COMMENT LETTER

April 30, 1997

Comment Letter on NASAA Proposal Relating to Suitability, April 1997

April 30, 1997

Ms. Leslie Scott, Chair
NASAA Broker-Dealer Sales Practices Committee
c/o Office of the Mississippi Secretary of State Securities Division
Post Office Box 136
Jackson, Mississippi 39201

Re: Proposed Suitability Rule

Dear Ms. Scott:

The Investment Company Institute[1] appreciates your providing us a copy of the Statement of Policy on customer suitability, which has been proposed for comment by the NASAA Broker-Dealer Sales Practices Committee. During the Committee's recent meeting in Vicksburg, Mississippi, I had the opportunity to discuss generally some of the concerns the Institute has with the proposal in its current form. At that time I agreed to follow up my comments with a letter to the Committee more specifically discussing our concerns, hence this letter.

Although the Institute has agreed to provide you with comments on the pending proposal, in view of the fact that the Committee is developing a Statement of Policy defining dishonest or unethical practices in connection with the offer or sale of investment company securities, we strongly recommend that suitability concerns arising in connection with recommendations involving the offer or sale of investment company securities be expressly excluded from the Committee's suitability proposal and included instead in the Committee's investment company proposal.

A review of the Committee's pending suitability proposal and its accompanying Commentary seem to indicate that the abuses the Committee seeks to redress through its extensive proposal are not necessitated from problems caused by the offer or sale of investment company securities. In recognition of this, it does not seem appropriate to subject recommendations involving such securities to the same rigorous information gathering exercise as may be appropriate for other types of securities, such as penny stocks. Accordingly, we recommend that the provisions of Section 2(d) of the Committee's proposal be incorporated into the Committee's pending investment company proposal, and that the suitability proposal be revised to expressly exclude recommendations that are

covered by the investment company proposal. Notwithstanding this recommendation, we submit the following comments on the Committee's proposal.

According to the Commentary accompanying the Committee's proposal, the Committee has proposed to replace NASAA's current provision governing suitability2 with a more detailed provision because (1) the NASDR interpretations that govern the suitability duties of members of the NASDR "lack the force of state law" and (2) such provision "has not proved to be fully serviceable outside the context of the specialized NASD member discipline and arbitration forums." In response to these concerns, the Committee proposes a suitability rule that lists "virtually all of the elements of the [NASDR's] suitability standard." In the view of the Committee, the pending proposal "has been an exercise of incorporation of existing standards."

Contrary to the views of the Committee as expressed in its Commentary, the Institute respectfully submits that the Committee's proposal does not merely restate existing NASDR standards but imposes additional, and in our view, inappropriate, overly intrusive and perhaps unlawful, standards on persons involved in the offer and sale of securities. Additionally, if the Committee's goal in proposing this rule is to ensure the enforceability of NASDR interpretations in state administrative, civil, or criminal proceedings, we believe that the appropriate way to accomplish this goal is to adopt a Statement of Policy that merely restates existing NASDR requirements. Instead, however, the Committee has chosen to rewrite and, in the process, substantially alter, the NASDR's long-standing suitability provisions. As a result, we are concerned that the current version of the proposal will not accomplish the Committee's goal and will instead have unintended adverse consequences for investors, states, and the industry.

Moreover, while the Committee may consider each of the items of information the proposal would require broker-dealers to obtain from customers to be relevant to a suitability determination, based upon the experience of our members, both as sellers and purchasers of securities, we believe many investors would find the proposed information gathering exercise to be unduly intrusive and unwarranted. Indeed, based upon the nature of the transaction, the information sought may be completely irrelevant to the broker-dealer. Before proceeding further with its proposal, the Institute strongly recommends that the Committee arrange a meeting with representatives of firms involved in the offer and sale and purchase of securities in order to elicit information about the practical consequences of the Committee's proposal, including its unduly intrusive impact on investors.

I. General Concerns

Before discussing specific concerns with the language of the Committee's proposal, the Institute would note the following general concerns, each of which is discussed in detail below:

There is no indication that the Rules of Conduct of the NASDR (1) are inadequate to redress unsuitable recommendations and (2) should be replaced with the more extensive requirements proposed by the Committee.

The proposal would inappropriately impose on all securities transactions suitability standards that, under the rules of the NASDR, are tailored to specific risky securities transactions, such as penny stocks or options.

The proposal would reduce a flexible suitability standard to a mechanized function, to the

disservice of customers, and could result in a person being found to have violated the Statement of Policy even in the absence of such person effecting an unsuitable transaction.

