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Invested in America

May 31, 2011

**BY EMAIL TO:** rule-comments@sec.gov

Elizabeth M. Murphy, Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

**Re:** SR–FINRA–2011–018

Dear Ms. Murphy:

The Securities Industry and Financial Markets Association ("SIFMA"),[1] through its Private Client Legal Committee, appreciates the opportunity to comment on the proposed consolidated Financial Industry Regulatory Authority ("FINRA") rule governing investment company securities.[2] As a general matter, we support FINRA's efforts as part of its process to develop a new consolidated rulebook to address its rules on the distribution and sale of investment company securities and its efforts to ensure that related disclosures lead to better decision-making by investors and reduce the potential for conflicts of interest and abuse. We also applaud FINRA's consideration and adoption of certain of SIFMA's views in reshaping earlier iterations of proposed FINRA Rule 2341 (the "Proposed Rule").[3] Specifically, SIFMA supports FINRA's shift of approach from relying on mutual fund prospectus disclosure of special cash compensation – which is outside the control of member firms – to disclosure of additional cash compensation by member firms themselves.[4] This affords member firms the flexibility to craft disclosures in the manner and level of detail that they believe are appropriate given their

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[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association ("GFMA"). SIFMA's Private Client Legal Committee serves as legal counsel to the Private Client Group ("PCG") Steering Committee and addresses PCG-identified priorities; prepares and files comment letters; develops legal analyses and other work product; and otherwise advocates industry positions on private client-related issues. More information about SIFMA is available at http://www.sifma.org.

[2] Notice of Filing of Proposed Rule Change and Amendment No. 1 to Adopt NASD Rule 2830 as FINRA Rule 2341 (Investment Company Securities) in the Consolidated FINRA Rulebook, U.S. Securities and Exchange Commission Rel. No. 34-64386, 76 Fed. Reg. 26779-87 (May 9, 2011) (the "Proposed Rule Notice").

[3] *See* FINRA Notice to Members 09-34 (June 2009).

[4] SIFMA also supports the elimination of the concept of "special cash compensation." FINRA member firms have struggled with applying this term in practice, and at least one hearing panel decision determined the term was unduly vague. NASD Disciplinary Proceeding No. E8A2203062001, Hearing Panel Decision (June 28, 2007).

different types of customer relationships and financial relationships with fund complexes, as well as to adapt disclosures as these relationships change over time.

While we generally support the approach taken by the Proposed Rule, we have set forth below several comments and suggested changes that we believe must be reflected in any final rule.

## I. Procedural Matter

### 1. Future Disclosure Initiatives and Related Guidance Should Be Harmonized with the Proposed Rule.

Recognizing that the proposed disclosures would not (and should not) operate in a vacuum, the Proposed Rule changes should specifically contemplate, and work in tandem with, any future disclosure requirements of the sort being contemplated now by the SEC and FINRA – again, so that member firms have the flexibility to craft disclosures that they believe are appropriate given their customer relationships. These include, but are not limited to: (i) possible rule proposals from the SEC on "point of sale" disclosure;[5] and (ii) FINRA's separate initiatives on "relationship disclosure" and "markups, commissions and fees."[6] In this regard, FINRA should make clear that nothing in the Proposed Rule is intended to restrict a member firm from incorporating the proposed disclosures in other documents, including without limitation customer agreements and other disclosure and informational documents, including those being contemplated by FINRA and the SEC described above. In addition, given the possible overlaps and inconsistencies in these disclosure requirements, we emphasize the need that FINRA and the SEC work together to coordinate and harmonize disclosure requirements to avoid inconsistencies in disclosures, reduce unnecessary and potentially duplicative costs for member firms, and diminish possible confusion among the investing public. Furthermore, we ask that FINRA and the SEC consider this proposal in view of other disclosure regimes such as the requirements announced by the Department of Labor under Section 408(b)(2) of ERISA (29 C.F.R. § 2550) to help ensure that plan sponsors and plan participants understand the fees and expenses associated with their investments.

