supra* note 15. *But see* Clyde Mitchell, *Ten Years After Gramm-Leach-Bliley: A Defense*, N.Y. LAW J., Jan. 8, 2010 at 3, citing Lawrence H. White, *How Did We Get into This Financial Mess?*, CATO Institute, Briefing Paper No. 110, Nov. 18, 2008 at 2, *available at http://www.cato.org/pubs/bp/bp110.pdf* (last visited Jan. 8, 2010).

Following the passage of GLB, unsophisticated depository customers were exposed to a slew of new offerings from giant hybrid financial services entities which, according to at least one observer, "were given the right to merge into behemoths, but regulators remained scattered and focused on a world that had ceased to exist."[19] Just months before the recent economic decline accelerated, John Reed, the "architect" of combining Travelers (insurance), Citibank, N.A. (commercial banking) and Salomon Smith Barney (securities brokerage and investment banking) – forged into what was then the world's largest financial services firm, Citigroup – reflected on that transaction and admitted it was a "mistake."[20]

Years after GLB's passage, Congress promulgated the Financial Services Regulatory Relief Act of 2006, which, *inter alia*, required the SEC and the Federal Reserve Board to adopt final rules and implement the exceptions to the definition of "broker" under GLB § 201 to govern the joint activity of banks and broker-dealers.[21] Commentators may differ about the root causes of the 2008-09 market collapse and the "Great Recession" that followed, but even some

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According to Mitchell and White, repeal of the key provisions of Glass-Steagall "opened the door for financial firms to diversify: a holding company that owns a commercial bank subsidiary may now also own insurance, mutual fund, and investment bank subsidiaries. Far from contributing to the recent [economic] turmoil, the greater freedom allowed by [GLB] has clearly been a blessing in containing it." *Id.*

[19] Chris Suellentrop, *Sandy Weill - How Citigroup's CEO rewrote the rules so he could live richly*, SLATE.COM, Nov. 20, 2002, *available at http://www.slate.com/id/2074372/* (last visited Jan. 8, 2010).

[20] Francesco Guerrera, *Citi Merger Architect Calls Deal 'Mistake,'* FIN. TIMES, Apr. 4, 2008, *available at http://www.ft.com/cms/s/0/adb7e4a6-019d-11dd-a323-000077b07658.html* (last visited Jan. 8, 2010). *See generally*, Edward Pekarek, *et al*., *Bank Merger Reform Takes an Extended Philadelphia National Bank Holiday*, 13 FORDHAM J. CORP. & FIN. L. 595, 679-81 (2008).

[21] *See* the FINANCIAL SERVICES REGULATORY RELIEF ACT OF 2006 (Pub. L. No. 109-351), codified in scattered sections of U.S. Code, Titles 12 and 15, *See also* 15 U.S.C., Subchapter 1, §§ 6801-09 and Regulation R at 17 C.F.R. 247.700-781.

of the staunchest GLB proponents point to insufficient regulatory oversight as one main cause for recent market and economic turmoil.[22]

## *III. Proposed FINRA Conduct Rule 3160*

The proposed rule change aims to harmonize FINRA rules[23] with relevant provisions of GLB and Regulation R.[24] The proposed rule change calls for FINRA members to: (1) establish written networking agreements with banks identifying responsibilities and compensation; (2) segregate the retail deposit-taking area from all securities activities occurring on bank premises; (3) permit some inspection and examination access by the SEC and FINRA; (4) require customer communications to "clearly" identify that all brokerage services are provided by the broker-dealer, not by the bank; (5) disclose that securities products offered are not insured like savings products; and (6) make reasonable efforts while opening an account to obtain a customer's written acknowledgement of the receipt of the required disclosures.[25]

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[22] Mitchell, *supra* note 18 ("[T]he [SEC] never really was given (or exercised) sufficient regulatory authority over investment banks and their capital positions, which, based upon their deterioration (Bear Stearns, Morgan Stanley and Merrill) and failure (Lehman Brothers), proved to be inadequate.")

[23] The FINRA rulebook, presently known as the "Transitional Rulebook," is comprised of: (1) NASD Rules and (2) the rules incorporated from the NYSE. FINRA Information Notice, *Rulebook Consolidation Process*, Mar. 12, 2008, *available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p038121.pdf* (last visited Jan. 6, 2010). In connection with its ongoing process to consolidate the Rulebook, FINRA staff is reviewing existing NASD and NYSE Rules for: 1) obsolescence; 2) differences between them; 3) ways to synthesize them; and 4) rules that can be transferred into the Consolidated Rulebook without substantive modification. *Id.* "[A]s the SEC approves new rules for inclusion in the Consolidated FINRA Rulebook and they become effective, FINRA members will become subject to those rules. . . . [and] the Transitional Rulebook will be reduced by the elimination of those rules that address the same subject matter of regulation. When the Consolidated FINRA Rulebook is completed, the Transitional Rulebook will have been eliminated in its entirety." *Id.*

