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August 30, 2004

Jonathan G. Katz, Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: S7-26-04 Regulation B (Networking)

Dear Mr. Katz:

Thank you for the opportunity to comment on banks and networking arrangements, including referral fees. While I fully support your efforts to limit referral fees, I believe bank employees should receive **no fees or other types of incentives** for referrals to an investment service in a networking arrangement when the investment service:

- Is located on bank premises,
- Carries a name similar to that of the bank, or
- Shares employees, including dual employees.

When a networking arrangement has an investment service located on or inside a bank's premises, shares employees, encourages bank employee involvement through referrals, or has a similar name to the bank, bank customers can become confused that the investment service offers the same financial protections for investments as the bank. Investment service activities that involve bank employees who customers normally see for their banking needs greatly add to the potential for confusion.

The SEC's final rule should not exacerbate the problem of customer confusion. By allowing the payment of fees and other incentives to bank employees for referring bank customers to the investment service, the rule encourages bank employee involvement in investment service activities. Their involvement may further blur important distinctions between the investment service and the bank, which customers need to understand before investing in less safe investment service products.

In addition, the SEC should not sanction any activities that may result in predatory behavior. Seeking fees and incentives, bank employees may pressure and divert bank customers from safe insured bank products into less safe products sold by the investment service.

Without better regulatory oversight over the current environment of networking arrangements, which promotes customer confusion and holds the potential for predatory behavior, the SEC should reduce bank employee involvement in investment service activities <u>by prohibiting referral fees and other incentives for referrals</u>. Bank employee referrals are a particular threat to less sophisticated elderly bank customers, who by the nature of past experiences with banks are trusting of the bank and its employees. The elderly, who often hold significant amounts of money in CDs, are the ones most likely targeted for referral to the investment service.

This comment letter will discuss various issues that impact consumers when banks have networking arrangements with investment (brokerage) services located on bank premises. My comments are based on an elderly bank customer's (Mrs. D's) experiences with a national bank's wholly owned on-site investment service subsidiary that sold uninsured, risky non-bank products, such as mutual funds and other non-deposit retail investment products. It all began with a bank employee's over- zealous referrals to win a contest for a trip to Washington, D.C.

General Background

Mrs. D had been a customer of U Bank[1] for over thirty years. She often paid her utility bill at the bank, and would stop and chat with one of the bank's friendly employees, an experienced Account Specialist (AS). During these visits, the AS repeatedly suggested to Mrs. D that she should invest her money in something other than a CD,[2] and urged her to talk to the on-site investment advisor (broker), who was also a senior vice president of U Bank (dual employee). The bank's investment service, U Bank Investment Services, sat inside the bank's building around the corner from the AS's desk.

On June 30, 1999, having entered the bank to pay a utility bill, Mrs. D stopped by the AS's desk, and within the next 30 minutes, Mrs. D had invested a substantial portion of her life's savings, $75,000, in Putnam mutual funds. Having great trust in her bank, Mrs. D unknowingly placed her savings in uninsured and risky investments that she believed to be as safe as a CD, because she was under the impression that the investment service and the bank were the same entity, and that therefore, the investment service offered the same financial protections as those provided by the bank.[3] The AS and the broker received lucrative fees and incentives for this sale.

<u>Losses Began Immediately</u>

The investment began to fall in value, along with the stock market, beginning sometime in the fall of 1999. Mrs. D noted her monthly statements indicated a dramatic decline in the value of her initial investment.[4]

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[1] U Bank is not the real name of the bank.
[2] Often the suggestions went beyond a referral, and became specific recommendations of Putnam mutual funds. See Appendix A for additional details on the referral.
[3] Protections provided by banks include FDIC-insurance on deposits, including CDs and money market accounts.
[4] Someone in the employ of the bank, either the AS or the broker, advised Mrs. D that she could earn more income from Putnam mutual funds than she could from a CD. The broker set up a "cash flow" arrangement such that shares of

Permanent losses[5] in addition to temporary losses[6] significantly depleted Mrs. D's investment at an alarming rate. Repeated calls and visits to U Bank for an explanation resulted only in assurances by the broker's assistants that the market would stabilize. The assistants as well as the AS told Mrs. D not to worry, and that she should "hang" in there.[7] No one appeared to understand the impact of the cash flow arrangement, which needed to be stopped. Mrs. D's trust in the bank and its employees led her once again to trust their advice, and she "hung" in there. By 2001, Mrs. D's losses, both temporary and permanent, reached approximately $40,000, over half of her investment. When Mrs. D asked me for help, she could not explain her investment, and she was upset that the Internal Revenue Service had notified her that she had misreported the monthly redemption amounts as interest income on her tax returns.[8] Mrs. D eventually stopped the monthly automatic redemptions to protect her remaining assets.