The proposal would require inquiries that likely would be considered by many customers to be unduly intrusive, offensive, and patronizing.

The provision in the proposal imposing a duty to warn investors of unsuitable transactions is completely contrary to existing securities law and attempts to shift responsibility to a broker-dealer for conduct that is not and should not be the broker-dealer's responsibility.

The proposal would result in current compliance systems having to be completely revamped.

A significant portion of the proposal appears to be violative of the National Securities Markets Improvement Act of 1996 ("NSMIA").

A. Adequacy of the NASDR's Rules of Conduct

As mentioned above, the Committee notes in its Commentary to the proposal that it is an exercise in incorporating existing NASDR suitability standards. As will be discussed in more detail throughout this letter, however, the result of the Committee's exercise is a proposal that would impose suitability requirements that are substantially different from those of the NASDR. This is of great concern to the Institute. Because of the nationwide nature of the brokerage industry and consistent with the intent of NSMIA, we believe that it is absolutely crucial that state and federal standards governing conduct in the industry be conterminus. If even one state were to adopt the Committee's proposal, the rules of the NASDR would, in large part, be rendered moot because it would be virtually impossible for a broker-dealer[3] to have two redundant systems for ensuring compliance with suitability requirements—one that tracks the NASDR's standards and one that tracks state requirements. Instead, the broker-dealer would be forced to tailor its compliance system to ensure compliance with the more restrictive of the two systems, that proposed by the Committee.

If the NASDR standards were found to be inadequate or lacking, perhaps this result would be appropriate. However, nowhere in the Committee's proposal is there even a hint of allegation that the NASDR's standards are inadequate. Because we see no reason to support the Committee's wholesale rewrite of the NASDR's long-standing suitability requirements, we strongly recommend that the Committee revise its proposal to be identical with the NASDR Rules of Conduct.

B. It Subjects All Transactions to Specialized Suitability Requirements

Under NASDR Rule of Conduct 2310, except as expressly excluded, all broker-dealers recommending a securities transaction are required to have reasonable grounds to believe that the transaction is suitable for the customer. To make this determination, the broker-dealer is directed by the NASDR to obtain information concerning the customer's financial status, tax status, investment objectives, and such other information used or considered to be reasonable in making recommendations to the customer. Excluded from this directive are broker-dealers making a recommendation (1) to an institutional client or (2) involving a money market mutual fund. If, however, the recommendation relates to securities such as penny stocks, options, or speculative low-priced securities, in addition to the information required by Rule 2310, the NASDR's Rules of Conduct require the recommending broker-dealer to obtain even more information from the client in order to assess the suitability of the recommendation.[4] In other words, under the NASDR's regulation of the suitability of recommendations, there is a direct correlation between the amount of detailed personal

and financial information a broker-dealer must know about a customer when recommending a transaction to a customer and the risks associated with such transaction. Similarly, under the NASDR's regulations the amount of information a broker-dealer obtains from a customer may be related to the sophistication of the client. The same is not true of the Committee's proposal.

While the Committee's proposal would retain the NASDR's general prohibition against recommending a transaction without a reasonable basis to believe that the recommendation is suitable,5 it would require a broker-dealer to obtain from the client information beyond that required by the NASDR. In essence, it appears as though the Committee reviewed the information required by the NASDR in connection with various types of transactions, determined the most extensive of these requirements, and issued a proposal requiring broker-dealers recommending any transaction, with the one exception of money market mutual funds, to obtain such extensive information.6 As a result, under the Committee's proposal there would be no correlation between the type of transaction recommended by the broker-dealer, or the services sought by the customer, and the amount of information the broker-dealer is required to know about the customer in order to ensure that the recommendation is suitable.

Consequently, a broker-dealer recommending exclusively mutual fund products would be subject to the same information gathering requirements as a broker-dealer that only recommends speculative penny stocks. Like hunting a mosquito with a bazooka, this appears to be overkill, especially in view of the fact that, as discussed above, this approach is substantially different from that of the NASDR and there has been no determination that the NASDR's suitability requirements are in any way inadequate or deficient. Absent such determination, we do not believe the Committee should be deviating from the NASDR's requirements.