[24] *See* SEC Release No. 34-60475, *supra* note 8; 15 U.S.C., Subchapter 1, §§ 6801-09 and Regulation R at 17 C.F.R. 247.700-781; *see also* 17 CFR Parts 218, 240 and 247, Definitions of Terms and Exemptions Relating to the "Broker" Exceptions for Banks, *available at http://edocket.access.gpo.gov/2007/pdf/07-4769.pdf* (last visited Jan. 8, 2010); Securities Exchange Act §3(a)(4)(B), 15 U.S.C. § 78c(a)(4)(B); Federal Reserve Press Release: *Agencies Adopt Final Rules to Implement the Bank "Broker" Provisions of the Gramm-Leach-Bliley Act*, Sept. 24, 2007, *available at http://www.federalreserve.gov/newsevents/press/bcreg/20070924a.htm* (last visited Jan. 8, 2010).

[25] *See* SEC Release No. 34-60475, *supra* note 8.

While the proposed rule change contemplates broker-dealer internet activities generally, at a minimum by implication through the FINRA by-laws, adoption of the setting regulations of the proposed rule change addresses only "on premises" activities in the "retail deposit-taking area."[26] Unfortunately, this provision ignores the fact that an ever-increasing number of bank deposits, including "substitute drafts" as permitted by the "Check 21 Act" and electronic payroll deposits,[27] both of which are facilitated online, and which should logically result in expansion of the covered "area" to include cyberspace, at least for the purposes of appropriate setting regulation.[28] In our view, the proposed rule change, in its present form, is a regulatory setback that substantially undermines the maxims of market integrity and investor protection, particularly in light of the increasing information asymmetry that exists between broker-dealers and their customers.

*IV. Investment illiteracy and customer confusion – the need for regulation*

Over the past twelve years, individual investors have been confused regarding the role of the financial institution – as defined within the proposed rule change – with respect to the securities activities of affiliated broker-dealers through network arrangements.[29] Investment illiteracy research conducted by the SEC in conjunction with the Office of the Comptroller of the Currency revealed pervasive customer confusion that extended across financial product

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[26] NASD Conduct Rule 2350(c)(1).

[27] *See* CHECK CLEARING FOR THE 21ST CENTURY ACT, 12 U.S.C. §§ 5001, *et seq*.

[28] Investors would benefit from the use of a broadly defined concept of the banking space, much like a "facility" is defined with regard to the activities of an exchange. *See* SECURITIES EXCHANGE ACT OF 1934, 15 U.S.C. § 77c(a)(2) ("[W]hen used with respect to an exchange *includes its premises, tangible or intangible property whether on the premises or not*, any right to the use of such premises or property or any service thereof for the purpose of effecting or reporting a transaction on an exchange (including, among other things, any system of communication to or from the exchange, by ticker or otherwise, maintained by or with the consent of the exchange), and any right of the exchange to the use of any property or service.") (emphasis added).

[29] *See* Networking arrangements, *supra* note 10.

"distribution channels."[30] For example, more than one of every eight (13.3%) mutual fund investors who participated in that study, and who invested through the so-called "bank broker-dealer" distribution channel, incorrectly believed they could not suffer a loss of principal in a bond fund investment; one of every five (20.1%) such investors inaccurately concluded they could not lose principal in a money market fund; and more than one-third (36.4%) of those surveyed had invested with the misapprehension that money market funds are federally insured. Another investment illiteracy study from that era made the startling determination that "fewer than one-fifth of all individual investors (in stocks, bonds, funds, or other securities) could be considered to be 'financially literate.'"[31] According to the most recent FINRA Investor Education Foundation study, financial illiteracy is not limited to any one cohort of investors; worse still, this troubling trend has actually accelerated among young adults who are notably less financially literate than previous generations.[32]

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[30] *See* Alexander, *et al*., *supra* note 5, at abstract. The mutual fund shareholder study consisted of a "nationwide telephone survey of 2,000 randomly selected mutual fund investors who purchased shares using the services of six different intermediaries, referred to as distribution channels – brokers, banks, mutual fund companies, insurance companies, employer-sponsored pension plans, and 'other' (*e.g*., financial planners)." *Id.* at 5.

[31] *Id*. at *n*.17, p.4, citing Princeton Survey Research Assocs., *The Investor Knowledge Survey: A Report of the Findings* (1996). The NASD subsequently defined "investor literacy" in 2003 as being "the understanding ordinary investors have of market principles, instruments, organizations and regulations." *NASD Investor Literacy Research* (2003), *available at http://www.finra.org/web/groups/Investors/@inv/@protect/documents/Investors/P011459.pdf* (last visited Jan. 8, 2010).