As further background, Mrs. D was 78 at the time of the investment, and was living alone in Missouri. While she may be astute and intelligent, as proffered by the broker, Mrs. D is not a college graduate and she is not a sophisticated investor. Most of her assets were inherited, or a result of saving. My background includes a law degree, an accounting degree, and an LL.M. in taxation, and work as the comptroller of a national bank. Even with this experience, I spent considerable time unraveling the complexities of the investment and the cash flow arrangement to determine why the investment was causing such dramatic losses.[9] I also spent considerable time sorting out Mrs. D's tax return to amend it. After that, I understood why Mrs. D did not understand her investment–it was complex due to the cash flow arrangement and the inherent risk and lack of diversity in the overall investment. In addition, we learned later that late-trading transactions at Putnam Company added to the losses in ways we could not see or calculate. We also learned that companies, including Putnam, paid brokers lucrative incentives to sell certain

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Mrs. D's mutual fund were redeemed automatically each month to pay Mrs. D a set amount of $545 a month, thus meeting her stated "income" objectives. These payments would be made regardless of how her investment performed. The performance of her investment was directly tied to the stock market's performance, because all of the mutual funds were in stocks. Thus, as Mrs. D's mutual fund shares declined in value in tandem with the decline in the stock market, there were no longer any gains to cover the monthly automatic redemptions, so they began coming solely out of principal. This created permanent losses that greatly devalued the initial investment, because more and more shares had to be redeemed at a loss to produce the set monthly payment amount of $545. Temporary losses were exacerbated because of the risk inherent in stock-based mutual funds. Mrs. D did not understand that her investment was tied to the stock market, that the monthly payments were not interest income, or that each payment (anytime the stock market declined or failed to grow enough value to cover the monthly payment amount) would cause permanent losses of principal.

[5] See footnote 4 above.

[6] See footnote 4 above.

[7] The broker was either not advised of Mrs. D's calls and bank visits, or if so advised, never bothered to call Mrs. D to offer assistance.

[8] Believing that she had invested in a product similar to a CD, Mrs. D reported the monthly payments of $545 as interest income on her tax returns.

[9] Mrs. D's investment as a whole and the associated arrangement for monthly payments were unsuitable for most any elderly investor with limited income and assets. The broker placed Mrs. D in a situation where her investment began paying out like an annuity, but she was without the benefit and protections of annuity planning, and it was done without consideration of market movement. The investment was further unsuitable because it was totally stock-based, which made the investment very susceptible to any downside movement in the stock market. The investment also completely lacked diversity. It was also unsuitable for an elderly person because of the 8-year penalty for full withdrawal.

funds, which potentially caused brokers to ignore suitability standards that mainly affected small, unsophisticated investors like Mrs. D.

<u>All This From An Institution of Trust–Her Bank</u>

Although the facts surrounding the day of purchase may be in question, it is not a question of fact that during the June 1999 visit:

- Mrs. D invested $75,000 in uninsured and risky stock based type B mutual funds with the understanding that she would receive a monthly income from the investment.
- Mrs. D purchased what she thought was a bank product. This impression was formed by the AS's referral within the bank to the broker, another bank employee (dual employee) within the bank.
- What Mrs. D got from the investment is approximately $19,000 in permanent losses, and the potential for further penalties against her remaining principal should she withdraw all her money for the next four years.[10]
- Mrs. D has limited assets; she is an elderly person on a fixed income.
- Mrs. D is not a sophisticated investor, and had no ability to comprehend the impact on her investment by automatic redemptions in a falling or stagnant stock market.
- These permanent losses most likely cannot be made up in her lifetime, and subsequently place her at financial risk for the remainder of her life.

Mrs. D's trust in the safety and security of her funds in the hands of U bank resulted from her long-standing relationship with the bank and its employees, and led her to believe that she could rely on the same protections she had always known at her bank. However, in a networking arrangement, the protections are not there and not intended to be there. Had Mrs. D not sought help outside of U bank, most likely the permanent losses would have increased to erode the entire investment of $75,000. All this from a financial institution she trusted over 30 years. And, it all began with a referral.

Inability to Distinguish the Bank from the Investment Service

Most importantly, and the reason for the above details, is that the prestige of the bank in Mrs. D's eyes and Mrs. D's long relationship with it and its employees, played a primary and distinct role in persuading Mrs. D to invest substantial funds. This is the danger of the networking arrangement when the investment service is located on bank premises, and bank employees are involved in referrals. Mrs. D would have never walked into a Smith-Barney or Merrill Lynch Investment Service on her own, but she would walk into her bank. She was comfortable there and was with familiar people. Mrs. D neither differentiated the investment service from the bank nor the broker from a bank employee.

[10] The funds have an 8-year withdrawal penalty (starting at 8% for the first year and reducing to 0% by the 8th year). Currently, Mrs. D's penalties are between 4% and 5% of what is left of her remaining principal. Mrs. D has to wait until she is 86 years old to access her cash penalty free.

She did not understand that a bank employee, the AS, who she normally saw for all her banking needs, was referring her to an entity completely legally separate from the bank.

