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

Re: S7-06-04 Broker Disclosures and Forms

Dear Mr. Katz:

Thank you for the opportunity to comment on the SEC's proposed disclosure forms and broker (financial consultant) communications to consumers about arrangements that may offer heightened financial incentives for the sale of a particular fund over another. My comments focus on two aspects of mutual fund sales:

- Arrangements that offer heightened financial incentives to brokers for the sale of a non-proprietary mutual fund under promotion by an unaffiliated fund company. For example, recent news articles have discussed Putnam Company's offers of additional financial incentives to brokers for sales of the Voyager Fund.

- Mutual fund sales on bank premises under a networking arrangement with an investment service.

Although the proposed rule appears to address distribution arrangements for both proprietary and non-proprietary mutual fund sales, the forms do not appear to separately address situations where a broker receives special incentives for the sale of a particular non-proprietary mutual fund over another. If the forms include such arrangements, the inclusion is not clear. Section D of the proposed forms and related definitions are clear that disclosures are required regarding proprietary funds promoted by affiliated parties. Likewise, there should also be a separate section for disclosing arrangements that offer heightened financial incentives to brokers for non-proprietary funds (like the Voyager Fund) offered by non-affiliated parties (like Putnam). Without question, consumers should know before they invest if their broker is receiving a higher commission for selling them one fund over another under any type of arrangement.

While the proposed disclosure forms provide information not previously available for average consumers, the best protection would be to prohibit fund promoters (like Putnam) from paying brokers extra financial incentives to sell a particular fund over another. As described in the news articles, these incentives affect broker recommendations, raise serious questions about conflicts of interest, and may dramatically increase the risk that some brokers will sell these funds without regard to suitability.

My comments are based on an elderly person's (Mrs. D's) experience with a broker (Financial Consultant) selling mutual funds in an investment service in a Missouri national bank (U Bank). The Financial Consultant sold Mrs. D a high-risk mutual fund (Voyager Fund) that may have provided the Financial Consultant with extra financial incentives for its sale. These financial incentives may have caused the Financial Consultant to improperly limit the range of mutual fund choices presented to Mrs. D, and thus, ignore important suitability standards in order to receive the extra compensation. Mrs. D may be just one of hundreds of elderly bank customers who were sold this particular fund under a special incentive arrangement.

It is questionable whether the SEC's proposed forms would have alerted Mrs. D to the existence of a conflict of interest, and whether she would have associated it with the unsuitability of her investment. Mrs. D is not a sophisticated investor, and implicitly trusted her bank that housed the Financial Consultant and the investment service. Banks with investment services on their premises pose unique problems for consumers, who are typically bank customers, and often elderly. The SEC should address, in another rulemaking, disclosure forms used by investment services located in banks.

Oral Disclosures

It is imperative that the SEC requires brokers to make oral disclosures about general compensation arrangements, and any other arrangements that offer heightened financial incentives to sell a particular fund or class of funds. Brokers should clearly and separately disclose, orally and in writing, the payments, and reveal the arrangement. For certain consumers and in certain circumstances, it may take such oral disclosures to generate the desired understanding the SEC seeks.

For example, Mrs. D signed a disclosure form when she made her investment in mutual funds at U Bank. Since then, the bank and the Financial Consultant have used the form and Mrs. D's signature as proof that Mrs. D fully understood the risks of her investment, which could not be farther from the truth or reality. Merely handing a customer, particularly an elderly customer such as Mrs. D, a disclosure form, full of numbers and "legalese," without oral disclosures, is meaningless. It takes more than a jumbled form full of occupational jargon and legal terms to protect average consumers. If the Financial Consultant had orally disclosed her $3,000 compensation and any additional financial incentives she may have received for selling Mrs. D the Voyager Fund, perhaps such revelations would have raised a red flag for Mrs. D, and at a minimum, caused her to question the transaction.

Suitability Enforcement

The SEC must also ensure that it and the National Association of Securities Dealers (NASD), the self-regulator of brokers and an arm of the SEC, enforce suitability standards more rigorously. Congress should ensure that both entities have the necessary resources to enforce these standards for individual cases when conflicts of interest arise, and resulting investments are unsuitable. There should be no requirement for fraud in a suitability case, or a requirement that multiple complaints against a broker be filed before the SEC or NASD takes an interest. Until all brokers, large and small, take the threat of enforcement seriously, disclosure forms will serve mainly to protect unscrupulous and unethical brokers who sell funds without regard to suitability in order to receive additional financial incentives. Above all, a broker should be held to meet suitability standards regardless of a disclosure form.

Disclosures of Arrangements for Non-proprietary Mutual Fund Sales

As presented, the forms appear to focus on incentives to sell proprietary funds by affiliated parties (see Part D of the proposed forms). This is only half the problem – sales of non-proprietary funds that offer heightened financial incentives by unaffiliated parties pose a similar, and just as serious, conflict of interest problem. However, I find nothing in the forms that address such sales that would alert an average consumer. The form does not appear to directly separate out and flag this type of arrangement.