In addition to failing to distinguish suitability requirements based upon the nature of the security being recommended, the Committee's proposal fails to distinguish them based upon the nature of the client. While NASDR Rule of Conduct 2310 generally does not differentiate between retail clients and institutional clients in imposing suitability standards, it does with respect to the information that must be considered by the broker-dealer in determining suitability. In particular, NASDR's Rule of Conduct IM-2310-3, Suitability Obligations to Institutional Customers, states that "[t]he two most important considerations in determining the scope of a [broker-dealer's] suitability obligations in making recommendations to an institutional customer are the customer's capacity to evaluate investment risk independently and the extent to which the customer is exercising independent judgment in evaluating a [broker-dealer's] recommendation."7 The Rule goes on to provide broker-dealers guidance as to what information should be obtained to ensure the suitability of recommendations made to an institutional client. In addition, this Rule of Conduct recognizes that not all institutional investors need be treated identically:

. . . In determining the applicability of this [suitability] interpretation to an institutional customer, the [NASDR] will consider the dollar value of the securities that the institutional customer has in its portfolio and/or under management. While this interpretation is potentially applicable to any institutional customer, the guidance contained herein is more appropriately applied to an institutional customer with at least $10 million investment in securities in the aggregate in its portfolio and/or under management.

The distinctions that are expressed in the NASDR's Rules of Conduct are not present in the Committee's proposal. Instead, the Committee's proposal would require all broker-dealers

recommending a transaction to a client, whether an institution or individual, to obtain the same information. We submit that this is not only inconsistent with requirements under federal law, but will result in broker-dealers being required to obtain information that may, in large part, be completely irrelevant to a suitability determination as a result of either the nature of the transaction or the nature of the client. We strongly recommend that the Committee revisit the appropriateness of its proposed approach to suitability regulation and revise its proposal to be substantively identical to the NASDR's regulation of suitability.

C. The Proposal Would Reduce Suitability Determinations to a Mechanized Function

As previously stated, both the NASDR Rules of Conduct and the NASAA Statement of Policy relating to dishonest or unethical business practices prohibit a broker-dealer from making an unsuitable recommendation to a client. Both also require the broker-dealer, in making a suitability determination, to obtain information relating to the customer's investment objectives, financial situation and needs, and any other relevant information known by the broker-dealer.8 Because of the varied nature of securities transactions and securities clients, the Institute strongly believes that these more flexible standards are in the best interest of clients. Instead of imposing rigid information gathering requirements on broker-dealers, the existing provisions require a broker-dealer to consider any relevant information known by it in making a suitability determination.

While the Committee proposes to retain the existing NASAA suitability standard as Subsection 2(d) of the Committee's proposal, it would additionally require pursuant to Subsection 2(a) of the proposal that every broker-dealer obtain from each client to whom it recommends a transaction a minimum of eleven items of information.9 We believe the Committee's attempt to list all "relevant factors" that, in the Committee's view, should be considered before making any recommendation will disserve clients.10 We believe that it will convert the careful and deliberative process inherent in the current system, whereby a broker-dealer is held accountable for considering any relevant information known to the broker-dealer, to a mechanized and routinized process. As appropriately recognized by the NASDR in the context of institutional recommendations, a suitability determination "can only be made on a case-by-case basis taking into consideration all the facts and circumstances of a particular member/customer relationship, assessed in the context of a particular transaction."11 Moreover, those broker-dealers that are not conscientious about effecting transactions that are in the best interest of the client—which broker-dealers should be the focus of the Committee's efforts—will be able to "go through the motions" by satisfying themselves that so long as they inquire about each of the eleven items included on the Committee's list they have satisfied their suitability duties under the law.

D. The Proposal Would be Unduly Intrusive and Offensive to Customers

As proposed by the Committee, in each instance in which a broker-dealer or investment adviser recommends a securities transaction to a customer, the broker-dealer or investment adviser would have to ensure that it obtains each of the eleven items of information included in Subsection 2(a) of the Committee's proposal. From the extensiveness of the list, one might conclude that the Committee assumes that every customer to whom a broker-dealer or investment adviser recommends a trade is a novice investor. We disagree, and believe that in many instances customers would find such detailed inquiry to be unduly intrusive. Moreover, it seems inappropriate to subject all customers to such inquisition without regard to the particular services sought by the client.

For example, assume an investor with a great deal of experience investing in equity securities decides to invest his $10,000 year-end bonus into bonds, an investment with which he is unfamiliar. Though he has always made his equity investment decisions on his own and has effected them through a discount broker, because of his unfamiliarity with bonds and the bond markets, he decides to consult a full service broker-dealer for the very limited purpose of recommending bond transactions that are consistent with his investment objectives as he has determined them and presented them to the broker-dealer. Under the NASAA proposal, the customer would be subjected to a litany of questions that may be completely irrelevant to the services he seeks -- for example, his estimated annual income; his estimated net worth; his employment status; the number of his dependents; the amount and nature of his current investments; and the names of other persons he regularly relies upon to make investment decisions. Additionally, the broker-dealer may have to probe even further in order to fulfill his responsibility under the proposal to determine "the consequences associated with disposing of [the] assets" the customer proposes to invest in bonds.