## II. Threshold Matter

### 2. In light of the Difficulty or Inability of Member Firms to Determine Whether They Have Received, or Might Receive, Additional Cash Compensation, the Proposed Rule Should be Clarified to Afford Members the Flexibility to Make Both Initial and Narrative Description Disclosures Based on Broader Categories of Compensation.

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[5] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. Law No. 111-203 §913 and §919 (2010). Section 913(l) specifically directs SEC to "(1) facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers and investment advisers, including any material conflicts of interest; and (2) examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers and investment advisers that the Commission deems contrary to the public interest and the protection of investors." Section 919 clarifies the SEC's authority to issue rules that require broker-dealers to provide information to retail investors before purchasing an investment product or service from a broker-dealer.

[6] FINRA Regulatory Notice 10-54 (Oct. 2010) and FINRA Regulatory Notice 11-08 (Feb. 2011), respectively.

All disclosure obligations contemplated by the Proposed Rule appear to flow from the initial determination by a member firm as to whether it has received, or could receive, from an offeror "additional cash compensation," which is defined as "any cash compensation from any offeror, in addition to the sales charges and service fees disclosed in the prospectus fee tables of investment companies sold by the member."[7] However, a member may not know if it has received, or might receive, additional cash compensation if "service fees" are not separately broken out in fund prospectuses.[8] In other words, a FINRA member would have no way of knowing what is "additional" absent contacting every fund complex to ascertain what the line item of "Other Expenses" in a given fund prospectus encompasses vis-à-vis monies paid, or expected to be paid, to that specific FINRA member. Moreover, the initial disclosure requirements in the Proposed Rule are based on a calendar year while prospectus disclosure is based on a fund's fiscal year, thereby creating a disconnect. It is not entirely clear how a member could be expected to continuously track the prospectus disclosure (assuming it could even discern "service fees" from the prospectus) of potentially hundreds of different mutual funds, all on very different annual update schedules, for the purposes of determining whether the firm has received, or might receive, compensation that is "additional."

Accordingly, the Proposed Rule should be made clear that nothing should preclude a member firm from meeting both the initial and narrative description disclosure requirements if it cannot reasonably ascertain from the prospectus whether it has received additional cash compensation through disclosure made in tandem with information on other broad categories of compensation received in connection with the offer or sale of mutual funds, or as part of any discussion a member firm may make about its compensation arrangements generally.

## III. <u>Initial Disclosure Requirements</u>

### 3. The Term "Arrangement" Should be Changed to "Written Agreement."

The term "arrangement" contained in Paragraph (l)(4)(A) of the Proposed Rule should be changed to, or defined as, a "written agreement." The Proposed Rule states that any member "that within the previous calendar year has received, or has entered into an *arrangement* to receive" (emphasis added) additional cash compensation, must make certain disclosures. Currently, the Proposed Rule does not define "arrangement," and without any definition it may be unclear what constitutes an arrangement and when it might be deemed to come into existence. For example, in the case where an offeror provides cash compensation to a member firm simply for allowing its investment companies to be made available on a sales platform, a question is raised as to when the arrangement begins. At the time of discussion? At the time of member approval? At the time a draft contract is exchanged? At the time a written contract is executed?

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[7] *See* paragraph (l)(4)(A) of the Proposed Rule.

[8] Service fees are not a required line item in the prospectus fee table. Instructions to Form N-1A allow a mutual fund to subdivide "Other Expenses" into no more than three sub-captions that identify the largest expense or expenses comprising "Other Expenses." *See* Form N-1A, Item 3, Instruction 3(c)(iii). However, mutual funds do not routinely break out FINRA-defined service fees from the remainder of "Other Expenses." Also, member firms and investment companies can categorize things differently. For example, what might appear as revenue sharing to a member firm could be categorized by a fund as a fund expense for services received.

At the time the written contract takes effect and becomes binding? At the time of remuneration? Given this uncertainty, SIFMA believes that the Proposed Rule should be clarified to make it clear that an "arrangement" materializes only upon the execution of a written agreement pursuant to which an offeror has agreed to pay additional cash compensation to a member.

### 4. The Proposed Rule Should Be Amended to Clarify that Exceptions For Existing Customers Should Also Apply to New Customers.