[32] FINRA Investor Education Foundation, *Financial Capability in the United States* (2009), *available at http://www.finrafoundation.org/web/groups/foundation/@foundation/documents/foundation/p120536.pdf* (last visited Jan. 8, 2010). Financial illiteracy has become so significant that the U.S. Social Security Administration is providing millions in funding for a Financial Literacy Center founded by the RAND Corp., Dartmouth College and the Univ. of Pennsylvania's Wharton Business School to develop educational materials and programs to improve the presently dismal financial literacy of Americans of all ages. *See* RAND Press Release, *RAND Launches New Financial Literacy Center with Dartmouth College and the Wharton School*, Oct. 7, 2009, *available at http://www.rand.org/news/press/2009/10/07/financial_literacy.html* (last visited Jan. 8, 2010). The U.S. Treasury and Education Departments recently announced an initiative to increase the financial literacy of high school students. *See also* David Lawder, *Obama administration aims for high school financial literacy*, REUTERS, Dec. 15, 2009, *available at http://www.reuters.com/article/idUSTRE5BE3GG20091215* (last visited Jan. 8, 2010).

NASD's 2003 study of "a wide range of investors across income, gender, size of investment portfolio and types of investments," produced similarly dismal results of investment illiteracy, despite the fact that almost seventy percent of responding investors "described themselves as being 'somewhat knowledgeable' about investing."[33] For example, just slightly more than one-third (35%) of the NASD study's respondents were able to "answer[ ] seven out of the ten of NASD's Basic Market Knowledge questions correctly." Meanwhile, almost two-thirds (62%) of surveyed investors either did not know or believed, erroneously, that they were insured against stock market losses, and one-fifth of all respondents believed that such insurance was provided either by the SEC (16%) or the NASD (4%).

TD Ameritrade, a FINRA member, funded investment illiteracy research in 2006 which revealed that more than half of all investors surveyed incorrectly believed that a stockbroker owes "a fiduciary responsibility to act in [a customer's] best interests in all aspects of the financial relationship."[34] A FINRA Investor Education Foundation study from the same year measured the level of senior investor illiteracy, and found that "55% of respondents lost money on an investment" and of those who did lose investment principal, almost one in five "attribute[d] the loss to being misled or defrauded and 78% of those misled or defrauded did not report it."[35] These troubling findings translate into approximately 10% of all senior citizen investors being defrauded at some point, and, of that population, four out of five defrauded

[33] *NASD Investor Literacy Research*, *supra* note 31.

[34] *See Investor Perception Study*, conducted by Penn, Schoen and Berland Assocs. for TD AMERITRADE (2006), *available at http://www.tdainstitutional.com/pdf/InvestorPerceptionStudy.pdf* (last visited Jan. 8, 2010).

[35] *NASD Senior Investor Literacy and Fraud Susceptibility Survey Executive Summary* (2006), *available at http://www.finrafoundation.org/web/groups/sai/@sai/documents/sai_original_content/p036699.pdf* (last visited Jan. 8, 2010).

seniors will not report being victimized. This study also concluded that many "victims of fraud are relatively knowledgeable and active investors."[36]

The SEC maintained in 2007 that the prevention of fraud targeting senior investors was a top priority, yet realizing this laudable goal has remained elusive due, in large part, to substantially insufficient regulatory oversight, including erosion at the edges of the governing rules, such as that of the proposed rule change.[37] A 2007 FINRA Investor Education Foundation study determined, not surprisingly, that "personal relationships factor into senior investor decision making."[38] According to the Electronic Financial Services Council, "[i]nvestors are most vulnerable to high pressure sales tactics when they are interacting personally with a salesperson in whom they have placed their trust and confidence."[39] Two of every five senior investors who participated in the 2007 FINRA study "have hired a broker recommended by a friend, relative, co-worker or neighbor."[40] Nearly three of every five (58%) senior investors who

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[36] FINRA Investor Education Foundation, *Senior Investor Literacy and Fraud Susceptibility Survey Key Findings* (2007), *available at http://www.finra.org/web/groups/investors/@inv/@smart/documents/investors/p036810.pdf* (last visited Jan. 8, 2010).

[37] *See*, *e.g.,* Christopher Cox, *Speech by SEC Chair: Address to the Senior Investor Protection Symposium* (May 18, 2007), *available at http://www.sec.gov/news/speech/2007/spch051807cc.htm* (last visited Jan. 8, 2010); *see also* SEC webpage, *For Seniors*, *available at http://www.sec.gov/investor/seniors.shtml* (last visited Jan. 8, 2010).