Accordingly, the proposed forms, in either Parts A or C should include a separate obvious statement regarding the amount of special incentives. The SEC should require brokers to disclose these arrangements and the amount of the incentive separately from "Commissions" in Part A and from "Sales fees" in Part C. Or, the SEC should add a line under Part D for arrangements offering heightened financial incentives for the sale of non-proprietary funds promoted by unaffiliated parties. The SEC's emphasis should be on producing a form with language that clearly states whether or not a broker is receiving special incentives for selling a particular fund. The form should specifically name the fund provider or promoter, and name the fund with the special incentive, along with providing the amount of the incentive. As presented, it is doubtful these forms would have made it clear to Mrs. D that the Financial Consultant was receiving any special incentives out of the ordinary.

Therefore, I recommend the following clearer statement, or one with a similar effect:

"The Promoter (name of promoter) of the fund (name of fund) you have purchased has offered your broker (name of broker) additional financial incentives (commissions) for selling this particular fund. Broker (name) will receive $1,000 (amount) additional commissions for this sale, in addition to a regular commission of $3,000 (amount).

The broker must explain to you why this fund is suitable for you, and why there is no conflict of interest because of the special promotion of this fund. The broker should

not select a fund for you without regard to its suitability for your particular financial circumstances, or improperly limit the range of mutual fund choices presented to you.

If the fund choice is suitable, then the broker can explain and document why the sale of a particular fund that provides heightened financial incentives is suitable, and why it does not create a conflict of interest. If the broker fails to do so adequately, then most likely the fund is unsuitable, and is one that an investor should be able to unwind, without having to seek arbitration. Seeing, as well as orally discussing, a statement such as the one above with the broker may help a consumer, before finalizing the investment, question instances where a conflict of interest may be underlying the transaction. Unless such incentives are separately revealed from regular sales fees and commissions, consumers will be no wiser.

Did you conduct a study to test these forms with average consumers? If not, I strongly suggest that you do a trial study. Mrs. D would be willing to assist you as part of the study.

<u>Disclosures of Sales Loads</u>

Form 2, Part B provides information regarding back-end sales loads. The Financial Consultant placed Mrs. D in an investment with an 8-year back-end sales load. Mrs. D was 78 at the time. Thus, until Mrs. D is 86, she cannot access her funds without paying additional penalties against her principal (8% the first year to 0% in the 8th year). The investment service's disclosure form contained the following statement regarding this 8-year back-end sales load penalty:

"*Involves either an up-front sales charge, or a contingent deferred sales charge. All fees are fully described in the prospectus.*"

The above disclosure was meaningless to Mrs. D, and so was the fine print of the prospectus. The proposed forms improve on the above disclosure by any measure. The proposed forms specifically spell out what the above statement tries to conceal – that is, that there are long-term financial consequences for an investor if he or she needs to withdraw the investment before a certain time period.

One of the problems with the proposed form, however, is that the investor needs to understand what makes up the "investment" amount. In Mrs. D's case, she generally understood there was a penalty for withdrawal, but because she was in a bank, and confused about the exact nature of her investment, she associated this penalty with withdrawal fees on CD's – where the penalty is against interest, not principal. For mutual fund sales on bank premises that contain these back-end sales load penalties, the disclosure form should clearly state that the penalties are against principal, not interest. The form should include an example showing the penalty imposed on an estimated principal amount, such as the investor's initial investment. In Mrs. D's case, the form would use her initial investment, $75,000, and multiply it by the 8% penalty for the first year ($75,000 initial investment x 8% = $6,000 penalty for withdrawal). Clarifying the investment amount may have helped Mrs. D make a very important distinction between a CD penalty against interest and the new investment's penalties imposed against her principal should she need to withdraw her money suddenly for such things as health or nursing home care.

Additional Concerns

The proposed forms are generally well designed, but nonetheless, they are complicated for average consumers. The forms, for example, require an additional page just to define the terms used on the first page of the form. While, I recognize there may not be any other alternative, the SEC should recognize this is a complicating factor, and may affect some consumers' ability to understand the forms. In addition, some important terms are not defined – such as the "Sales fee." What makes up a sales fee, and how does it compare to "commissions" under Part A? In addition, some people like Mrs. D may have difficulty with complex terms such as "front-end load," "back-end load," "affiliated," "proprietary," and "revenue-sharing."

Overall, the forms, while welcomed, appear most appropriate for customers very familiar with investing, or those who are more sophisticated investors than Mrs. D. In substance, without more, such as oral disclosures about the information on the form and the addition of a separate disclosure about heightened incentives for sales of particular funds, these forms may not make much difference for average consumers who need the most protection. Moreover, the SEC should not allow brokers or financial consultants to use a disclosure form as prima facie evidence that, once signed, a consumer fully understood the risks of the investment when conflicts of interest exist, or unsuitable sales occur. A signature on a disclosure form does not make a conflict of interest disappear, or make an unsuitable sale suddenly suitable.