Mrs. D experienced an investment service located within a bank, carrying a similar name, a bank employee with whom she regularly did bank business urging her to invest, and a broker who was also a senior vice president of the bank. Thus, Mrs. D saw and reasonably made no distinction between the bank and the investment service, or the employees. Further, there was nothing to effectively encourage Mrs. D to make such a distinction. Yet, through the networking arrangement, U Bank was able to legally shield itself from responsibility for its investment service subsidiary and any improper employee actions, including predatory behavior.

Despite its awareness of our complaint, U Bank continues to blur the distinction between it and its investment services, and seeks to capitalize on its bank employees' ability to sway bank customers out of CDs into uninsured non-bank products. For example, U Bank has on its website under its investment services, the following information:

"For investment advice, U Bank Investments also has Financial Specialists located in U Bank branches. You've trusted them to help you with all your banking needs, now they are on hand to offer assistance with investing."

This is yet another example of how U Bank, and most likely other banks, purposefully encourage bank customers to connect the bank and its employees to the investment service and its operations, and to be comfortable with transferring money from safe insured bank products to those sold by the investment service that are risky and uninsured. Note also the use of the word "trust" associated with "banking needs" used in the site above.

It is unclear how U Bank's compensates its Financial Specialists for their dual roles and their advice, but most likely they receive incentives and fees for referrals and sales of investment service products. If bank employees, who are now also "Financial Specialists" at U Bank, receive fees and incentives for referrals to the investment service or for sales of investment service products resulting from a referral, does the SEC think a Financial Specialist will give advice to customers to buy CDs, which likely offer little or no monetary reward for the employee, or will the individual lead customers to buy products that offer greater rewards? The answer is that employees will do whatever they can to divert bank customers to products that provide the employees the greatest fees and rewards. These fees and other incentives greatly increase the likelihood of predatory behavior, and the potential that bank employees will divert unsuspecting bank customers to less suitable investments.

Customers Link Their Bank to the Bank's Investment Service

When an investment service is located on a bank's premises, has a name very similar to the bank or contains the bank's name (name recognition), encourages bank employees to recommend the investment service (and its products), and has an employee serving a dual role as broker and as a senior level officer of the bank, it creates an unquestionable impression that the investment service and broker are also part of the bank and its operations. These links create the strong sense and overall perception to a bank customer that he or she is dealing directly with the bank rather than a separate entity.

It is also not unusual for many people, like Mrs. D, to be in awe of the professional surroundings of a bank, and to put their faith and trust in what they experience. Everything Mrs. D experienced in the bank gave her the confidence that she was dealing directly with the bank, and that she was buying a bank product or a product that would behave just like a bank product (such as a CD).

Thus, when in June 1999, Mrs. D thought she was in the bank–she was. When she thought she was talking to an employee of the bank–she was. However, when she thought she had purchased a safe insured bank product–she had not.

Trust

A brokerage service in a bank has a tremendous advantage with customers over non-bank entities that sell the same non-bank products (mutual funds and annuities). This advantage is the general trust that people place in their bank. Banks hold their money, and there is general comfort that money is safe in a bank because it is "insured." It is not unusual for such trust in the bank to transfer to all aspects of a bank's other operations or operations that appear related to the bank. This is the very trust that U Bank seeks to capitalize.

One of the main reasons Mrs. D felt comfortable with U Bank's on-site investment service was because of her overall trust in U Bank for over thirty years. Her trust transferred to the bank's employees, as representatives of U Bank. When trust in a bank transfers to its personnel, their actions become trustworthy. So, when the AS and broker recommended that Mrs. D consider something other than a CD, and suggested Mrs. D could earn a higher rate of return than a CD through an investment in mutual funds, Mrs. D heeded the advice, and invested money that would have otherwise been invested in an insured CD. The AS and the broker, working together, successfully diverted Mrs. D out of a safe insured product into a high-risk investment within the walls of U Bank. Between the AS and the broker, they received over $3,000 in fees for doing so.

The AS's recommendations created an important link between U Bank, her employer, and U Bank's investment service for Mrs. D such that she extended her trust in U Bank and this friendly employee to the investment service. The broker's dual rule at U Bank as Senior Vice President of U Bank added to this link of trust.

Recommendations

When banks have networking arrangements and sell non-bank investment products (mutual funds) on bank premises, consumers like Mrs. D are unprotected from predatory bank employee actions and inappropriate or even negligent actions by investment service employees seeking fees and incentive rewards. It is very difficult to prove unsuitability unless there is fraud, and brokers escape responsibility to customers through a self-regulatory system that admits it suffers a lack of resources to handle individual complaints. The bank and its investment service along with the broker use self-serving disclosure forms that allow them to avoid responsibility for their actions. Arbitration clauses, finely printed in the contract, make it costly and difficult for the average investor to seek redress. It is further unclear whether any regulatory body has oversight of a networking arrangement as a whole.