[38] FINRA Investor Education Foundation, *Senior Fraud Risk Survey* (2007), *available at http://www.finra.org/web/groups/investors/@inv/@smart/documents/investors/p036813.pdf* (last visited Jan. 8, 2010).

[39] *Promoting Efficient Arrangements Between Portals and Online Brokers* (2000), submitted to the SEC by Intuit, Inc. and the Electronic Financial Services Council, *available at http://www.sec.gov/pdf/intuitefscpaper.pdf* (last visited Jan. 8, 2010).

[40] FINRA Investor Education Foundation *Senior Fraud Risk Survey*, *supra* note 38.

have been defrauded previously have entrusted their investing activity to a broker based on a personal recommendation.[41]

At least one observer recently concluded that the presence of a "'truth bias' caus[es] [senior citizens] to believe what they're told by someone who appears to be authoritative."[42] When customers are told by a professional who is surrounded by all the trappings of the bank setting that a product is "just like a CD, but even better," many might be prone to accept the veracity of such puffery, due to the phenomenon of "truth bias," particularly unsophisticated seniors.[43] The studies cited above highlight that the traditional financial institution setting has the potential to create false impressions of safety and security for customers who are ill-equipped to sense they are being solicited for their savings by professionals who typically enjoy information asymmetry and a position of trust.

*V. Vague regulatory language and sanctions, lax inspection and enforcement*

Bank customers have described to the authors confusing financial institution settings where the absence of appropriate on-premises signage is a regular occurrence,[44] vague customer communications and inadequate disclosure are standard, and securities activities transpiring in close proximity to retail deposit-taking areas, without appropriate segregation, is commonplace. Anecdotal evidence further suggests instances of bank employees utilizing customer account

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[41] *Id*. Additional decision-making biases are examined in detail by at least one scholar who has concluded that investor and consumer education programs are of questionable value. *See* Lauren E. Willis, *Against Financial-Literacy Education*, 94 IOWA L. REV. 197, 226 (2008).

[42] *See* Jayne W. Barnard, *Deception, Decisions, and Investor Education*, 7 ELDER LAW JOURNAL ___ (2009), *available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1291843*.

[43] *Id*.

[44] We urge the SEC to altogether eliminate disclosure loopholes provided by "The Interagency Statement," a scheme crafted in response to banking industry lobbyist efforts, allowing exempted non-disclosure in: "[i] radio broadcasts of 30 seconds or less; [ii] electronic signs [which] may include billboard-type signs that are electronic, time and temperature signs and ticker tape signs. Electronic signs would not include such media as television, on line services, or ATMs; and [iii] signs, such as banners and posters, when used only as location indicators." *Interagency Statement*, *supra* note 12.

data in order to apply relationship-based sales tactics when potentially investable funds become available, such as on or near the maturity date of a certificate of deposit. These customers likely do not know that the bank employee who recommends them to an affiliated broker-dealer may well be motivated by the compensation they receive, limited only by bank-friendly Regulation R, for steering customers toward non-depository products (*e.g.*, securities).[45]

These and other misleading activities have taken place despite the regime established by NASD Rule 2350, which strongly suggests that the current rule does not adequately protect unsophisticated investors from the very confusion it was supposed to eliminate. At least one market observer has acknowledged that "regulatory bodies have struggled with implementation of the bank 'broker' provisions."[46] Thus, because it appears designed to dilute the already inadequate *status quo ante*, the SEC should not approve the proposed rule change.

Instead, ambiguity within the proposed rule change, as it is currently constructed, leaves ample room for sharp parsing and actually invites misconduct. For example, the provision that intends to adopt NASD Rule 2350(c)(4) would require disclosures within "all of the member's advertisements and sales literature that promote the name or services of the financial institution. . . ." However, if a broker-dealer subsidiary employs an identical logo and a confusingly similar

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[45] *See* Regulation R, 12 CFR § 218 and 17 CFR § 247. According to former SEC Commissioner Laura S. Unger, "[t]he Commission [r]eceived [s]ubstantial [i]nput from the [b]anking [c]ommunity and the Rules [r]eflect [t]his [i]nput . . . [and] [p]rovide [f]lexibility to [b]anks to [c]ompensate [e]mployees." *Testimony Concerning Functional Regulation Provisions of the Gramm-Leach-Bliley Act, Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises and the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services U.S. House of Representatives* (Aug. 2, 2001), *available at http://www.sec.gov/news/testimony/080201tslu.htm* (last visited Jan. 8, 2010); *see also* Section 3(a)(4)(B)(i) of the SECURITIES EXCHANGE ACT of 1934, 15 U.S.C. § 77c(a)(4)(B)(i).

