The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

April 15, 1997

Comment Letter on NASAA Proposed Rules for Sales of Securities at Financial Institutions, April 1997

April 15, 1997

Ms. Denise Voigt Crawford
Chair, NASAA Securities Activities of Banks Committee
State Securities Board
P.O. Box 13167
Austin, Texas 78711-3167

Re: NASAA Proposed Model Rules for Sales of Securities at Financial Institutions

Dear Ms. Crawford:

The Investment Company Institute (the "Institute")1 has reviewed the North American Securities Administrators Association, Inc.'s ("NASAA") proposed Model Rules for Sales of Securities at Financial Institutions (the "NASAA Proposal"), which would regulate the conduct of broker-dealers selling securities on the premises of financial institutions. The Institute welcomes the opportunity to offer its comments on the NASAA Proposal to the NASAA Securities Activities of Banks Committee (the "Committee"). As you are aware, the Institute only became aware of the NASAA Proposal recently. Consequently, after our members have an opportunity to review the proposal in more detail, we may submit additional comments to the Committee.

I. Introduction and Summary

While the Institute is sensitive to the interest of the Committee in addressing the issue of sales of securities on bank premises, and in promoting efforts to reduce customer confusion in connection with such sales, adoption of the NASAA Proposal at this time is unnecessary or, at the very least, premature. The NASAA Proposal should be reevaluated because (a) it would duplicate existing or pending regulatory pronouncements on the same issue and, to the extent it is not duplicative, result in a layer of additional regulation that is inconsistent with or extends beyond existing positions; (b) certain provisions of the NASAA Proposal are preempted by the National Securities Market Improvement Act of 1996; (c) various provisions would be unduly burdensome to broker-dealers doing business on bank premises; and (d) the proposals would create greater customer confusion, rather than alleviate it.

A. The NASAA Proposal Would Impose Duplicative or Conflicting Requirements.

The Institute questions the need for the NASAA Proposal, as the issue of bank sales of securities has already been thoroughly addressed by the banking regulators, as well as NASD Regulation, Inc. ("NASD"). Specifically, the federal banking regulators have provided substantial guidance in the area of retail sales of securities in banking institutions in their Interagency Statement on Retail Sales of Non-Deposit Investment Products (the "Interagency Statement"), which was issued in February 1994.2 The Interagency Statement addresses such issues as the contents and timing of disclosure, advertising and the physical separation of brokerage activity on bank premises. As described in more detail below, the NASAA Proposal exceeds the requirements of the Interagency Statement in several significant respects. In other respects it conflicts with the requirements of the Interagency Statement. If the NASAA Proposal were to be adopted, the result would be conflicting rules governing bank sales of securities.

In addition, the NASD has proposed rules that specifically address many of the issues relating to bank sales of securities contained in the NASAA Proposal. The NASD proposal was initially published for comment in March 1996 (the "1996 NASD Proposal").3 The proposal was vetted through an extensive comment period during which many letters were filed expressing concerns on a variety of issues, including many that are represented in the NASAA Proposal. In response to these comments, the NASD recently re-released for comment two rule proposals that earlier had been included as separate provisions of the 1996 NASD Proposal. These new proposals consist of proposed Rule 2460, which would restrict the payment of referral fees to unregistered third parties for the referral of retail business, and proposed new Rule 3121, which would impose restrictions on NASD members' ability to share customers' personal financial information with other entities. The comment period for the NASD's new proposals ends on April 30, 1997. The remaining provisions of the 1996 NASD Proposal were forwarded to the SEC for formal release on March 24, 1997.4 Although these rules are not yet final, it is clear that many of the restrictions, limitations and required disclosures specified in the NASAA Proposal would go beyond what the NASD proposals would require.

B. Certain Provisions of the NASAA Proposal are Preempted.

Several provisions in the NASAA Proposal would, if adopted by a state, be preempted by the National Securities Markets Improvement Act ("NSMIA"). NSMIA preempted state authority over certain matters relating to shares of mutual funds and other "covered securities", such as advertising relating to such securities, and limited state ability to impose broker-dealer books and records requirements that exceed the requirements under federal law. The provisions in the NASAA Proposal relating to these subjects thus would be unenforceable and the Committee would be ill-advised to put forth a resolution to the NASAA membership including any such recommendation.