The Proposed Rule should be amended to clarify that the exceptions contained in Paragraph (l)(4)(B)(ii) apply not only to existing customers but also to new customers. The Proposed Rule requires that initial disclosure be delivered: "(ii) for customers existing as of [insert effective date of the proposed rule change], the later of either (a) 90 days after [insert effective date of the proposed rule change], or (b) prior to the time the customer first purchases shares of an investment company through the member after [insert effective date of the proposed rule change] (other than purchases through reinvestment of dividends or capital distributions or through automatic investment plans)." The exceptions for dividend reinvestments, capital distributions and automatic investment plans are not made for new customers in Paragraph (l)(4)(B)(i). Accordingly, the Proposed Rule could be read to suggest that the exceptions do not apply for new customers onboarded by a firm after the passage of the Proposed Rule. Accordingly, SIFMA believes that the Proposed Rule should be amended to clarify that the exceptions should also apply to new customers. Alternatively, the Proposed Rule should clarify that a "new customer" means any customer who has not yet made a purchase of investment company shares.

### 5. The Proposed Rule Should Not Apply To Principal Underwriters

The Proposed Rule should expressly exclude principal underwriters. As a technical matter, a principal underwriter could be deemed to be receiving additional cash compensation from an offeror (*e.g.*, a fund's adviser) when it acts as a conduit to make payments to selling broker-dealers. However, principal underwriters to mutual funds and other registered investment companies differ significantly from retail broker-dealers in many ways, none of which warrant the disclosure contemplated by the Proposed Rule because principal underwriters do not have the conflict faced by retail broker-dealers—that is, they are not compensated to sell one complex's funds over another. Moreover, the principal underwriter may receive monies from an investment company's adviser for purposes of allowing the principal underwriter to maintain operating capital. Such remuneration, even if it could be deemed additional cash compensation, in no way implicates the concerns underlying the Proposed Rule. Accordingly, we recommend that FINRA clarify that the disclosure obligations contemplated by the Proposed Rule do not apply to principal underwriters of mutual funds and other registered investment companies.

### 6. The Proposed Rule Should be Clarified to State that Disclosure Requirements Should Not Apply to Clearing Brokers.

The Proposed Rule, or any related supplementary material, should be clarified to state that, in the circumstance where an unaffiliated clearing broker is interposed between the investment company and an introducing broker and where such introducing firm may share fees with the clearing broker which the clearing broker has received from an offeror, the clearing broker has no disclosure obligations under the Proposed Rule. The text of FINRA's application to the SEC with respect to the Proposed Rule states: "Assuming the introducing firm sold investment company securities to a customer, the introducing firm would be responsible for disclosing any additional cash compensation it receives from an offeror, even if it shares such additional compensation with a clearing firm. In such a situation, the clearing firm would not be required to make the disclosures under proposed FINRA Rule 2341 to the customer."[9] While we agree with FINRA's interpretation, in order to provide greater clarity and finality on the matter, we suggest that such interpretation be added to the Proposed Rule itself, or any supplementary material related thereto.

## IV. <u>Mechanics and Disclosure Delivery Requirements</u>[10]

### 7. The Proposed Rule Should Adopt an "Access Equals Delivery" Approach for Disclosure Delivery.

The Proposed Rule should allow members to satisfy the disclosure obligation contemplated by Paragraph (l)(4)(A) of the Proposed Rule through web posting rather than actual delivery. In an earlier iteration of the Proposed Rule, FINRA asked "how this information should be disclosed to investors, particularly given the availability of the Internet? Should firms be permitted to deliver initial disclosure information…to customers electronically, unless a customer specifically requests paper-based disclosure?"[11] SIFMA strongly believes that member firms should be entitled to make any required disclosure available on the Internet and not be required to actually deliver disclosure to each customer (either electronically or in writing). In other words, an access-equals-delivery approach, which already is the paradigm for electronic delivery for certain prospectuses and affiliate marketing disclosures under SEC rules,[12] would alleviate

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[9] *See* Proposed Rule Change by Financial Industry Regulatory Authority Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934, File No. SR-2011-018 (April 19, 2011) at p. 28.