[46] Edwards, Angell, Palmer & Dodge, LLP, *Implications of Regulation R on Bank Distribution Channels Used for Insurance Sales*, *n.*3, *available at http://www.eapdlaw.com/newsstand/detail.aspx?news=1125* (last visited Jan. 8, 2010); *see also* Ashby Jones, *Brian Moynihan: From Edwards & Angell to the Top of BofA*, WALL ST. J. (LAW BLOG), Jan. 8, 2010, *available at http://blogs.wsj.com/law/2009/12/17/brian-moynihan-from-edwards-angell-to-the-top-of-bofa/* (last visited Jan. 8, 2010); Dan Fitzpatrick and Susanne Craig, *The Hole on Brian Moynihan's Resume*, WALL ST. J. (DEAL JOURNAL BLOG), Dec. 21, 2009, *available at http://blogs.wsj.com/deals/2009/12/21/the-hole-on-brian-moynihans-resume/* (last visited Jan. 8, 2010).

trade name to that of the affiliated financial institution, has that advertising content "promote[d] the name or services of the financial institution" within the meaning of the rule? The proposed rule change does not appear to prohibit such conduct.

The proposed rule change also substantially diminishes certain of the compliance and disclosure mechanisms when compared to NASD Rule 2350. For example, by eliminating the requirement of NASD Rule 2350(c)(3)(B), which compels broker-dealers to make objectively reasonable efforts to obtain written customer acknowledgement of receipt of mandated disclosures, FINRA provides its members far less incentive to ensure that associated persons are in fact disclosing the required information. Instead, an associated person can routinely state s/he made the requisite disclosures because the proposed rule would not affirmatively require an investor acknowledgement to verify this contention. Coupled with the absence of meaningful record-keeping requirements, surveillance and/or inspection provisions regarding the efforts undertaken to obtain the customer acknowledgement, this aspect of the proposed rule change is part of a pronounced retreat from the interests of investor protection and market integrity.

Likewise, the proposed rule change dilutes the setting requirements of the bank broker-dealer rule. Currently, NASD Rule 2350(c)(1) unambiguously requires the setting of the financial institution to be "clearly distinguished" from the broker-dealer.[47] In contrast, subsection 3160(a)(1)(c) of the proposed rule change requires a member firm to physically separate its broker-dealer products and services from the "routine retail deposit-taking activities of the financial institution," but only "to the extent practicable."

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[47] *See* NASD Rule 2350(c)(1) ("Wherever practical, the member's broker-dealer services shall be conducted in a physical location distinct from the area in which the financial institution's retail deposits are taken. In all situations, members shall identify the member's broker/dealer services in a manner that is clearly distinguished from the financial institution's retail deposit-taking activities. The member's name shall be clearly displayed in the area in which the member conducts its broker/dealer services.").

This language is particularly problematic because it invites subjective self-serving interpretation by the broker-dealer. The use of substantially similar aesthetic elements within retail bank branches that feature brokerage products and services, items known as "trade dress" (*e.g.*, identical interior décor, signage style, logos, etc.), as well as confusingly similar business names and identical website addresses, can create the illusion in a naïve investor's mind – perhaps deliberately – that the broker and the banker are actually one and the same.

Under the proposed regime, a broker-dealer can combine that tactic with a dubious semantic determination that segregating the banking from the brokerage area is "impracticable," setting a potential trap for the trusting customer. Anecdotal evidence indicates that, even under the current regime, the separation of the physical space between some bank tellers and brokers is *de minimis* and the interior banking areas lack required disclosure signage and/or are indistinguishable from each other. Rather than strengthening the setting requirements, the proposed rule change weakens them without explanation.

Similarly, despite the fact that the radio industry changed its pricing model five years ago[48] to one where the "30-second ad[vertisement] [became] the standard unit of measure for network radio sales," the relevant portion of the current rule, NASD Rule 2350(c)(4)(D), for some reason specifically excludes "radio broadcasts of 30 seconds or less" from the disclosure requirements of NASD Rule 2350(c)(4)(C).[49] The proposed rule change ignores this important

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[48] Clear Channel Communications, one of the nation's largest radio station operators, forever changed the radio industry pricing model in early 2005 to favor 30 second advertising "spots." *See* Roy H. Williams, *Radio Ads: How Long Should They Be? Everything you need to consider when choosing between 15-, 30- and 60-second spots*, ENTREPRENEUR, Sept. 13, 2004, *available at* *http://www.entrepreneur.com/advertising/adcolumnistroyhwilliams/article72584.html* (last visited Jan. 8, 2010) ("For the first time ever, 30- and 15-second ads will be priced worth the money. Up until now, all radio ads were priced essentially the same, regardless of length, so everyone ran 60s, . . .").

