



Securities Industry Association

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October 17, 2003

VIA Electronic and First Class Mail

Ms. Barbara Z. Sweeney
NASD
Office of the Corporate Secretary
1735 K Street N.W.
Washington, D.C. 2006-1500

Re: Rule Proposal Regarding Compensation for the Sale of
Investment Company Securities (NASD NTM # 03-54)

Dear Ms. Sweeney:

The Investment Company Committee of the Securities Industry Association¹ (“SIA”) appreciates the opportunity to comment on the above-referenced rule proposal (the “Proposal”), which would amend Conduct Rule 2830 to require NASD members to disclose “revenue sharing” and “differential cash compensation” arrangements relating to the sale of investment company securities. The Proposal would require that a member disclose these compensation arrangements in writing when a customer first opens an account or purchases fund shares. The Proposal would also require a member to update this information twice a year and make updates available to each customer.

As a threshold matter, we wish to state clearly that we support enhanced disclosure with regard to these compensation arrangements and look forward to working with NASD to help ensure that its initiative is implemented in the most practical and effective manner.

I. Background

¹ The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 700,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2002, the industry generated \$222 billion in domestic revenue and \$356 billion in global revenues. (More information about SIA is available on its home page: www.sia.com)

The Proposal is one of the more recent in a series of regulatory and legislative initiatives directed at enhancing the transparency of information relating to how mutual funds are offered and sold to investors. Other such initiatives or pronouncements include the legislation introduced by Congressman Richard Baker (R-LA)², the Oxley-Baker letter to SEC Chairman Donaldson³, and recent testimony by SEC Chairman Donaldson before the Senate Committee on Banking, Housing and Urban Affairs, in which Chairman Donaldson stated that:

...I envision that a revised confirmation would include information about revenue sharing arrangements, incentives for selling in-house funds and other inducements for brokers to sell fund shares that may not be immediately transparent to fund investors...⁴

The Baker legislation focuses on additional customer statement disclosure or other non-prospectus disclosure, while Chairman Donaldson's testimony appears to call for some form of enhanced confirmation disclosure. The Proposal on the other hand appears to require additional disclosure to be delivered in some manner other than by means of the confirmation, the customer statement, or the prospectus.

Meanwhile, as a by-product of the recommendation of the NASD Mutual Fund Breakpoint Task Force, in which SIA has been an active participant, task force working groups are currently developing confirmation modifications and a new disclosure document prototype to enhance disclosure of breakpoint information to customers. Each of these different initiatives has the potential of enhancing the transmission of relevant information to mutual fund investors. However, when considered together, there appears to be a substantial risk of disclosure fragmentation and associated investor confusion, particularly if these initiatives proceed without coordination and consistency of treatment.

II. Discussion

A. Revenue Sharing: Shelf Space vs. Expense Reimbursement

For purposes of this comment letter, we exclude from the definition of "revenue sharing" arrangements payments made through 12b-1 plans or otherwise from fund

² See HR 2420 mark-up dated July 24, 2003. Proposals regarding revenue sharing and differential compensation appear in Section 12 of the bill.

³ Letter to SEC Chairman Donaldson from Representative Michael Oxley (R-OH), Chairman, House Financial Services Committee and Representative Richard Baker (R-LA), Chairman Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (July 30, 2003).

⁴ Testimony of William H. Donaldson, Chairman U.S. Securities and Exchange Commission before the Senate Committee on Banking, Housing and Urban Affairs (September 30, 2003); pp. 5 and 6.

assets. We believe this approach is consistent with the intent of NASD.⁵ Additionally, we take note of the fact that the Proposal would expand the definition of cash compensation to include payments received from third parties relating to services provided to an investment company, regardless of whether such payments relate to the provision of “shelf space” or expense reimbursement.

We appreciate that NASD recognizes that as described in the proposal, revenue sharing arrangements may encompass more than the provision of shelf space. In many cases, these payments help reimburse broker-dealers for the expenses associated with processing fund transactions and maintaining customer accounts, including, among other things:

- Customer Sub-accounting
- Mailing confirms, prospectuses and other disclosure documents.
- Maintaining information websites.
- Reviews of prospectuses, SAIs and other marketing materials.
- Implementing changes initiated by funds, including revising systems and procedures and communicating changes to registered representatives and customers.
- Overseeing and coordinating fund wholesaler activities at the firm.