Surely such a detailed inquiry under these circumstances is completely unwarranted and would be viewed by the customer as unduly intrusive and perhaps even patronizing. In such a case, where the client is not seeking advice as to the appropriateness of the decision to invest in bonds but rather in which bonds to invest, the broker-dealer should only be charged with obtaining those facts necessary to determine which bonds are appropriate for the customer.12 We submit that, based upon the nature of the services sought by the customer, the broker-dealer should not be required to obtain all of the information that would be required by Subsection 2(a).13 On the other hand, it may be relevant to require a broker-dealer to conduct a more in-depth inquiry before making recommendations to a customer that professes complete ignorance regarding investments or its investment needs. The Committee’s proposal fails to take into account issues such as these and, as a result, would subject all customers to the inquisition that would be required by Subsections 2(a) and 2(c) without regard to the services sought by a particular customer.

Additionally, the Committee’s proposal fails to differentiate between retail and institutional investors in the scope of the inquiry. In the institutional context, it is not uncommon for an institutional client consulting an investment adviser to provide the investment adviser with limited investment parameters. For example, a pension plan consultant may have determined to invest a specific portion of the plan’s assets in equity securities. The consultant, on behalf of the plan, may engage an investment adviser that specializes in equity investments to recommend appropriate securities in which to invest this portion of the plan’s assets. In this situation, the investment adviser should be able to rely upon the information provided by the pension plan consultant, as the plan’s agent, and should not be required to assess whether equities are a suitable investment for the pension fund nor should the investment adviser be required to inquire further based upon the Committee’s determination that there are more "relevant facts" as listed in Subsection 2(a) of the Committee’s proposal that should be considered before recommending specific equity securities. To require otherwise would be contrary to the expectations of the client and may require analysis of information about the plan that would not be accessible to the investment adviser.

The Institute notes that it is the proposal’s rigid approach to "relevant facts" in imposing suitability requirements and its failure to distinguish between the services sought by a client and whether the client is a retail client or an institution that results in the concerns of the Institute. If the Committee’s proposal were revised to be consistent with the NASDR’s

Rules of Conduct, these concerns would not arise inasmuch as the scope of the broker-dealer's duty to a customer would be determined based upon (1) whether the customer was an a retail or institutional customer and (2) what factors it would be reasonable under the circumstances for the broker-dealer to consider in making a recommendation to the customer.

E. Imposing a Duty to Warn of Unsuitable Transactions is Inappropriate

Subsection (3) would require a broker-dealer or investment adviser, who has reason to know that an unsolicited transaction is unsuitable to inform the customer that the transaction is unsuitable. The Institute strongly objects to inclusion of this provision. It is completely contrary to existing securities laws and it attempts to shift responsibility to a broker-dealer for conduct that is not and should not be the broker-dealer's responsibility. If a customer takes it upon itself to make its own investment decision without seeking advice from any securities professional, we do not believe a person effecting the customer's requested trade should be charged with gratuitously volunteering the information that would be required under the Committee's proposal. Nor do we believe that the broker-dealer should assume any responsibility for the customer's decision. Discount brokers are not compensated by their customers to build the training, supervision, and compliance infrastructures that would be required to perform suitability analyses on their customer's self-directed trading activity.14 Additionally, a customer that voluntarily elects to use an "execution-only" or other discount brokers has deliberately chosen to utilize the services of a broker that provides low-cost, streamlined services to customers who do not want to pay for advice and do not expect it.

The only way to manage the type of risk the Committee proposes to impose on broker-dealers would be for broker-dealers to impose full suitability requirements for all customers -- no doubt something many customers would find unduly intrusive and something for which they would be unwilling to pay. Because we think the Committee's proposal will disserve customers and would, in essence, subject mutual fund underwriters and discount brokers who make no investment recommendations to unwarranted and costly regulation that is completely at odds with the nature of their business, it is imperative that NASAA's "duty to warn" be deleted in its entirety.