[49] Mark Lipsky, *Google Radio Misses Success by 30 Seconds*, RADIO DIRECT RESPONSE (BLOG), *available at* *http://www.radiodirect.com/blog/?p=173* (last visited Jan. 8, 2010). Incidentally, "NASD Regulation staff has [also] extended this [non-disclosure] exception to letterhead, envelopes and business cards that do not reference

shift in broadcast media advertising and, despite its claim "to give consideration to the rapidly evolving nature of the securities business,"[50] FINRA has continued an almost slavish adherence to the 1995 Interagency Statement, an outdated proviso developed as the internet entered its commercial infancy.[51] Among the effects of the proposed rule change will almost invariably include increased confusion for customers of all ages.

*VI. Failure to clearly regulate internet activities of broker-dealers*

The proposed rule change fails to clearly regulate the confusingly commingled internet presence of financial institutions and affiliated broker-dealers, despite the fact that online banking now surpasses visits to "brick and mortar" branches within key demographic groups.[52] According to a 2007 FINRA study, "a majority of older investors (55 and older) are interested in a variety of online resources, [although] they are less interested than younger investors: . . . [but they] are more likely to visit brokerage firm web sites to research investment[s] than other web

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investments or securities products" directly, thereby relieving broker-dealer affiliates of the onerous burden of a nine-word disclosure. *See* FINRA Advertising Regulation, *Ask The Analyst, Advertising Regulation Seminars (held in Washington, DC on Oct. 14-15, 1999, and in Seattle, Washington on Oct. 20, 1999), available at http://finra.complinet.com/en/display/viewall_display.html?rbid=1189&element_id=1159004984* (last visited Dec. 31, 2009); *see also* NASD Conduct Rule 2350 (c)(4)(C), which calls for the following cautionary language: "Not FDIC Insured, No Bank Guarantee, May Lose Value." It should be noted that FINRA's guidance was provided before the passage of GLB.

[50] FINRA Information Notice, *Rulebook Consolidation Process*, *supra* note 23.

[51] *See Interagency Statement*, *supra* note 12; *see also* Robert H'obbes' Zakon, *Hobbes' Internet Timeline*, *available at http://www.zakon.org/robert/internet/timeline/* (last visited Jan. 8, 2010) ("1995: . . . dial-up systems (CompuServe, America Online, Prodigy) begin to provide Internet access. . . .").

[52] Tiffany Hsu, *More consumers prefer to bank online, says American Bankers Assn.,* LA TIMES (BLOG), Sept. 21, 2009, *available at http://latimesblogs.latimes.com/money_co/2009/09/more-consumers-prefer-to-bank-online-says-american-bankers-assn.html* (last visited Jan. 8, 2010). An August 2009 survey of 1,000 consumers conducted on behalf of the American Bankers Association by market research firm Ipsos-Reid, revealed findings the bank lobbyist called a "watershed change." The study revealed that:

> Twenty-five percent of all bank customers under age 55 now prefer the speed and convenience of Internet banking to phone and mail options. For customers ages 18 to 34, a whopping 38% preferred banking online. Among older customers, 26% still prefer visiting their local branch. But just 21% of the overall group would rather bank at physical locations, and only 17% prefer ATMs. Just 1%, mostly 18- to 34-year-olds, are most likely to enjoy mobile banking on cellphones or personal digital assistants.

sites, such as Yahoo and Morningstar."[53] As mentioned above, younger Americans are more comfortable with online and mobile banking technology, but they are also more financially illiterate than any other cohort – two rapidly converging trends with serious implications for the lack of regulation of securities activities on bank websites.[54]

Presently, domestic retail banking "areas" maintained online are utilized to market investment products and services without meaningful segregation between banks and brokers and, to date, appear to lack appropriate surveillance, inspection and enforcement. This contradicts federal regulatory guidance provided to the banking industry which directs national banks to "make certain that their disclosures on Internet banking channels, including websites, remain synchronized with other delivery channels to ensure the delivery of a consistent and accurate message to customers."[55]

A recent sampling of commercial banking websites revealed a pattern of blending of securities activities with traditional banking functions on the same internet website, located at the same URL address, apparently hosted on the same network server, and which frequently utilized

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[53] FINRA study, *Insights on Investment Attitudes and Behaviors Comparing Older and Younger Investors* (2007), *available at http://www.finra.org/web/groups/investors/@inv/@smart/documents/investors/p036812.pdf* (last visited Jan. 8, 2010).