C. Provisions of the NASAA Proposal would be Unduly Burdensome for Affected Broker-Dealers.

The additional layer of regulation that would be added by the NASAA Proposal would create unique burdens for broker-dealers doing business on bank premises. These burdens would not be shared by other broker-dealers. Great care has been taken by various regulatory agencies to achieve a level playing field where possible with respect to all broker-dealers, regardless of the location in which they operate.5 The NASAA Proposal would negate these efforts by imposing significant additional requirements on broker-dealers operating in banks. The burdens of these additional requirements are not justified; to the extent there

exists an inherent risk of confusion in conducting brokerage activities on bank premises, this risk has been adequately addressed by existing regulations.

D. The Proposal Would Create Customer Confusion.

The NASAA Proposal, by mandating detailed disclosures in addition to those already required under the Interagency Statement and the NASD proposals, would add to customer confusion. A primary goal of recent regulatory efforts has been to promote clear and concise disclosure of information intended to eliminate potential confusion that may result from brokerage activity in the retail deposit taking area of a bank. The NASAA Proposal, by imposing additional disclosure obligations, threatens to confuse rather than instruct customers by cluttering important disclosure documents.6 The Institute strongly urges the Committee to adopt the "clear and concise" standard and accept the disclosures required by the Interagency Statement and the NASD proposals.

II. Specific Comments on the Provisions of the NASAA Proposal

Set forth below are our specific comments on the individual provisions of the NASAA Proposal. Several of our comments include recommended changes in the event that the Committee determines not to withdraw the NASAA Proposal. We still, however, strongly urge its withdrawal.

A. Scope

The NASAA Proposal apparently would apply to all "arrangements between broker-dealers and financial institutions for the provision of broker-dealer services." This is overly broad and goes well beyond the 1996 NASD Proposal and the Interagency Statement, which are limited to broker-dealer services "on the premises of financial institutions where retail deposits are taken". As a result, the NASAA Proposal would appear to apply to situations in which there is little, if any, risk of confusion between securities products and bank products -- such as non-retail transactions, transactions with sophisticated purchasers and transactions with fiduciaries.7

B. Definitions

The proposed definition of "confidential financial information" in paragraph (a) provides that even a name, address, and telephone number could be confidential if the customer so specifies. As a practical matter, it is unclear how customers would provide notice of their desire for such information to remain confidential or how broker-dealers would track those customers who have requested confidential treatment of this information. We further note that the NASD has proposed its own definition of confidential customer information as part of proposed Rule 3121, which is currently out for public comment. The Institute recommends that the Committee await the final NASD rule so that the definition of this term will be consistent.

The definition of "financial institution" in paragraph (b) would allow each state to adopt its own definition of financial institution. This would result in inconsistent application of the requirements of the NASAA Proposal among the states, making it extremely difficult, if not impossible, for a broker-dealer conducting business on a nationwide basis to comply with the requirements.

The definition of "participating broker-dealer" in paragraph (c) appears to include any broker-dealer acting pursuant to any arrangement with a financial institution. Similar to our

recommendation above, the Institute recommends that the definition be narrowed to specifically cover only those broker-dealers conducting retail sales of securities from the retail deposit taking area of a financial institution.

C. Dual Employees

Paragraph (c) would prohibit a dual employee from identifying himself or herself as a bank employee or "implying" that he or she is an employee of the bank. The use of the term "imply" presents a difficult compliance issue -- what determines whether an individual has "implied" that he or she is a bank employee? To avoid confusion, the Institute recommends that the provision be changed to instead require that any dual employee make clear the capacity in which he or she is working when performing services for a customer. In addition, bank employees who register as Bank Securities Representatives under recently proposed bank rules relating to qualification requirements should be excluded from this provision.8

Further, the requirements of proposed paragraph (e) would exceed current regulatory requirements. This paragraph would require the broker-dealer to notify the financial institution of "the termination, suspension or other disciplinary action taken against a dual employee." The 1996 NASD Proposal, in contrast, would require notification of termination for cause (Proposed Rule 2350(c)(5)). This is a more reasonable requirement and the NASAA Proposal should be revised consistent with the NASD position.