F. The Proposal Would Require Revamping Current Compliance Systems

The practical consequences of the Committee's proposal, which will be both extensive and costly, should not be underestimated. The Committee is proposing to require all broker-dealers that recommend transactions to clients to revamp the manner in which they collect, maintain, and utilize customer information. Not only will new account cards have to be amended, but representatives would have to be retrained regarding their obligations in making recommendations and supervisory procedures relating to the account approval process would most likely have to be completely revised in order that a broker dealer can assure itself that its representatives are routinely obtaining all required information. Additionally, broker-dealers would have to establish supervisory procedures regarding their duties and obligations in instances in which a customer fails or refuses to provide the information requested.15 Aside from such considerations in connection with opening accounts, consideration will need to be given to how often the information must be updated and what are the ongoing responsibilities of a broker-dealer under the rule. As mentioned above, we strongly recommend that the Committee meet with representatives of the industry to discuss issues such as these in order to assess the practical consequences of

the Committee’s proposal.

G. The Proposal Violates NSMIA

Amendments in the National Securities Markets Improvement Act of 1996 ("NSMIA") to Section 15(h)(1) of the Securities Exchange Act of 1934 expressly prohibit any state from imposing any law, rule, regulation, order, or other administrative action relating to the making and keeping of records that differs from or is in addition to regulations under the Exchange Act. Under current law, broker-dealers are required by NASDR Rule of Conduct 2310 to obtain specified information from customers when making a recommendation to such customer. Rule 17a-4 under the Exchange Act requires broker-dealers to preserve "any account cards or records which relate to the terms and conditions with respect to the opening and maintenance of such account" for at least six years. Aside from the NASDR’s requirements, we are not aware of any other specific provisions in the rules of the Securities and Exchange Commission ("SEC") or the NASDR under the Exchange Act governing the contents of customer account records. We note, however, that in October 1996, the SEC proposed for comment amendments to Rule 17a-3 under the Exchange Act that would require broker-dealers to maintain an "account form" for every customer account and specify the contents of such account form.16

As a result of NSMIA, we submit that the Committee’s authority under law to require broker-dealers to obtain information is limited by the recordkeeping requirements established by the SEC or the NASDR under the Exchange Act. Accordingly, to the extent the list of items in the Committee’s proposal exceeds those required under federal law, either currently or as amended in the future, the Committee’s proposal would need to be amended to limit the information it requires broker-dealers to obtain. While it is true that the amendments in NSMIA to the Securities Act of 1933 expressly preserve the authority of states to investigate and bring enforcement actions with respect to fraud or deceit or unlawful conduct by a broker or dealer in connection with securities or securities transactions, it is worth emphasizing that the amendments to the Securities Exchange Act in NSMIA include no similar savings clause that would permit a state to exceed the limits imposed on state authority under Section 15(h) of the Exchange Act. In the absence of such savings clause, we respectfully submit that, while nothing precludes NASAA from adopting Statements of Policy governing unethical conduct, under federal law individual states could not enforce such proposal if it imposes recordkeeping requirements that exceed those under federal law.17 To read NSMIA otherwise would be to render moot the limitations added by NSMIA to Section 15(h) of the Exchange Act.

To avoid running afoul of NSMIA, the Committee’s proposal must be revised to limit the information a broker-dealer is required to obtain from a customer to what is permitted by the NASDR or the SEC under the Securities Exchange Act of 1934.

II. Specific Concerns

A. Definitions

1. "Customer"

The Committee has proposed to define "customer" to include (1) natural persons, (2) artificial persons, and (3) any "consultants, advisers, or individuals regularly relied upon by [a natural or artificial person] in making investment decisions." According to the Committee’s Commentary, this definition was drafted intentionally to include institutional

customers and persons to whom a customer has delegated decision-making.

We find the Committee's defining "customer" to include persons relied upon by the "customer" to be overly broad and confusing, both with respect to the definition and the use of the term "customer" throughout the proposal. The incorporation of consultants appears to be an attempt to incorporate the requirements of NASDR Rule of Conduct IM-2310-3, which governs suitability obligations to institutional customers. As previously discussed, this Rule requires broker-dealers to determine whether an institutional customer "is exercising independent judgment in evaluating a [broker-dealer's] recommendation." According to the Rule, if the broker-dealer determines that the "customer has delegated its decision-making authority to an agent, such as an investment advisor or bank trust department" the broker-dealer must assess whether such agent is exercising independent judgment.