[54] *See* CHECK CLEARING FOR THE 21ST CENTURY ACT, 12 U.S.C. §§ 5001, *et seq.*; Saul Hansell, *Scanning Your Money to the Bank*, NEW YORK TIMES (BLOG), Feb. 7, 2008, *available at http://bits.blogs.nytimes.com/2008/02/07/scanning-your-money-to-the-bank/* (last visited Jan. 8, 2010) ("To use the service, consumers would sign onto their bank's [w]eb site, activate a piece of software, type in the amount, and then scan the front and back side of each check they want to deposit. The bank has the option of immediately sending the check image to be cleared or to have a human review it first."); Miranda Marquit, *Wanna Deposit Checks from Home?*, MAINSTREET (BLOG) POWERED BY THESTREET.COM, July 13, 2009, *available at http://www.mainstreet.com/article/moneyinvesting/savings/remote-check-deposit-slow-coming-consumers* (last visited Jan. 8, 2010) ("Right now, the 150 largest banks offer this service, which allows you to fax or email checks to your bank for deposit. Among those who do are Key Bank [ ], Wells Fargo [ ], Chase [ ], Citi [ ] and Bank of America [ ]. Many regional banks provide remote deposit services as well. According to the Community Bankers of America, 50% of banks offer remote deposit, and 70% plan to have it by next year.").

[55] *Comptroller's Corporate Manual - The Internet and the National Bank Charter*, Jan. 2001, p. 89, *available at http://www.fdic.gov/regulations/information/ebanking/Internet&NationalBankChrtr.pdf* (last visited Jan. 5, 2010).

the same widely-recognized bank logo(s), trade name(s) and trade dress.[56] Often, the only "segregation" between bank and non-bank offerings marketed online is an html-coded tab, button or hyperlink at or near the top of a web-page designed to enable customers to seamlessly navigate between checking and savings accounts, credit cards, mortgages, HELOCs, student loans, and a host of brokerage activities involving non-depository investment products such as common equities, mutual funds, options, commodities, forex products, futures and the like, for the roughly 42% of all internet users who presently bank online.[57] In fact, on most of the banking/brokerage websites we sampled, the "trading" tab was featured prominently, often adjacent to the "banking" tab. Almost without exception, required disclosures were buried at the bottom of the respective webpage(s).[58]

The absence of any meaningful regulatory oversight of this fast-growing distribution sub-channel undermines the investor protection potential of the proposed rule change.[59] All too often

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[56] Some of the websites sampled include: Bank of America, *available at https://www.baisidirect.com/live/login.jspv* (last visited Sept. 8, 2009); BB&T, *available at http://www.bbt.com/personal/products/investments/default.html* (last visited Sept. 8, 2009); Citi, *available at https://online.citibank.com/US/JRS/pands/detail.do?ID=InvestingOverview* (last visited Sept. 8, 2009); JP Morgan-Chase, *available at https://www.chase.com/ccp/index.jsp?pg_name=ccpmapp/individuals/investments/page/plan_brkg* (last visited Sept. 8, 2009); Key, *available at https://www.key.com/html/ira-investments-retirement.html* (last visited Sept. 8, 2009); PNC, *available at https://www.pnc.com/webapp/unsec/ProductsAndService.do?siteArea=/pnccorp/PNC/Home/Personal/Investments+and+Wealth+Management/Investments* (last visited Sept. 8, 2009); Regions, *available at http://www.regions.com/personal_banking/morgan_keegan.rf* (last visited Sept. 8, 2009); and Wells-Fargo, *available at https://www.wellsfargo.com/investing/styles/comparison* (last visited Sept. 8, 2009).

[57] Atul Prakash, *et al*., *Analyzing Websites for User-Visible Security Design Flaws*, *available at http://cups.cs.cmu.edu/soups/2008/proceedings/p117Falk.pdf* (last visited Dec. 18, 2009).

[58] Notably, courts have been reluctant to deem legally effective website disclosures if the user has to scroll to the bottom of the webpage to read them. *See Specht v. Netscape Commc'ns Corp*., 306 F.3d 17, 20 (2d Cir. 2002) ("[P]laintiffs could not have learned of the existence of those terms unless, prior to executing the download, they had scrolled down the webpage to a screen located below the download button.… a reasonably prudent Internet user in circumstances such as these would not have known or learned of the existence of the license terms before responding to defendants' invitation to download the free software, and that defendants therefore did not provide reasonable notice of the license terms.").