D. Disclosure

The disclosures that would be required under the NASAA Proposal would exceed the requirements of the Interagency Statement and the 1996 NASD Proposal. The Interagency Statement and 1996 NASD Proposal require disclosure that indicates that the product is not insured by the FDIC, not a deposit or other obligation of or guaranteed by the depository institution and subject to investment risks, including loss of principal. The disclosures are required to be conspicuous and presented in a clear and concise manner.9 The additional disclosures required under the NASAA Proposal, however, would make it all but impossible to ensure that they are made in a clear and concise manner. They would thus add to customer confusion, as well as impose additional burdens on broker-dealers doing business on bank premises.

For example, Part 1 of the Disclosure provision of the NASAA Proposal would impose a requirement that "[a]t or prior to the opening of a securities customer account, a participating broker-dealer must deliver to the client and receive from the client a point-by-point initialed acknowledgment of receipt of a disclosure document containing [certain required] information." The provision then imposes a litany of requirements that must be included in the document given to, and received from, the customer at that time. While some of these items are required by the Interagency Statement, others are not. For example, paragraph (e) requires disclosure concerning SIPC coverage. This is not required by the Interagency Statement unless there is a representation concerning insurance coverage and such (written or oral) disclosure is necessary to avoid confusion with FDIC insurance.

Another example is paragraph 1(f), which would require disclosure of fees, including commissions, surrender charges or penalties. While the Interagency Statement does require that similar disclosures be made at the time an investment account is opened, it does not include the further requirement in the NASAA Proposal that disclosure be made that the fees would reduce the principal amount of the investment or that the broker-dealer will provide the customer with information concerning the fees charged for services.

Part 2 would require broker-dealers to repeat orally the information they have disclosed in writing prior to each sales presentation. This is inflexible and unduly burdensome, and would be very difficult to monitor from a compliance standpoint. At the very least, the provision should be revised so that it would apply prior to each sale, rather than prior to each sales presentation.

Part 4 would require a broker-dealer to maintain as part of its books and records the customer's written acknowledgment required by Part 1. New Section 15(h) of the Securities Exchange Act, which was enacted under NSMIA, states that "no law, rule, regulation, or order, or other administrative action of any State . . . shall establish . . . making and keeping records or operational reporting requirements for brokers, dealers . . . that differ from, or are in addition to, the requirements in those areas established under this title." The requirement to maintain the customers' acknowledgments is a requirement not imposed under federal law. As such, it would be in violation of NSMIA and should be deleted.

E. Ministerial Duties

The NASAA Proposal attempts to identify specific activities that are ministerial and may be performed by a non-registered person, and those that are non-ministerial and must be performed only by a registered person. In many instances, however, the examples given are unclear and may be contrary to current law. For example, paragraph 1(d) would allow the distribution of materials by a non-registered person only if the materials do not relate to specific products or securities. While it is clearly the case that a non-registered person should not be making recommendations concerning specific investments, it is neither uncommon nor inappropriate for such a person to respond to a request for a prospectus (which would also appear to be prohibited under paragraph 2(c)) or fill envelopes with materials that relate to a specific product.10 This requirement also would prohibit the distribution by bank personnel of literature developed by the bank that catalogues the variety of services available through the financial institution, including mutual funds. To define ministerial activities in such a limited fashion would place unique and unnecessary burdens on those broker-dealers doing business on bank premises and would be inconsistent with both the Interagency Statement and the 1996 NASD Proposal.

There are other examples, as well. While we agree that the activities described in paragraphs 2(a), (b) and (i) are non-ministerial and should only be performed by a registered person, it is quite possible that activities that fall within the scope of paragraphs 2(c), (d), (e), (f), (g), (j), (k) and (m) might be ministerial, depending on the circumstances. Moreover, the meaning of paragraph 2(h) is unclear. Paragraph 2(j) also is vague and it is unclear how it differs from paragraphs 2(k), (l) and (m). Paragraph 2(k) uses the term "investment vehicle", a term that is not used elsewhere in the NASAA Proposal. Finally, paragraph 2(m) includes the terms "familiarity" and "judgment", which are not defined and the meanings of which are unclear.

F. Physical Separation of Brokerage Activities

Both the Interagency Statement and the 1996 NASD Proposal include specific requirements pertaining to the physical separation of brokerage activities from deposit taking areas of a bank.11 While the NASAA Proposal is, for the most part, not inconsistent with these pronouncements, it is unclear what additional investor protection would be provided by its adoption by the states. Moreover, in some respects the NASAA Proposal does go beyond the Interagency Statement and the 1996 NASD Proposal. For example, Part 2 provides that the services of the broker dealer should be distinguished from the activities of the financial institution, as opposed to from the activities in the retail deposit taking area of the financial

institution. Also, while the NASD would require that the broker-dealer information, signage, etc. specify that the broker-dealer is providing the services, the NASAA Proposal additionally (and unnecessarily) requires an affirmative statement that the financial institution is not providing the service.