The result for consumers is an incredible system that ignores accountability and responsibility. It is a system that allowed U Bank to create the impression that it and its <u>on-premises</u> investment service (with a similar name and involving the same employees) were one and the same, but at the same time allowed it to escape responsibility when something went wrong.

<u>First Step - Prohibit Referral Fees</u>

When networking arrangements include subsidiaries located on bank premises, carry a similar name to that of the bank, and employ dual employees, banks, brokers, and fund owners (like Putnam) <u>should not</u> pay any fees or provide other incentives to bank employees or dual employees for referrals.[11] Such fees and incentives increase the risk that bank employees will pressure and divert unsuspecting customers walking into the bank for other business into visiting the investment service where additional pressure is likely to occur to make a sale. Already numerous links exist to confuse customers about a bank and its relationship to its on-site investment services such that further involvement by bank employees only heightens that confusion as it did in Mrs. D's case.

For example, when most customers enter a bank, they first see a teller or an account representative. These bank employees are first in line to handle a customer's money, open a new account, and sell bank products like CDs. These employees are also privy to the customer's accounts and financial information. They are in an opportune position to know which customers to pressure, and they have the access to pressure. Since banks have had networking arrangements in place, it has become common for bank employees to suggest to a customer that he or she visit the bank's brokerage service or "investment advisor/broker".

What most bank customers do not know is that these referrals can be quite lucrative for bank employees. In the past, these employees could earn cash payments in the amount of $5 to $100, or more per referral, and also trips, bonuses, or other prizes in contests. All they have to do is get a bank customer to visit the broker–usually a purchase need not be made. There may be additional incentives for a bank employee when a customer makes a

[11] The broker in a networking arrangement situated on bank premises should orally disclose to the customer any fees or commissions earned for a sale once the amount of the customer's investment is known. All fees and commissions should also be clearly documented and prominently disclosed on the disclosure form. The amount of any incentives paid to promote certain funds should be included in the disclosure.

purchase. In Mrs. D's case, the AS may have been in a contest sponsored by Putnam Company to win a trip to Washington, DC.

In addition to the potential for predatory behavior, bank employee referrals create the distinct impression that there is some connection between the bank and its on-site investment service, because the employee who regularly handles a customer's banking needs is also demonstrating involvement with the investment service. Bank employee involvement with the investment service through referrals send an erroneous message to customers that they are dealing directly with the bank and thus, have the protections of the bank. This perception of a connection, which is intentionally perpetuated in many ways, allows an investment service located on bank premises to capitalize on customers' general trust in the bank.

Referral fees at the current rates appear to be sufficiently motivating referrals. Recent visits by Mrs. D to four different banks to renew CDs resulted in three banks' account representatives suggesting that she speak with the broker. Some were quite insistent, and I was glad that I was along. The one bank employee who did not refer us did not have an on-site broker. The consistency in the referrals Mrs. D experienced raises a red flag regarding the potential for bank employees, hoping to receive a referral fee or bonus, to pressure bank customers into discussing other financial options with a broker situated in the bank. Thus, the question to be answered is whether referral fees and the use of other incentives causes bank employees to pressure bank customers. If banks request an increase in the fees through this rulemaking above $15, it is an indication at how successful their bank employees are in diverting bank customers to the investment service, which apparently is more lucrative for banks than selling bank products.

It is inappropriate for the SEC to propose a rule that increases the likelihood of predatory actions. However, if the SEC permits the proposed referral fee payments to bank employees, and allows bonuses or other incentives as well, then people with elderly parents who like to visit their bank and the see the friendly faces there should be on high alert. When an elderly parent enters a bank to transact bank business (most likely to buy or roll-over a CD), a bank employee, usually low-paid and very much aware of the availability of referral fees or other incentives, will likely suggest, direct, or even pressure that elderly person to visit the investment service. Such referrals may seem harmless, but they can result in dire financial consequences as they did for Mrs. D. (See Appendix A).

Second Step–One Regulator For The Networking Arrangement and Its Transactions

Consumers are unprotected unless federal regulatory standards and enforcement dramatically improve, and at least one entity takes responsibility for oversight of banks' on-premises networking arrangements, whatever the corporate structure. Otherwise, banks should not have networking arrangements when the investment services are located on or near bank premises.

The current three-part regulatory scheme appears to allow each party to a transaction to evade responsibility. NASD, the broker self-regulator, stated that it lacks resources to investigate individual complaints.[12] NASD staff also said they have no authority to ask questions of Putnam company or the bank regarding employee actions.[13] The national bank's primary regulator, the Office of the Comptroller of the Currency, said it has no authority over the broker or the investment service even though all actions took place inside the bank. By analogy, the SEC most likely has no authority over the bank, and relies on NASD to regulate the brokers. So, no one entity examines the networking arrangement's transactions as a whole.[14] As is, the regulators functionally look to the other, and no one appears in charge of oversight.

