The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 23635

July 17, 2009

Institute Draft Comment Letter On FINRA'S Proposed Compensation Rule Amendments; Feedback Requested by July 22nd

[23635]

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TO: SEC RULES COMMITTEE No. 43-09
SMALL FUNDS COMMITTEE No. 13-09
BROKER/DEALER ADVISORY COMMITTEE No. 40-09
ETF ADVISORY COMMITTEE No. 22-09 RE: INSTITUTE DRAFT COMMENT LETTER ON FINRA'S PROPOSED COMPENSATION RULE AMENDMENTS; FEEDBACK REQUESTED BY JULY 22nd

As we previously informed you, last month FINRA published for comment a new FINRA Rule 2341 to replace existing NASD Rule 2830, which governs members' cash and non-cash compensation arrangements in connection with investment company securities. [1] Of note, the new rule would impose additional disclosure requirements when broker-dealers receives "special compensation" in connection with the offer and sale of mutual fund shares. The additional disclosure would be required of mutual funds in their prospectus (or SAI) and broker-dealers at the point of sale, supplemented though information on a website or via a toll-free phone number. FINRA's proposed amendments are substantively identical to amendments to Rule 2830 that the NASD published for comment in 2003 [2] but never adopted.

The Institute has prepared the attached draft letter on proposed Rule 2341, which is briefly summarized below. Comments are due to FINRA no later than Monday, August 3rd. Persons with comments on the Institute's letter should provide them to the undersigned by

phone (202-326-5825) or email (tamara@ici.org) no later than close of business Wednesday, July 22nd .

With one major exception, the Institute's letter supports adoption of the proposed rule and reiterates the comments we submitted on the 2003 proposed amendments. The one major exception relates to a provision in the proposal that would prohibit a FINRA members from receiving special compensation in connection with mutual fund shares unless "the name of the member and the details of the arrangement are disclosed in the prospectus." The Institute strongly opposes requiring mutual funds to amend their prospectus disclose to accommodate broker-dealers' acceptance of special compensation. According to the letter, our concerns with this requirement are based on mutual funds prospectuses not being the most effective medium for communicating point-of-sale conflicts to investors. (This was most recently recognized by the SEC when it adopted the summary prospectus.) Also, the SEC only recently adopted reforms to Form N-1A that are deliberately designed to address the same concerns addressed by FINRA's proposal – alerting investors to the broker-dealer's conflicts of interest. As such, it seems inappropriate for FINRA to impose requirements beyond those that mutual funds are currently implementing.

In lieu of requiring mutual funds to enhance their prospectus disclosure to alert investors to the broker-dealers' conflicts of interest, the Institute letter states that broker-dealers should have the sole responsibility for disclosing their conflicts. According to the Institute's letter, this duty should fall to broker-dealers because:

- It is the broker-dealer's (not the mutual fund's) conflicts of interest that are at issue and it's the broker-dealer that is in the best position to alert the investor to them and provide the investor meaningful information about them. Also, it is the broker-dealer that benefits financially from the conflicts so they should bear the costs of alerting investors to them;
- It is the broker-dealer that the investor has the relationship with and looks to for assistance with his or her financial needs and the entity the customer is more likely to listen to; and
- The information that would be required to be disclosed by broker-dealers is probably already being disclosed as a result of enforcement actions in this area.

Accordingly, the Institute's letter strongly recommend that FINRA revise proposed Rule 2341 to delete any provisions that would directly or indirectly impact mutual fund prospectus disclosure and instead ensure that all disclosure obligations are imposed on the broker-dealer. In addition, the Institute's letter repeats the relevant recommendations from our 2003 comment letter. In particular, as in 2003, we recommend that FINRA:

- Revise the provisions in subdivision (l)(4) to address practical concerns with implementing the proposed contents of the required disclosure and the timing of providing it to investors;
- Provide a de minimis threshold for disclosures;
- Expand the scope to require all broker-dealers to provide relevant disclosure of conflicts of interest without regard to the product offered or sold; and

- Delete the provisions of subdivision (l)(4)(E) as superfluous.

The letter also recommends that FINRA confirm that, as used in the rule, “service fees” will retain their current meaning under NASD guidance.

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Attachment

endnotes

[1] See FINRA Regulatory Notice 09-34 (June 2009).

[2] See NASD Notice to Members 03-54 (September 2003).