In the absence of such third party payments, many of these administrative and other broker-dealer expenses incurred in processing mutual fund transactions and servicing mutual fund accounts inevitably would be borne by fund shareholders through higher fund operating expenses.

Additionally, as a general matter, we do not believe this type of expense reimbursement presents the same type of potential conflict that a payment for “shelf space” or inclusion on a preferred list does. The use of revenue sharing arrangements to fund broker-dealer reimbursements has aided the development of mutual fund supermarkets and benefited fund investors who appreciate the convenience and broad access to different mutual fund offerings that these supermarkets provide. Moreover, across the industry (both within and outside fund supermarkets) it is common for revenue sharing payments to be calculated based upon the full range of services provided, rather than a summation of the costs associated with specific services. As a practical matter, one cannot with any degree of confidence always attribute a specific percentage of a revenue sharing payment to the offering of shelf space or inclusion on a preferred list, as opposed to other services.

The rank ordering aspect of the Proposal would also engender inappropriate comparisons across fund groups of different sizes. For example, a fund group with a significant number of accounts and/or assets on the books of a broker-dealer firm is likely

⁵ Such payments are, of course, subject to prospectus disclosure, and thus do not raise the same transparency issues.

to be ranked toward the top of the list, simply because the ordering is based on total payments received. Other fund groups might offer relatively higher revenue sharing payments, based on accounts and/or assets, but the greater potential conflict associated with such higher payments would not be apparent to the investor. However, changing the basis of the rank ordering to some sort of rate-based comparison would not be feasible or appropriate either, because of the significant variation in the manner in which these payments are determined across the industry, and the “mixed purpose” character of the payments.

Thus, any rule that required the disclosure of revenue sharing payments based on a quantitative analysis (including the Proposal’s requirement to list firms by descending order based upon the total amount of compensation received from each firm) would unavoidably distort investor perceptions of potential conflicts of interest.

B. Importance of Consistent Disclosure Approach

We cannot stress too strongly the importance of maintaining a uniform approach with respect to revenue sharing and differential compensation disclosure mechanisms among the various legislative and regulatory entities contemplating new requirements in this area. Given the fact that all of these proposals are in their initial stages, these entities have a unique opportunity to work cooperatively, rather than competitively, to achieve a consistent disclosure approach. To do otherwise would so fragment the disclosure process as to significantly increase disclosure costs, while decreasing, rather than enhancing, investors’ understanding of all the critical information needed to make informed investment decisions.

The concept of regulatory consistency should apply to both the content of disclosure as well as the method of delivery. The concept should not only apply across regulatory entities, but also within them. For example, as previously noted, the NASD Mutual Fund Breakpoint Task Force is presently considering recommending confirmation and other disclosure mechanisms to enhance investor understanding of breakpoint opportunities. It would appear that utilizing some or all of the same disclosure mechanisms for disclosure of mutual fund compensation arrangements would be an effective and efficient approach, as opposed to creating separate documents for different aspects of mutual fund disclosure, or at least broker-dealers should be given reasonable latitude to choose the disclosure mechanisms they believe will be the most effective given the particular characteristics of their business.

Under the Proposal, revenue sharing arrangements and differential compensation disclosure would be treated in a similar manner. As we have pointed out, revenue sharing arrangements are utilized for a multiplicity of purposes, many of which do not pose the types of potential conflicts, particularly the point of sale conflicts, at which the proposal is directed. More fundamentally, in those situations where such arrangements are likely to generate potential conflicts, it is also likely that the arrangement will involve

differential compensation and be subject to those disclosure requirements or else restrict the scope of funds that registered representatives may recommend. We believe that these distinctions should be taken into account when considering the content of amendments to Conduct Rule 2830.

III. Recommendations

In light of the foregoing, we present the following recommendations for your consideration. These recommendations address specific provisions of the Proposal, as well as some of the additional matters on which NASD has specifically requested comment.

A. Regulatory Coordination

It is of the utmost importance that NASD coordinate with other regulators and/or legislators to ensure not only that there is consistency regarding the content of broker-dealer disclosure regarding revenue sharing arrangements and differential compensation, but also with respect to the delivery mechanism for disclosure.

These requirements should also be consistent with any disclosure methodologies developed as the result of NASD Mutual Fund Breakpoint Task Force recommendations. We urge NASD to defer adoption of the Proposal to the extent necessary to allow for this extremely critical coordination.