G. Advertising

The NASAA Proposal would regulate "all advertisements, sales literature, or similar materials used to describe products or services" offered by a broker-dealer in the bank. This provision is inappropriate to the extent it relates to covered securities under NSMIA. States may not dictate the content of advertising for such covered securities and this prohibition is not negated by describing the materials as broker-dealer materials.

Section 102 of NSMIA, which amends Section 18 of the Securities Act of 1933, provides that "no law, rule, regulation or order or other administrative action of any State. . .shall directly or indirectly prohibit, limit or impose conditions upon the use of . . . any . . offering document that is prepared by or on behalf of an issuer." The report of the House Commerce Committee explains that the intent of this provision was to eliminate the states' authority to require or otherwise impose conditions on the use of offering documents with respect to offerings of covered securities, including advertising and sales literature used in connection with such offerings.12 Accordingly, the authority of states to impose requirements on such advertising is preempted by NSMIA and the NASAA Proposal would be contrary to federal law.

Even if they were not largely preempted, the advertising requirements in the NASAA Proposal would create rather than relieve consumer confusion. While many of the items in this provision are merely redundant of the items requested under the Interagency Statement and the 1996 NASD Proposal or existing NASD rules, the additional disclosure that is required by the proposal would obfuscate the important messages and risk disclosures that are mandated under existing regulations. For example, Part 2 would require that the name of the participating broker-dealer be displayed prominently in the materials. This could be interpreted to require that funds sold by multiple broker-dealers list every broker-dealer in their materials. In addition, the requirement in Part 3 to explain the presence of SIPC insurance is in need of clarification. The NASD requires that advertisements carry a legend "Member SIPC." If that is the only reference to SIPC in an advertisement, additional lengthy disclosure will promote more confusion than it resolves. Furthermore, Part 4, which requires broker-dealers to establish and maintain an approval procedure for advertisements, sales literature or other similar materials should be deleted as the NASD already imposes extensive regulation in this area.

H. Restricted Products

This provision, which would prohibit the sale of non-deposit products with names that are identical or "substantially similar" to that of a bank, is inconsistent with positions taken by federal bank and securities regulators. Under current standards, identical names may not be used and, if similar names are used, the sales program should be designed to reduce the risk of confusion.13

I. Unregistered Employee Compensation

The NASAA Proposal includes a broad prohibition on the receipt of "any cash or other remuneration for locating, introducing, or referring a person to a participating broker-dealer." This goes far beyond the Interagency Statement, which expressly allows a one-time nominal fee of a fixed dollar amount that is not dependent upon the success of the

sale.14 In addition, as noted earlier, the NASD has issued a revised proposal addressing referral fees, which is currently out for public comment. Until the rule is final, it would be ill-advised for the Committee to recommend what could turn out to be an inconsistent position on the issue of referral fees. Furthermore, there is no reason to subject those broker-dealers doing business on bank premises to more restrictive regulations governing referral fees. Indeed, it was in recognition of this fact that led the NASD to revise its 1996 Proposal and propose a new rule that would apply to all broker-dealers.

J. Confidentiality

The NASAA Proposal would require the express written consent of a customer before the broker-dealer can access confidential financial information. This is inconsistent with the NASD's pending proposal. Proposed Rule 3121 would permit the disclosure of customer information to non-affiliates if the customer agrees (in writing) to "opt out" of the prohibition on such disclosure. With respect to affiliates (including entities with which the broker-dealer has entered into a "networking arrangement"), disclosure of the information would be permitted unless the customer affirmatively objects. (In both cases, clear and conspicuous disclosure that the information may be released would be required.) The NASD's Notice to Members states that, "Releasing information to business affiliates is treated differently from releasing it to other persons to reflect the different expectations that customers may have with respect to the sharing of confidential information. In addition, it might not be feasible to require affirmative written consent in every case, particularly where such information is maintained by a member and an affiliate in a central database."15 The NASAA Proposal takes no account of these important considerations. The Institute strongly recommends that the Committee await the outcome of the comment process on the NASD proposal before adopting a potentially inconsistent position.