Unlike the NASDR rule, however, which addresses situations in which the customer has delegated decision-making authority, the Committee's proposal would apply whenever a customer regularly relies on another to make its investment decisions, even if the customer retains full decision-making authority. So, for example, if a husband "regularly relies" on his wife in making investment decisions, his wife would be considered a "customer" for purposes of the Committee's proposal even though the account was held solely in the husband's name and all investment decisions were made by the husband. Similarly, if an investor regularly consults her accountant prior to making investment decisions, the accountant may be considered to be the broker-dealer's customer even though the accountant had no contact with the broker-dealer and the investor possessed sole decision-making authority over the brokerage account. We submit that if the Committee's proposal were read, as appears to be its intent, to require the broker-dealer in such instances to consult those persons that the customer "regularly relies on", the actual customer would find such contacts to be inappropriate, offensive and patronizing.

So long as the customer retains responsibility for making investment decisions, it seems inappropriate, unwarranted, and most impractical for the Committee to treat a person who the customer regularly relies upon as the customer. The Institute recommends that the Committee's proposed definition be revised to more closely conform to the NASDR's treatment of a customer's agent(s). We believe this would also address the concerns we have with the confusion caused by the proposed definition. We therefore recommend that the definition be revised as follows:

(a) "Customer" for purposes of this section includes any natural or artificial person to whom financial products or services are offered.

Finally, while we do not object to the inclusion of artificial persons in the definition of "customer", we reiterate our objections to subjecting natural and artificial persons to the same suitability considerations for the reasons discussed above under Sections I.B. and I.D. of this letter and below under Section II.B.1.

2. "Recommend"

Though the NASDR's Rules of Conduct regulate recommendations made by broker-dealers, the NASDR does not define the term "recommend." We recommend that the Committee follow the NASDR's practice and not attempt to define this term. While the Committee's Commentary expresses the interest of the Committee in defining this term to ensure that a "supervisor's acts directing [a recommendation] by an agent is also included in the

definition of ‘recommend’", we find the resulting definition to be so vague as to not provide clear guidance as to what conduct is proscribed and so overly broad as to encompass activities that have no correlation to a broker-dealer "recommending" a transaction as such term is and has been understood in the securities industry. For example, the Committee defines the term to include "any affirmative act . . . that . . . importunes or intentionally aids such person to engage in such conduct."18 Would not the mere issuance of securities by an issuer be conduct that, however remotely, "importunes" a person to purchase such securities? Similarly, could not the placement of an advertisement -- including a tombstone ad -- in a publication constitute an affirmative act importuning a person to purchase such securities? Surely this is not the conduct with which the Committee is concerned. If the Committee’s goal in defining the term was to ensure it apply to certain conduct by a supervisor, we recommend that the Committee add a specific provision to the proposal addressing the conduct of supervisors, rather than attempting to capture such conduct indirectly through an overly broad definition. Accordingly, we strongly recommend that the Committee delete this definition in its entirety.

B. The Suitability Determination

1. Relevant Facts

Notwithstanding that the Committee’s proposal includes a definition of "securities transaction", Subsection 2(a) of the Committee’s proposal does not use this term and instead requires any broker-dealer, agent, investment adviser, or investment adviser representative "recommending the purchase, sale or exchange of any security" to obtain specified information from the client. The Institute recommends that the quoted language be deleted and replaced with "recommending a securities transaction." This change would ensure that the provisions of 2(a) not apply to recommendations involving money market mutual funds.

Also, for the reasons previously discussed under Section I of this letter, the Institute strongly recommends that the list of information that must be obtained from the customer be limited to that information required by the NASDR based upon the nature of the transaction and nature of the customer. As discussed, if the client is a retail client, the broker-dealer would be required under the NASDR Rules of Conduct to obtain information relating to the customer’s financial status, tax status, investment objectives, and any other information the broker-dealer considers reasonable in order to determine the suitability of the transaction. Though a broker-dealer may additionally find some of the information in the Committee’s list to be relevant, to the extent it is not expressly required by the NASDR, we recommend that it not expressly be required by the Committee. In the event the nature of the client or the nature of the transaction would result in the NASDR requiring additional information from the customer (e.g., when the broker-dealer recommends an options transaction), we would not oppose the Committee also imposing a more extensive requirement, so long as such requirement was identical to that of the NASDR.

We note that Subsection 2(a) fails to address those situations in which a customer "regularly relies" on another person in making investment decisions. 19 Based upon the manner in which the proposal defines the term "customer", this omission raises several issues in complying with Subsection 2(a). For example, whose investment objectives are relevant -- the consultant’s or the "customer’s"? Whose investment experience is relevant -- the consultant’s or the "customer’s"? What is the appropriate response to Item (11) in such situations?20 Similar questions needs to be considered with respect to each item listed in this subsection. In this regard, we also note that the Committee’s proposal fails to consider

the weight to be afforded the various "relevant facts" listed in Section 2(a). For example, where an investor authorizes its broker-dealer to exercise investment discretion over the investor's brokerage account, it would seem the investor's investment experience is irrelevant to determining the suitability of trades made on the investor's behalf. 21 Nonetheless, in such instances the proposal would seem to require the broker-dealer to inquire about the investor's experience. 22

Finally, we note that the Committee's proposal fails to address significant issues such as: how this list is to be applied to institutions; how often must the information be updated; and, the consequence of an investor electing not to provide such information.