[10] Paragraph (l)(4)(B) of the Proposed Rule would require that the "disclosure required by subparagraph (A) shall be delivered in paper or electronic form: (i) for new customers on or after [insert effective date of the proposed rule change], prior to the time the customer first purchases shares of an investment company through the member; or (ii) for customers existing as of [insert effective date of the proposed rule change], the later of either (a) 90 days after [insert effective date of the proposed rule change], or (b) prior to the time the customer first purchases shares of an investment company through the member after [insert effective date of the proposed rule change] (other than purchases through reinvestment of dividends or capital distributions or through automatic investment plans)."

[11] *See* FINRA Notice to Members 09-34.

[12] In 2005, the SEC adopted a new set of prospectus delivery rules that established an "access equals delivery" standard for many, but not all, securities. Under that standard, if an issuer posted a prospectus online for easy investor access, broker-dealers were not required to provide a final prospectus with confirmation for certain securities transactions. *See* Securities Act Release No. 8591, 70 Fed. Reg. 44722 (Aug. 3, 2005). Those rules did not apply to mutual funds, exchange-traded funds and certain other securities issued by investment companies. However, in 2009 the SEC promulgated the so-called summary prospectus rule which did allow investment company issuers to be deemed to deliver a fund's statutory prospectus by posting it on a website. *See* Inv. Co. Act. Rel. No. IC-28584, 74 Fed. Reg. 4546 (Jan. 26, 2009). In defending the access equals delivery model for statutory prospectuses, the SEC noted that "A recent survey indicated that 90% of investors surveyed had access to the Internet [and that] over half (56%) rely on the Internet to some extent (ranging from 'a little' to 'completely') in making investment decisions….The survey report further indicated that 53% of respondents who own mutual funds accessed investment information via the Internet." *Id.* at 4560, n. 195. FINRA also has supported the notion of access equals delivery for mutual fund prospectuses and, in the context of commenting on the SEC's profile prospectus rule, stated that: (i) "Internet disclosure is the only effective way to assure that investors receive the information they desire at the point of sale. The Commission should mandate Internet delivery of the point of sale

tremendous administrative costs and burdens and yet still make the disclosure available to all who have access to the Internet. Otherwise, delivering written disclosure to each customer would present an unnecessarily expensive and burdensome endeavor. This is particularly the case with mutual fund purchases on an "application-way" basis where a FINRA member may not know whether or when a customer makes a mutual fund purchase or even have current contact information for such investor. In that case, the member may not be able to send out any required written disclosures within the required time period. Requiring physical or electronic disclosure of application-way clients would be a tremendous burden on firms, particularly smaller firms that conduct much of their mutual fund business in via application-way. Of course, if a customer requests that the member provide such disclosure in writing it could do so consistent with the way in which access-equals-delivery regimes currently operate.

**8. The Proposed Rule's Timing of Delivery Should Be Extended or Alternatively Provide for More Flexibility in Certain Circumstances.**

The time frame for delivery under the Proposed Rule, *i.e.*, "prior to the time the customer first purchases shares of an investment company through the member," should extend through settlement (*e.g.*, "at or before the completion" of the first purchase of shares of an investment company through a member) to allow disclosure to be delivered with confirmations. Delivering disclosure "prior to the time the customer first purchases shares…" may be practically impossible in many circumstances where a customer purchases shares contemporaneously with account opening (so-called "inception-day trades") because of communication delivery processes that commence only upon a member's approval of a customer account. In that case, disclosure under the Proposed Rule could be mailed only after the transaction order was placed, which would not be timely under the Proposed Rule. While a member firm could conceivably restrict new customers from engaging in mutual fund trades when opening an account, doing so may not be in the customer's best interests. It would also subject mutual funds to purchase restrictions not applicable to other investment options. In addition, the Proposed Rule should allow for oral disclosure by a firm's representative in the case of inception-day trades.