If no one agency can or will regulate the bank, its employees making referrals, the broker in the on-premise investment service, the investment service, dual employees, and the provider of the product as a whole, then consumers have no protection when things go wrong. As is, it appears no regulatory body takes a comprehensive look at actions between the bank and the investment service, and thus, responsibility is passed around making regulations ineffective. When misconduct crosses over between the bank and its investment service, the functional separation of oversight of the regulators should not serve to divide regulatory authority or allow regulators to pass off responsibility to the other. Rather, it should insure that the system protects consumers.

Third Step –A Need for Stricter Standards

If the SEC, for example, takes ultimate responsibility for oversight of networking arrangements, it should establish stricter rules for banks when these arrangements involve an on-premises investment service subsidiary. In addition to prohibiting referral fees for bank employees and dual employees, the SEC should require stricter standards for disclosures (Appendix B) and customer financial information (Appendix C) collected by a broker located in a bank. It should enforce suitability standards (Appendix D)[15] and eliminate arbitration clauses (Appendix E). Until such changes occur, a networking arrangement on a bank's premises creates an atmosphere where the bank and its investment service are potential predators against the bank's own customers, many of whom are elderly.

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[12] The lack of resources NASD faces translates into two disconcerting realizations: There are no protections for the average consumer and NASD's suitability rules are meaningless. If NASD is without resources, then brokers have free reign. It was disconcerting that Mrs. D's complaint did not warrant a closer examination not only into the suitability of the investment as a whole for Mrs. D, but to consider that there were likely many other elderly investors of U Bank experiencing a similar problem. It is against common sense that Mrs. D was the only elderly person placed in such a transaction, or is the only one who suffered such losses with this broker.

[13] News has revealed how Putnam Company issued special incentives to brokers to sell certain funds. Mrs. D was in one of those funds, which was an extremely high-risk stock fund – the Voyager Fund. It seems odd that an elderly person stating a need for income would be in one of Putnam's most risky funds, and it seems odd that, after word of the incentives paid to brokers to put people in this fund that she was the only one in this situation. Yet, NASD relegated to me the job of finding others in Missouri similarly affected as Mrs. D.

[14] Although not a regulator, even Putnam Company, who should be concerned about reputation risk as the provider of the product being sold at U Bank, claimed it had nothing to do with the broker's actions even though Putnam executives regularly attend the bank's investment service seminars, and apparently offer contests for trips and other incentives to sell their funds.

[15] If suitability standards are only guidance, the SEC should establish rules.

Ultimately, the lack of oversight and enforcement is a disservice to those banks and investment services that are ethical, follow the rules, and have customers' best interests in mind. Unfortunately, misconduct by a few can discredit the whole investment service industry, and may eventually erode the trust banks themselves enjoy.

Conclusion

If this comment letter achieves nothing else, it should serve as public notice to regulators that the system is broken. It is also a warning to bank customers in general and to those with elderly parents that they need to protect their financial interests from unethical and predatory actions by those seeking monetary rewards associated with or directly employed by banks with investment services <u>on bank premises</u>. The essential first step to protect customers is to prohibit any referral fees, bonuses, or incentives when those making the referrals are bank employees or dual employees, and the investment service office is located <u>on bank premises</u>. In cases such as Mr. D's, a regular bank employee was essentially an investment specialist in disguise awaiting the unsuspecting customer. U Bank now blatantly advertises that the bank employees customers trust with their banking needs may also be investment specialists ready to give investment advice. This one statement shows how banks, such as U Bank, intentionally blur the line between them and their investment service, and this should stop. Without better oversight, prohibitions on referral fees, and changes in the process discussed in the Appendices, banks with networking arrangements and on-premises investment services, like U Bank, may continue to prey on consumers like Mrs. D. I urge the SEC to act so as to protect the elderly and other potential unsuspecting bank customers.

Appendix A

Networking Arrangements, Referrals, and Bank Employee Involvement

Mrs. D's experiences with the bank employee's referrals demonstrate the hazards for consumers when bank employees receive referral fees. The SEC is proposing to limit referral fees to $15, but yet it will provide exemptions for other arrangements for bonuses or other incentives. **Bank employees should not receive any form of compensation for referrals to an on site investment service or broker.**

On June 30, 1999, Mrs. D entered the bank to pay a utility bill. As she had done many times before, she typically went to say hello to the bank's account representative, an experienced "Account Specialist," and ask about interest rates. From Mrs. D's various bank visits, the Account Specialist knew Mrs. D needed income. She also had access to Mrs. D's accounts.

During many if not most of their visits, the bank Account Specialist may have been in an undisclosed dual role as a lower-level investment advisor for the on bank premises investment service. At the time, the Account Specialist appeared to be a bank employee. Although inappropriate for a bank employee, the Account Specialist strongly recommended and encouraged Mrs. D to invest in Putnam funds (sold at the bank's on-site investment service). The Account Specialist sought to convince Mrs. D that an investment in Putnam funds was a means to earn more income. She repeatedly suggested that Mrs. D visit the senior vice president of the bank who was also the broker of the investment service (part of a networking arrangement) located just down the hall. Up to this point, Mrs. D's financial dealings with the Account Specialist had always been with regard to insured funds–CDs and money market funds. Now, Mrs. D was hearing the Account Specialist recommend other products she could buy.