2. Essential Facts

The Institute requests that the Committee provide clarification as to what is meant by the "nature" of the transaction (Item 2(b)(1)) and the "consequences associated with disposing of any customer assets" (Item 2(b)(3)). We also note that in the Commentary accompanying this provision, the Committee states that "the proposal is based on repeated NASD Notices to Members ('NTM')." Cited in a footnote to this explanation are NTMs relating to speculative and low-priced securities, speculative securities, and mutual funds. And yet, the Committee's proposal would impose the duty to obtain such essential facts on all broker-dealers, not just those required by the NASDR to obtain such facts.

3. The Customer's Understanding

Subsection 2(c) of the Committee's proposal attempts to incorporate an "implied" provision from the NASDR Rules of Conduct that requires a broker-dealer to determine the customer's understanding of certain features and risks of the recommended transaction. We question, however, how a broker-dealer is expected to demonstrate compliance with this provision—in the view of the Committee, will it suffice to obtain a standardized written statement from the customer affirming the customer's understanding? If not, what more would be required? We are concerned that any trade that loses money, will, in hindsight, be a trade the investor did not understand. Robert Citron is an example of an investor that has professed complete ignorance of his trading strategy as soon as it began to lose money. In conducting an examination to ensure compliance with the proposed rule, how would the Committee expect a broker-dealer to demonstrate the appropriateness of its conduct and defend itself against such disclaimers? Also, is it necessary that an investor understand each and every trade in its account, or rather the overall trading strategy?

Finally, we note that the Committee's Commentary states that the provision in Item 2(c)(3), which would require a broker-dealer to determine that the customer understands the financial benefits to the broker-dealer of the recommended transaction, "is added to incorporate the commands of existing anti-fraud and agency law. Omitting to state material facts that undermine the basis for the recommendation constitutes a fraudulent practice under state and federal securities laws where the omitted facts are likely to have 'actual significance' to the decision making of the potential investor." It appears, however, that the Committee is implying that any financial benefit to the broker-dealer recommending the transaction undermines the basis for the transaction. We believe this is an erroneous implication and one, therefore, that should not be codified. Also, if the conduct the Committee attempts to proscribe through this provision is already recognized as fraudulent and therefore sanctionable under state and federal securities law, why is it being included as a dishonest or unethical practice? The Institute is concerned that, rather than codifying existing law, the Committee is inappropriately attempting to convert behavior that is lawful

under current law into an unethical practice. We recommend that the Committee delete this provision and rely upon current state and federal antifraud law to sanction broker-dealers who violate such laws by placing their own pecuniary interest above those of their clients.

C. Duty to Warn of Unsuitable Transactions

As discussed previously, the Institute strongly opposes inclusion of this provision because we believe it is inappropriate and contrary to existing securities laws. In addition to our express policy concerns, we have concerns with the specifics of the provision. For example, the scope of the broker-dealer's duty under this provision is unclear. What does it mean for a broker-dealer to have "reason to know" that a particular transaction is unsuitable? Does this mean that a telephone representative of a mutual fund complex will be held to have constructive knowledge of every piece of information that his or her firm may have with respect to the particular investor? What onus does this place on a broker-dealer with respect to existing customers who opt to make their own investment decisions?23 We are quite concerned that this provision may be construed to impute to a broker-dealer knowledge of its affiliates and thereby impose an affirmative duty on the broker-dealer to elicit information from other persons (e.g., advisory affiliates) that may be unconnected to the immediate unsolicited transaction. Such imputation would be inappropriate because (1) in the course of the customer placing the order it may be difficult and burdensome for the broker-dealer to determine who has relevant information and to gain access to it, and (2) the broker-dealer should be able to rely upon the client to make its own investment decision if the client has not asked for the broker-dealer's input into the decision. In fact, the customer may consider the broker-dealer's input in such situations to be intrusive, patronizing, and offensive. Additionally, as discussed above, we are concerned about the potential liability that broker-dealers and investment advisers may be subjected to under this provision .