[59] *See*, *e.g.*, John Adams, *Small Banks Seen Flocking to Online Account Products*, AMERICAN BANKER, May 29, 2009 ("Online account-opening applications offer a low-cost way to increase deposits, according to community and regional bankers"), *available at http://www.americanbanker.com/issues/174_106/-379234-1.html* (last visited Jan. 8, 2010); *see also* Press Release, *Bank of America Corp. - 1st Quarter Results*, April 20, 2009, PR NEWSWIRE EUROPE

a broker-dealer affiliated by network arrangement with a financial institution utilizes a confusingly similar trade name to that of the contracting financial institution, with a perfunctory appendage such as "Investment Services, LLC," added to an already widely recognized brand and logo(s).[60] This trend exposes customers to greater risk online and in the physical bank setting, because the use of confusingly similar trademarks and names may lead to the inference that the banker and the broker are one and the same with a further blurring of the line between insured savings products and risky investment products. Unfortunately, the proposed rule

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(Bank of America maintains a total of "approximately 55 million consumer and small business relationships . . . [and] online banking with nearly 30 million active users"); Bill Stoneman, *Rationale for Online Banking Starts to Shift*, AMERICAN BANKER (USA), Mar. 12, 2001, 2001 WLNR 2793600. Online banking has a boon for financial services marketing:

> But just as with the ATM and automated phone systems of a generation earlier, Internet banking didn't cause a mass migration of transactions from high- to low-cost channels. Instead, bankers say, *it has spurred more transactions than ever*. . . . Wendy Grover, a spokeswoman for Wells Fargo & Co.'s Internet services group, said the San Francisco banking company has seen the same benefits that Mr. Andrews described and more. The company is no longer worrying about the kind of benefits it initially expected from online banking, she said, and instead enjoys customer retention, *cross-selling*, and balance growth rewards. [emphasis added].

*See also* Hsu, *supra* note 52; CHECK CLEARING FOR THE 21ST CENTURY ACT, *supra* note 54.

[60] *See Rescuecom Corp. v. Google Inc.*, 562 F.3d 123, 130 (2d Cir. 2009), citing 15 U.S.C. § 1125(a); *Estee Lauder Inc. v. The Gap, Inc.*, 108 F.3d 1503, 1508-09 (2d Cir.1997) (discussing the likelihood of consumer confusion standard within the LANHAM ACT context); *see also* Securities Industry Ass'n, Regulatory Correspondence to the Texas Securities Board regarding *Proposed Rules for Sales of Securities at Financial Institutions*, Apr. 16, 1997, *available at http://www.sifma.org/regulatory/comment_letters/comment_letter_archives/31224607.pdf* (last visited Jan. 8, 2010) ("A non-deposit investment product must not have a name that is identical to the name of the financial institution"). An example of the use of identical marks by both a financial institution and its affiliated broker would be that of Citi and its affiliate(s), as noted in its disclaimer located on the Citi website's Online Investing Overview page, which reveals that:

> Citi Personal Wealth Management is a business of Citigroup Inc., which offers securities through Citigroup Global Markets Inc. ("CGMI"), member SIPC. Insurance is offered through Citigroup Life Agency LLC ("CLA"). In California, CLA does business as Citigroup Life Insurance Agency, LLC (license number OG56746). CGMI, CLA and Citibank, N.A. are affiliated companies under the common control of Citigroup Inc. *Citi and Citi with Arc Design are registered service marks of Citigroup Inc. <u>and its affiliates</u> and are used and registered throughout the world.* [emphasis added].

*Citibank Online - Investing Overview*, *available at https://online.citibank.com/US/JRS/pands/detail.do?ID=InvestingOverview* (last visited Dec. 18, 2009).

change does nothing to prevent what appears to have become a standard stratagem employed by bankers and brokers to make one business indistinguishable from the other.

## *VII. Conclusion*

The language of the proposed rule change is wholly insufficient to prevent fraudulent and manipulative acts and practices, and, in general, to protect investors and the public interest. It also lacks adequate surveillance, inspection and enforcement measures and appropriate sanctions for non-compliance. The statutory purpose of "ensur[ing] that communications with customers clearly identify that the broker-dealer services are provided by the member"[61] is offended by the false sense of security created within the confines of the financial institution setting. This is true whether one considers the on-premises "bricks," or the off-premises "clicks," particularly when coupled with relationship sales tactics employed by compensated bank employees whose mission it is to steer customers to affiliated broker-dealers who utilize confusingly similar trade names and feature the same, or confusingly similar, logos and trade dress, inadequate signage and vague or non-existent disclosure.

The level of documented investment illiteracy demonstrates a pressing need for thorough investor protection, yet profound regulatory gaps continue to exist with regard to, *inter alia*, the industry's present use of networking agreements between financial institutions and affiliated broker-dealers, as outlined within the proposed rule change and this article. We urge the SEC to press FINRA to substantially enhance the provisions of the proposed rule change so as to protect individual investors and bolster genuine market integrity.

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[61] 74 Fed. Reg. 41774, at § II(A)(1)(4).