In her attempt to divert Mrs. D to the investment service, the Account Specialist often emphasized her own satisfaction with Putnam funds, which she said she and her sister owned as personal investments. The recommendations may have become somewhat aggressive as Mrs. D recalls the Account Specialist telling her she was "crazy" not to have Putnam funds. Mrs. D asked the Account Specialist if her sister received a monthly income from her investment in Putnam funds and the Account Representative said yes. Somehow in these discussions, Mrs. D became convinced that she could meet her income needs by investing in Putnam funds rather than investing in a CD.

Once Mrs. D decided to invest, the Account Specialist immediately contacted the broker, and informed her that Mrs. D wanted to invest $75,000 in Putnam funds. They wasted no time, and immediately set up a meeting down the hall.[16] Right before the meeting, the Account Specialist arranged for Mrs. D to withdraw $75,000 so that Mrs. D walked into the broker's office with a $75,000 cashier's check in hand. All this occurred within a

[16] This was the only occasion that Mrs. D ever saw the broker without having to make an appointment. Any other time Mrs. D was in U Bank and asked to see the broker, she was told she could not see her without an appointment.

matter of minutes. Both the Account Specialist and the Broker received compensation for the sale and the referral. The broker earned $3,000, and maybe more. There was also apparently a contest for a trip to Washington, D.C. sponsored by Putnam Company.

The concern I have for the average elderly bank customer is how easily Mrs. D was diverted from purchasing a CD, and that a major factor in Mrs. D's decision to invest in a product other than a CD occurred because of her confusion over the involvement of the bank in its investment service, a bank employee's strong recommendations that possibly put her under pressure to invest, and her overall trust in her bank.

Appendix B

Inadequate Disclosures

See previous comments on inadequate disclosures in the SEC's NPR File NO. S7-06-04. Those comments are also relevant to networking arrangements in banks, and the letter is currently available on the SEC's website under "proposals" and Christine A Smith.

As is typical, Mrs. D signed a disclosure form. This form relieved U Bank, the broker, and U Bank investment services from any responsibility for the networking arrangement, the manner in which they made the investment, and generally for every aspect of the investment's suitability.

At the same time, banks and their investment services capitalize on trust to attract customers and win their confidence, they use the disclosure form to effectively and legally dissolve every link, tie, or connection that may cause them to take responsibility for their actions. U Bank, the broker, and U Bank investment services contend that Mrs. D's signature on the form indicates she fully understood the risks of the investment (even though she did not), and that her signature automatically makes the investment suitable (even though it was not).

U Bank, the investment service, and the broker used the disclosure form as a legal means of deception to be freely exercised on Mrs. D. Its purpose is to prove that a consumer, like Mrs. D, was fully apprised of every aspect, no matter how dubious, of her non-bank product purchase. Despite the disclosure form's statements, it did not undo Mrs. D's perception (intentionally created by U Bank) that U Bank and its on-site investment service were one in the same.

Although frequently used in business settings, most reasonable people know that disclosure forms are not designed to protect consumers. Anyone who has signed mortgage papers or ever purchased a CD knows how quickly forms are signed without reading them. They are completely ineffective in terms of guaranteeing that those signing them have read them or fully understand the rights they may be signing away, which have particular importance when the lost rights involve non-bank investment product purchases. Rather, companies use disclosure forms to protect themselves.

Visual and personal contacts during a transaction such as Mrs. D's further limit the value and impact of disclosures forms. Yet for the investing public with so much at stake, such disclosure forms generally undo any and all consumer protections. In a networking arrangement, a disclosure form helps protect a bank from its involvement in selling mutual funds. This kind of protection allows banks to further capitalize on bank trust, and extend it to their investment services, even though the transfer of such trust increases the likelihood that many customers who purchase products from the investment service will believe they are purchasing safe insured bank products, when that is never the case with an investment service product.

Thus, a disclosure form at its worst protects those most apt to engage in wrongdoing. The regular use of a disclosure form is the best evidence that banks and their investment services <u>on premises</u> know they confuse customers.

It is also remarkable that a disclosure form can simply wipe away all of the bank's connections to a networking arrangement and responsibilities for improper actions including placing elderly people in unsuitable investments. Having a person like Mrs. D sign a disclosure form does not, in any way, suddenly make her investment suitable. When people's financial interests are at stake, particularly the elderly, it really is time to stop banks with networking arrangements from using a disclosure form as significant proof that a customer understands the risks, or if investments are unsuitable that the investor assumes the risk.