**9. The Proposed Rule's Exclusions Should Be Expanded.**

The parenthetical exclusion in the Proposed Rule of "purchases through reinvestment of dividends or capital distributions or through automatic investment plans" should be expanded or further exclusions should be provided in Supplementary Material to include: (i) purchases made through money market fund sweeps; (ii) accounts for which an investment adviser exercises discretion; (iii) bulk exchanges of money market mutual funds pursuant to NASD Rule 2510; and (iv) transactions unsolicited by a member firm.

Accounts that are managed on a discretionary basis should be excluded from this disclosure obligation whether managed by affiliated or unaffiliated advisers, registered or not. Advisers who manage accounts on a discretionary basis are generally subject to fiduciary and/or

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disclosure document;" and (ii) "the SEC should take an 'access equals delivery' approach to mutual fund prospectus delivery." *See* Letter from Robert G. Glauber (Chairman and CEO of NASD) to Jonathan G. Katz (Secretary of the SEC) (March 31, 2005) (available at: http://www.sec.gov/rules/proposed/s70604/nasd033005.pdf).

suitability obligations in performing these duties that require disclosure of conflicts of interest with respect to compensation. Customers who choose to have their accounts discretionarily managed are not involved in the selection of investments or the consideration of costs associated with various investments and generally do not desire or benefit from the disclosure information contemplated under the Proposed Rule.

### 10. The Proposed Rule Should Allow for Incorporation of Required Disclosure into Other Documents.

The Proposed Rule should explicitly state that the disclosures required by Paragraph (l)(4)(A) and (C) may be incorporated into other documents delivered to customers. The Proposed Rule mentions FINRA's proposed conflict disclosure document (proposed in Regulatory Notice 10-54) and states "FINRA staff conceives that the document would include, in the case of investment company securities, the information required by proposed FINRA Rule 2341."[13] Accordingly, the Proposed Rule should explicitly acknowledge that the required disclosures may be incorporated into other documents delivered to customers so that, as described earlier, customers need not be provided with fragmentary disclosures.

## V. Narrative Disclosure Requirements[14]

### 11. The Proposed Rule Should Define "Preferred Lists" to Exclude Fund Supermarkets and Funds Purchased Using Interactive Tools.

The Proposed Rule should define the term "preferred list" to exclude: (i) mutual fund supermarkets with a broad universe of funds on their platform where fund inclusion is made principally without regard to the receipt of additional cash compensation; and (ii) mutual funds recommended through an interactive analysis tool offered by a member or otherwise selected through objective screening criteria where the identification of those mutual funds is made principally without regard to the receipt of additional cash compensation.

### 12. The Proposed Rule Should Limit the Required Listing of Investment Companies to Naming Funds or Fund Complexes, Rather than All Actual Offerors.

Rather than requiring that a member firm name all offerors who pay member firms additional cash compensation, the Proposed Rule should be clarified to offer member firms the flexibility to name only: (i) the investment company; or (ii) the investment company complex, if the name of the complex could allow an investor to reasonably recognize that his or her fund is part of such complex. The Proposed Rule requires disclosure by members of the names of the specific

[13] Proposed Rule Notice at n. 7.

[14] Paragraph (l)(4)(C) of the Proposed Rule would require that the web page or toll-free telephone number required by subparagraph (l)(4)(A)(iii) disclose the following information: "(i) a narrative description of the additional cash compensation received from offerors, or to be received pursuant to an arrangement entered into with an offeror, and any services provided or to be provided by the member to the offeror or its affiliates for this additional cash compensation; (ii) if applicable, a narrative description of any preferred list of investment companies to be recommended to customers that the member has adopted as a result of the receipt of additional cash compensation, including the names of the investment companies on this list; and (iii) the names of the offerors that have paid, or entered into an arrangement with the member to pay, this additional cash compensation to the member."

investment companies on a preferred list and the names of offerors that have paid, or could pay under an arrangement, additional cash compensation. There may be multiple "offerors" (*e.g.*, a fund, its transfer agent, its distributor and its adviser) that are part of any given compensation arrangement or transaction and this level of detail would not be helpful or meaningful to investors. Instead, the investor is likely to be overwhelmed by the volume of information, which would seem to be at odds with the presumed goals of the Proposed Rule. It is important, however, that an investor knows which investment company, or investment company complex, provides additional cash compensation. In this regard, SIFMA believes that it is important that member firms be given the flexibility to name an investment company complex in lieu of listing each and every investment company, so long as it is reasonably clear to an investor from the name of the investment company complex that his or her fund is included.