K. Participating Broker-Dealer Duties

This section contains a series of open-ended provisions regarding, among other things, compliance procedures for broker-dealers and financial institutions. The procedures require financial institutions to create, implement, and maintain rules to ensure adequate compliance with the proposed rules. However, no guidance is provided with respect to the type and level of sufficiency required to ensure compliance.

With respect to specific provisions, paragraph (a) should expressly limit the supervisory obligation of the broker-dealer to only the securities activities of the dual employee. Paragraphs (c), (d), (f) and (h) impose compliance burdens on financial institutions that may be objectionable to certain banking agencies.16 Paragraph (d) raises the same issue relating to referral fees that are discussed above. Paragraph (f) is limited by NSMIA as it imposes requirements with respect to advertising. Paragraph (g) conflicts with current NASD requirements that mandate annual inspections of offices of supervisory jurisdiction, but allow branch office examinations on a schedule that is not necessarily annually. Finally, paragraph (h) is vague and could result in compliance difficulties.

* * *

For the reasons noted above, we strongly urge the Committee to withdraw or, at the very least, delay action on the NASAA Proposal. If you have any questions, please do not hesitate to contact me at (202) 326-5813.

Sincerely,

Marguerite C. Bateman

Associate Counsel

Attachments

cc: Members, NASAA Committee on Securities Activities of Banks

ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 6,309 open-end investment companies ("mutual funds"), 443 closed-end investment companies, and 10 sponsors of unit investment trusts. Its mutual fund members have assets of about $3.631 trillion, accounting for approximately 95% of total industry assets, and have over 59 million individual shareholders.

2 The banking regulators that issued the Interagency Statement are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Office of Thrift Supervision. A copy of the Interagency Statement is attached.

3 Securities Exchange Act Release No. 36980, 61 FED. REG. 11913 (March 22, 1996).

4 Amendment No. 4 to File No. SR-NASD-95-63 (March 24, 1997).

5 The NASD was sensitive to this concern when it deleted from the 1996 NASD Proposal and re-released proposed rules on referral fees and confidentiality as rules that would apply to all NASD members, not only those operating at banks. See NASDR Notices to Members 97-11 (relating to referral fees) and 97-12 (relating to confidential financial information) (March 1997).

6 Furthermore, if states were to adopt the NASAA Proposal in a less than uniform manner, it is possible that customers in various states would receive different disclosure concerning bank sales of securities.

7 See Interagency Statement at page 3. In addition, while the NASAA Proposal would include "networking arrangements", it nowhere defines the phrase. Inclusion of this phrase would be superfluous in any event if the scope of the NASAA Proposal applied to all broker-dealers doing business on the premises of a bank where retail deposits were taken.

8 61 FED. REG. 68824 (Dec. 30, 1996).

9 See Interagency Statement at page 7; Proposed NASD Rule 2350(c)(3).

10 In addition, it appears inconsistent to allow a non-registered person to "accept[] cash, checks, or securities for the securities customer accounts of the participating broker-dealer" (as would be permitted under paragraph 1(f)), but not to allow the same person to deliver a prospectus to the customer. Does the Committee seriously contend that investor protection would be furthered if these tasks were required to be carried out by separate individuals?

11 Interagency Statement at page 10; Proposed NASD Rule 2350(c)(l).

12 See Report of the House Committee on Commerce on H.R. 3005 at page 30 (June 17, 1996).

13 Interagency Statement at pages 9-10; Letter from the Office of the Comptroller of the Currency to [Institute Member], dated Sept. 17, 1993 (copy attached); see also Report of the Senate Committee on Banking, Housing and Urban Affairs on S. 1815 at pages 8-9 (June 26, 1996). In granting the Securities and Exchange Commission expanded authority to prohibit deceptive or misleading investment company names by rule, the Committee noted specifically that "[t]his provision should not be construed to be a bar against common or similar names between a registered investment company and an affiliate organization, such as an insured bank." Id.

14 Interagency Statement at page 12.

15 NASDR Notice to Members 97-12 (March 1997).

16 The Office of the Comptroller of the Currency has on a number of occasions reiterated its position that state law is inapplicable to national banks if it conflicts with federal law, unduly burdens the operations of national banks or interferes with the objectives of the national banking system. See Letter from the Office of the Comptroller of the Currency to [Institute Member], dated Oct. 29, 1990 (copy attached).