B. Content of Disclosure

1. Revenue Sharing Arrangements – As noted above, revenue sharing arrangements, as defined in the proposal, may relate to the provision of a broad array of services, many of which are not associated with shelf space or preferred lists. Since expense reimbursement for administrative services can be a major component of a revenue sharing arrangement, there is not necessarily a correlation between amounts received and incentives to promote or provide shelf space for particular funds or fund families. Therefore, we do not believe that any ranking based on revenue received (whether utilizing descending order approach, or otherwise) would provide meaningful information to investors. More fundamentally, it is the simple fact that the revenue sharing arrangement exists, rather than the amount received, that is of most relevance to investors, unless the receipt of revenue sharing payments translates into receipt of differential compensation (which we do not believe is typical), or the existence of a preferred list restricts the range of fund investments that a registered representative may recommend to a customer. The NASD may wish to consider whether disclosure is necessary regarding “revenue sharing arrangements” where neither of these circumstances exist.

2. Differential Compensation – We believe that, subject to certain qualifications discussed below, the scope of the disclosures set forth in the Proposal is appropriate.

C. Timing and Location of Disclosure

We recommend that broker-dealers be given flexibility with regard to the manner of providing generic disclosure with respect to both revenue sharing and differential compensation. The goal, regardless of the methodology, would be to assure contemporaneous receipt of all the information that the investor should weigh and consider in conjunction with his or her purchase. Given the practical limitations of customer statements and confirmations some broker dealers may wish to include these disclosures in a separate disclosure document, while others may wish to include this additional information in modified versions of other documents already furnished to customers.

D. Definition of Differential Compensation

The definition of differential compensation should be kept as simple and straightforward as possible. It should not include money market funds for a number of reasons. Most fundamentally, the lower payout ratios involved would essentially subject every broker-dealer to the differential compensation disclosure requirements, even if they otherwise had adopted a level compensation program with regard to fund sales. Furthermore, most money market fund sales are effectuated through automated cash sweep programs, not involving point of sale recommendations.

We agree that a determination of whether differential compensation exists should be based upon whether different payout ratios exist among funds, and not upon higher compensation that might result from greater dealer concessions. Aside from the significant tracking and monitoring difficulties the latter approach would entail, it would, as is the case in the money market context, impair the ability of broker-dealers to eliminate differential compensation if they so chose.

We also recommend that NASD avoid extending differential compensation disclosure requirements to other investment products. There may be myriad factors that determine the compensation associated with any given product, including among other things, the product's complexity and the process involved in offering the product. Thus, it would be incorrect to conclude that the percentage payout alone will induce a point of sale recommendation. In fact, increased payouts may have more to do with increased selling effort than other factors. In such a case, a higher payout could have the effect of encouraging registered representatives to recommend products that are in the best interests of their customers.

Additionally, in keeping with the need for a simple and straightforward definition of differential compensation, we recommend that proposed Rule 2830(b)(1)(F)(ii) focus

only on the waiver of ticket charges and that the vague phraseology regarding “other practices that cause an associated person to earn different rates of compensation” be eliminated. For similar reasons, in light of the proposal, we would also support elimination of the confusing special compensation language in current Rule 2830(l).

In summary, we believe that the definition of differential compensation should be confined to a higher payout ratio situation involving non-money market funds, or the waiver of ticket charges. As a practical matter, this is the information that is readily known by registered representatives. It is also something they would be in a position to convey to investors at the point of sale.

IV. Summary and Conclusion

In summary, we recommend that NASD:

- Coordinate rulemaking regarding differential compensation and revenue sharing arrangements with other regulators and legislators.
- Provide broker-dealers with flexibility as to the methodology for addressing these, and possibly other, broker-dealer related mutual fund disclosures.
- Define “differential compensation” in a simple and straightforward manner.

Given that a principal goal of the Proposal is to ensure that a customer is aware of potential conflicts of interest that could either bias recommendations made, or restrict the investment choices offered, the NASD should consider whether it is appropriate, necessary or useful to extend disclosure requirements beyond differential compensation situations, or where use of preferred lists restricts recommendation to customers.

We trust you will find these comments helpful. We are prepared to meet with you at your convenience to discuss our comments further. If you have any questions or would like to arrange a meeting, please contact Michael Udoff, SIA Vice President, Associate General Counsel and Secretary, at 212-618-0509.

Sincerely,

Stuart R. Strachan
Chairman
Investment Company Committee

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