Stricter Requirements Needed for Disclosures

Disclosures must have stricter requirements so that the broker must make oral disclosures along with clearer written ones. In particular regulators should require that brokers located on bank premises take the following actions:

- Make disclosures clearer and use plain English. Rather than using vague terms such as, "these funds may lose value," the words used on U Bank's Investment Service disclosure form, require words, both oral and written that people understand, such as "**you may LOSE MONEY with this investment**." In fact, brokers should advise investors that they could **LOSE ALL** their money. The words <u>lose money</u> would have meant something to Mrs. D.

- Make clearer obvious oral and written disclosures about the bank's involvement (or lack thereof) in its on-premises investment service and its products.

- Disclose in dollar amount, both orally and written, the compensation received for any specific transaction, and point out any additional compensation for sales of certain funds. As in my mother's case, it would have made a difference to her had she heard the following: "**I (investment advisor/broker) have earned $3,000 for selling these mutual funds to you, and I will also receive an additional bonus for placing you in the Voyager Fund.**" It would be safer for consumers if the SEC prohibited companies like Putnam from paying brokers in banks extra incentives to sell certain funds. These incentives increase the risk that brokers will select funds without regard to suitability.

In addition, regulators should require the broker to provide written documentation verifying that he or she made specific oral statements prior to the customer's purchase. These oral statements, in a similar format, should include:

- I (customer's name) understand that the products (by name) I am purchasing are **NOT INSURED**. I understand that CDs and money market accounts are insured and that the investments I am purchasing are <u>not insured</u>. (Customer initials)

- I (customer's name) understand that the products (by name) I am purchasing are not a CD, or similar to a CD, and will/will not (circle one) pay me interest income. (Customer initials)

- I (customer's name) understand that the products (by name) I am purchasing may cause me to **LOSE MONEY**. (Customer initials)

- My primary/only (circle one) goal with this investment is ________________(customer writes in the goal).

- I understand that the **Bank (name)** has no responsibility should I **LOSE MONEY**. (Customer initials).

- I fully understand the **RISK** of my investment in (name the funds) such that I can list and explain the risks. The following risks are: _____________________ (have the investor write down the risks he or she understands might occur).

- I understand that this investment may **complicate my taxes.** (Customer Initials)

- The form should require a witness signature from someone outside of the bank– preferably a family member.

Shock Test

Prior to purchase, the SEC should require brokers <u>on bank premises</u> to produce, for customers, a type of **<u>market movement shock test</u>** (similar to interest rate shock tests performed by banks for assets and liabilities). This document would help brokers explain the risks and would allow customers to see how 100-point movements in the stock market, up and down, could affect their investments.

Suitability Statement

The SEC should also require the broker <u>on bank premises</u> to provide a "**suitability statement**" for the customer. In this statement, the broker should demonstrate in <u>writing</u> and orally discuss how a particular investment is appropriate for the customer in terms of the customer's financial status, income, and long-term financial wellbeing. The customer should have to sign the statement that includes the suitability statement, and that it was discussed.

Continued Tracking

For cash flow arrangements, or any kind of arrangement that could cause permanent losses, such as Mrs. D's, the broker should not only be required to perform a market movement shock test and provide a suitability statement at the date of investment, but also be required to track market movement and the effect on such cash flow arrangements. A certain level of losses (percentage of invested assets per customer) should trigger required action by the broker to contact the customer to discuss other options, and whether it is in the customer's best interest to continue the investment. If the broker is on bank premises, then there should be a record that the bank was notified of the losses, and of any subsequent action taken. Because most investment service customers are likely also bank customers, the bank should have responsibility for follow-up on losses.

Appendix C

Inadequate Customer Financial Information

The customer financial information collected by the broker at U Bank was inadequate to allow any reasonable determination of suitability, because the information on the form was too general, and the broker failed to verify information. The broker gathered information quickly from Mrs. D, in a matter of minutes–such that Mrs. D had to report her total assets, income, and tax status from memory. Most importantly, many aspects of a Mrs. D's financial status that were important to provide her a proper suitability determination for an investment were not part of the financial information form, and therefore were not considered. Whatever kind of suitability analysis the broker made for Mrs. D, it was incomplete and made without confirming information.

Assets That Should Not Be Included As Total Assets

Brokers should document that customers are not including the value of their homes or cash held to buy a home when they list their total assets.[17] They should also document other considerations, such as whether there are reserves for nursing home costs that should not be put at risk.

Determine the Make-up of Total Assets

In Mrs. D's case, her total assets already included many stocks, most of which were inherited. With the additional Putnam investment in stock-based mutual funds, nearly half of her life savings were now in high-risk investments. The broker failed to consider this type of information, which was highly relevant to properly determining the suitability of the particular funds selected for Mrs. D.

Verification of Income and Tax Status

Regulators should require a broker to verify a customer's financial status and income just as banks do when making a loan. Brokers can easily verify income with a tax return[18]– preferably using two previous years' returns. The broker asked Mrs. D to circle her "tax status" on the form. Since few people know or understand what "tax status" is, the answer has a high probability of being incorrect.