Other General Disclosure Concerns – Banks and Networking Arrangements

As mentioned, the disclosures used in Mrs. D's situation were inadequate given an investment service's unique circumstances with bank customers when it is located in a bank, and has a name very similar to that of the bank. Bank customers are a readily available source of potential investors for an investment service located in a bank. Bank customers trust their banks, and may not readily discern any difference between the bank they trust and its on-site investment service. Accordingly, they may not understand the difference between a safe bank product sold in the bank's lobby from a risky product sold around the corner.

Requiring financial consultants in banks to disclose compensation and other incentives is just one small part of the overall problem with disclosures. In effect, the disclosure form that Mrs. D signed has served more of a purpose to protect U Bank and its Financial Consultant, rather than ensure that they disclosed important information in such a way that Mrs. D was not confused about the nature of her investment.

However, despite the disclosure form, Mrs. D still thought she was in a bank (she was); she thought she was talking to a bank employee (she was – a bank employee referred her to the Financial Consultant and the Financial Consultant was an executive of U Bank – that is, a dual employee); therefore, not surprisingly, Mrs. D thought she was buying a bank product, or a product that was just as safe as a bank product (she was not).

Plain English

Some simple changes, such as using plain English on forms, may provide average consumers or bank customers like Mrs. D needed additional information. As an example, the disclosure form that Mrs. D signed used the following language:

"Investments are subject to investment risks, including the loss of principal."

A statement in plain English that is clearer and more understandable for the average person is:

"This investment may cause you to **LOSE MONEY.**"

Had Mrs. D fully understood that her investment could lose money, she may have realized she was not purchasing a CD, or an investment like a CD, despite what she was being told. In addition, a straightforward message that there is a risk of **LOSING MONEY** would likely have gotten her attention, and caused her to rethink the investment. It would have been particularly helpful to Mrs. D had the Financial Consultant orally stated (and even discussed) that the mutual funds Mrs. D bought were not a CD or anything like a CD, even though the account was set up to pay Mrs. D a monthly "income" just like a CD.

Market Movement Shock Disclosures

In addition to the proposed compensation disclosures, the SEC should consider in future rulemakings requiring brokers to produce, for customers, a type of **market movement shock test** disclosure (similar to interest rate shock tests performed by banks for assets and liabilities). Such a document would help brokers explain the risks of the investment, and allow customers to see how 50-or 100-point movements in the stock market, up and down, could approximately affect their investments. The market movement shock test, along with the following statement

"*This shock test shows you what happens to your investment when the stock market goes up and when it goes down*"

better serves the average consumer than the following disclosure that was presented to Mrs. D:

"*A mutual fund invests the money it receives in various securities depending on its objective. The rate of return and market value of the fund shares will fluctuate with changes in general market conditions.*"

Most importantly, the market movement shock test may encourage brokers to do a better job analyzing suitability, and encourage them to consider not only the upside potential of an investment, but also the downside, and whether any particular customer can absorb the potential losses. Thus, a market movement shock test may help certain financial consultants or brokers who are not experts to better understand how investments affect the financial health of their customers.

Suitability Statements

Because of the potential for confusion for bank customers when sales of mutual funds occur on bank premises, the SEC should require financial consultants and brokers operating on bank premises with access to this readily available source of consumers to provide a "**suitability statement**" to the customer. In this statement, the financial consultant should demonstrate, in writing, as well as orally discuss with the investor, how a particular investment is suitable in terms of the investor's financial status, income, and long-term financial wellbeing or goals.

As an alternative, for investments that may be potentially unsuitable, the SEC should require a disclosure form in which the customer specifically notes in writing his or her understanding that a particular investment or arrangement is unsuitable, and describe the risks with regard to his or her particular financial circumstances. In other words, the investor should describe in his or her own words why an unsuitable investment may be appropriate, and why he or she is financially able to absorb downside risks of the investment.

Because of the unique circumstances that exist when banks have networking arrangements with investment services, the SEC should consider developing a specific set of disclosures and requirements that address the potential confusion caused for average bank customers when dealing with their bank's on-site investment service. Suitability statements, in particular, take on added importance when investments are sold on bank premises, given the confusion for bank customers over bank and non-bank products. In addition, the source of customers – those walking in the bank to do bank business – are likely not sophisticated investors for the most part.

Conclusion

While the SEC is on the right track with these proposed forms, the best practice is for the SEC to prohibit brokers and financial consultants from accepting any extra financial incentives to sell particular non-proprietary funds over other funds. Alternatively, the SEC should establish a separate disclosure in the proposed forms to alert consumers to such arrangements. In addition, the SEC and NASD must begin to more effectively and consistently address suitability issues for individual investors, rather than limit investigations to those where there is fraud or where multiple investors have filed a complaint. Arrangements offering heightened incentives for sales of a particular fund over another can detrimentally affect average consumers' financial health and, in some instances, the ability to live independently when such arrangements cause brokers and financial consultants, large and small, to ignore suitability criteria. Because of this investment, Mrs. D had total losses of over $40,000 plus she lost the ability to earn income on the entire investment of $75,000. Most likely, any special incentive for this investment was small by comparison to Mrs. D's losses. How important are these incentives when compared to the potential consequences?

Sincerely,

Christine A. Smith

Attachment of the Bank's disclosure form included with mailed response.