**13. The Proposed Rule's Updating Requirements Should Be Amended to Eliminate "Prompt" Update of Disclosure and Change the Materiality Standard.**

SIFMA recommends that FINRA change the "materially inaccurate" standard to "inaccurate as to a material fact" and change the standard of "promptly" to "within 30 days of when the member becomes aware of the inaccurate material fact." Paragraph (l)(4)(D) of the Proposed Rule would require that "each member shall update the information required to be disclosed by subparagraph (C) annually within 90 days after the calendar year end. In addition, if this information becomes materially inaccurate between annual updates, each member shall update it promptly." SIFMA does not object to an annual update of information within 90 days after the calendar year end. However, requiring a member firm to update information about additional cash compensation "promptly" when the information becomes "materially inaccurate" is an unnecessarily arduous requirement that also makes an annual update somewhat moot. Accordingly, as noted above, SIFMA believes the "materially inaccurate" standard and requirement of "promptly" updating disclosure should be changed.

## VI. Exchange-Traded Funds

**14. The Proposed Rule's Exchange-Traded Fund Provisions Require a Clarification Concerning a Member's Due Diligence Obligations.**

The Proposed Rule would add a clarifying provision that "[n]othing in this Rule shall be deemed to prohibit the trading of an exchange-traded fund on a secondary market or securities exchange at prices other than the exchange traded fund's current net asset value, *provided that such transactions are consistent with applicable SEC rules and orders* (emphasis added)."

The language of the proposed clarification might suggest that a member has an obligation to undertake due diligence or otherwise confirm that the "transactions are consistent with applicable SEC rules and orders." SIFMA believes that the Proposed Rule should not impose on a member firm the kind of suitability due diligence obligations required of, for example, an ETF's designated liquidity provider ("DLP"), lead market maker ("LMM") or authorized participant ("AP").[15] Accordingly, FINRA should clarify in either the Proposed Rule or in Supplementary

[15] See, e.g., NASD Notice to Members 03-71 (outlining due diligence/reasonable-basis suitability obligations).

Material that a member may rely on the fact that an exchange-traded fund is approved for listing or trading on a national exchange to satisfy this obligation.

## VII. Compliance Date

### 15. The Compliance Date of the Proposed Rule Should be Set 365 Days from SEC Approval

The Proposed Rule states that "FINRA will announce the implementation date of the proposed rule change in a Regulatory Notice to be published no later than 90 days following Commission approval. The implementation date will be no later than 365 days following Commission approval."[16] While SIFMA appreciates that "FINRA will take into account that firms would need to modify their compliance systems in light of the new required disclosure,"[17] the Proposed Rule Notice should set a firm compliance date that is, at minimum, 365 days following SEC approval of any final rule. We expect that this will allow firms a reasonable amount of time to enhance systems and compliance procedures and train personnel.

## VIII. Miscellaneous

### 16. The Proposed Rule's Disclosure Should not Be Deemed Advertising

The Proposed Rule or Supplementary Material should make it clear that any disclosure required to be delivered or posted or otherwise transmitted to customers by members will not be deemed advertising or sales literature for purposes of Conduct Rule 2210.

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Thank you for giving SIFMA the opportunity to comment on the proposed consolidated FINRA rule governing investment company securities. If you have any questions regarding this comment letter, please contact Kevin Carroll, at 202.962.7382 (kcarroll@sifma.org), or outside counsel Steven Stone at 202.739.5453 (sstone@morganlewis.com) or Barry Pershkow at 202.739.5675 (bpershkow@morganlewis.com).

Sincerely,

Kevin M. Carroll

Kevin M. Carroll
Managing Director and
Associate General Counsel

cc: Joe Savage, Vice President and Counsel, Investment Companies Regulation, FINRA
Stan Macel, Assistant General Counsel, Office of General Counsel, FINRA

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[16] Proposed Rule Notice, 76 Fed. Reg. at 26786.

[17] *Id.*