Rather than completing the transaction in a few minutes, a responsible broker would have asked Mrs. D to return to the bank with her last two years tax returns.[19] A tax return in

[17] Mrs. D's total reported assets should not have included substantial money set aside to buy a home.
[18] Some people may be embarrassed to report their income when it is very low, and may inflate it to the broker, not understanding the impact that may have on the suitability of the investment.
[19] Using a tax return, the broker would have discovered that Mrs. D's income was not $25,000, but rather $17,000 a year, and that some of this income was from a part-time job. At age 78, it was doubtful Mrs. D would continue working much longer. Since this was an 8-year investment per se, Mrs. D's income would likely decline in that time when she stopped working. So, it would have been more reasonable to project

hand is the most accurate indicator of income and tax status. Brokers on bank premises can also verify financial status through credit reports, bank statements, and other investment documents just as a bank does when qualifying a bank customer for a loan.

Mrs. D’s income over the next 8 years to be closer to $13K to $15K. Income levels affect suitability determinations.

Appendix D

False Security in NASD's Suitability Standards

NASD's standards for suitability appear clear, straightforward, and sensible, and give the impression that they protect consumers. However, most instances that appear to incite NASD to act in favor of a consumer were those that involved only the most extreme and egregious illustrations of fraud. Thus, transactions that are unsuitable without fraud, even though they fail to meet NASD's suitability criteria, will likely not receive attention. Thus, failing to meet suitability criteria alone is not enough for NASD to force a broker to unwind a transaction and make a consumer whole. If a transaction must involve fraud to be unsuitable, then the current suitability criteria are unclear and misleading, and consumers are unprotected.

NASD also has the discretion not to pursue a case whenever questions of fact occur. Thus, all a broker has to do is tell a different story. [20] NASD said if Mrs. D could produce other people who were having the same problem with the broker, then NASD would consider re-opening the case. Thus, for Mrs. D's claim to undo the story told by the broker, Mrs. D had to produce numerous other people. Only then could she add credibility to her case and raise its level of importance. So essentially, it takes many consumers' voices and only one broker's word. If this is how NASD determines whether it acts, then filing a complaint alone seems rather pointless.

[20] The broker's response to NASD generally stated that the Putnam funds chosen for Mrs. D were "established" Putnam funds. The letter contained no analysis to indicate that the broker understood the serious impact a cash flow arrangement would have on an investment in a declining market. The broker merely stated Mrs. D understood the impact. The selling point was convincing an elderly bank customer that she could earn "income" from an investment in the networking arrangement just like from a CD, but only more. It was a strong selling point, and the bank's employee, the Account Specialist, played an important role in convincing Mrs. D that she was better off having Putnam mutual funds than an insured CD. NASD failed to require a detailed analysis of how Mrs. D's financial status warranted an overall risky investment, and did not question the suitability of an 8-year withdrawal penalty for a 78-year-old investor. NASD also did not require the broker to answer whether Putnam paid her any incentives to sell the Voyager fund, a particularly risky fund. NASD never questioned why the broker failed to follow-up on her own initiative with a customer placed in a risky cash flow arrangement when the market went into decline even though the broker should have known a decline would have a deleterious effect. Rather, NASD accepted the broker's story that Mrs. D never complained. Mrs. D did not realize she had a situation that required immediate attention, because she **DID NOT UNDERSTAND** her investment. When she raised questions rather than directly complaining, the broker's assistants as well as the Account Specialist effectively diverted her from seeing the broker with words of encouragement that the market would turn around. Mrs. D trusted their advice, as she trusted her bank. With my calls, the broker became aware there was a problem with (and a complaint about) Mrs. D's investments, but even with that knowledge, the broker never personally followed-up with Mrs. D. Thus, once Mrs. D handed over her money, she had to make a formal appointment to see the broker, or sign a power of attorney to allow someone else to speak for her. During all this, time was of the essence, and losses mounted. Because the broker escaped responsibility, NASD essentially made the situation the investor's problem.

Appendix E

Arbitration Clauses as Further Victimization

There is a currently accepted practice that allows investment services to embed a clause in their sales contracts that causes consumers to waive their right to go to court should a problem arise. This practice is anti-consumer, and adds to a consumer's difficulty in rectifying problems with a broker backed by large corporations.

Arbitration is expensive for consumers who have already lost money. A consumer will need to hire a lawyer to argue the case before the arbitrator or arbitration board. Estimated costs to go to arbitration range from $1000 to over $10,000, or more for the average case. By comparison, such costs are negligible to a billion-dollar bank or mutual fund company.

Recent news articles have raised the issue of fairness when consumers unknowingly waive their rights to go to court in the fine print of an investment service's sales contract. Other articles have discussed the disadvantages to consumers when relegated to arbitration as the only recourse, and some suggest that is very rare for consumers to succeed. In the few instances where there may be success, consumers may never receive the awarded compensation. Consumers should not suffer a loss of rights in the fine print of a contract that strengthens the hand of big corporations when there is misconduct or unsuitable actions that take away life savings.