* * *

Needless to say, the Institute has very serious concerns with the current form of the Committee's proposal. As noted above, we believe that it should be revised to exclude investment company securities from its ambit. More generally, while we understand the concerns of the Committee with being able to appropriately and effectively redress unsuitable recommendations, the Committee should not subject broker-dealers to requirements that so far exceed those necessary to ensure the protection of the public that they disserve the public. We also strongly recommend that before proceeding further with its proposal, the Committee make arrangements to meet with representatives of the securities industry to discuss in detail its proposal and the consequences that are logically expected to flow from it.

We appreciate having the opportunity to provide the Committee these comments. If you have any questions or would like any additional information concerning these comments, please contact me at 202/326-5825.

Sincerely,

Tamara Cain Reed
Associate Counsel

Attachment

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 See Item 1(a) of "Dishonest or Unethical Business Practices", as adopted by the NASAA membership on April 23, 1983. This item provides that it shall be a grounds for denial, suspension, or revocation of a broker-dealer's state registration, or such other action authorized by statute, for a broker-dealer to recommend "to a customer the purchase, sale or exchange of any security without reasonable grounds to believe that such transaction or recommendation is suitable for the customer based upon reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other relevant information known by the broker-dealer."

3 Unless the context indicates otherwise, the use of the term "broker-dealer" in this letter is intended to include broker-dealers, issuer-dealers involved in the offer and sale of their securities to the investing public, and representatives of such broker-dealers and issuer-dealers.

4 See Attachment I to this letter for some examples of the additional information required of broker-dealers effecting more speculative transactions.

5 See Subsection 2(d) of the Committee's proposal.

6 The Institute strongly supports the Committee's carve-out for money market mutual funds, which corresponds to a similar carve-out under the NASDR Rules of Conduct.

7 To assist broker-dealers in fulfilling their suitability obligations, the Rule mentions various factors to be considered by the broker-dealer in order to determine the customer's capacity to evaluate investment risk independently and the extent to which the investor is exercising independent judgment.

8 The NASDR's Rule of Conduct additionally requires consideration of the client's tax status. See Rule of Conduct 2310.

9 As mentioned above, this list of eleven items appears to be derived in large part from requirements imposed by the NASDR in connection with recommending risky transactions such as options.

10 As previously noted, according to the Commentary to the proposal, the Committee's proposal was, in part, motivated by a determination "that a new Suitability Rule must clearly list virtually all the elements of the suitability standard."

11 See NASDR Rule of Conduct IM-2310-3.

12 This is but one of countless scenarios demonstrating the inappropriateness of requiring a broker-dealer to obtain all the information that would be required by the proposal prior to recommending any security to a customer.

13 Similarly, in such circumstances we do not believe the broker-dealer should have any duty under Subsection 2(c) of the Committee's proposal to determine the "consequences associated with disposing of [the customer's] assets" or under Subsection 2(d) to warn the investor that the decision to invest in bonds is unsuitable.

14 The Committee's proposal also fails to recognize that under the NASDR's registration requirements for broker-dealer representatives, the representatives of a discount broker may be registered in an "order taker" capacity, which would preclude such representative from making the disclosure the Committee proposes to require.

15 As previously discussed, we believe it likely that, notwithstanding the interest of the Committee in protecting investors, some investors will find these requests intrusive and will elect not to provide the information requested.

16 See SEC Release No. 34-37850 (October 25, 1996). As proposed, the rule would be amended to provide in relevant part as follows:

(16)(ii) Each account form shall contain the following information:
(A) For natural persons, the customer's name, Social Security number (or other identifying tax number), address and telephone number, age, marital status and number of dependents, educational level, employment status including occupation and employer's name, annual income , and net worth (excluding value of primary residence). In the case of a joint account, such information shall be included for each individual on the joint account.

(B) For customer other than natural persons, the name of the entity, its address, telephone number, Internal Revenue Service employer identification number, and the name and telephone number of the individual or individuals at that entity authorized to effect securities transactions in that account.

(C) A designation of the customer's investment objective(s), from a list of objectives that shall include a definition of each category of objectives in simple language. . . The investment objectives on customer account forms shall be designated upon opening a new account and updated, if required, on an annual basis thereafter.

(iii) The neglect, refusal, or inability of a customer to provide the required information for such customer's account form shall excuse a member, broker or dealer from obtaining such required information, provided that the member, broker or dealer maintains a written memorandum of such customer's neglect, refusal, or inability to provide the required information.

This proposal remains pending.

17 Because of the absence of a savings clause in NSMIA's amendments to the Securities Exchange Act of 1934, the fact that the Committee characterizes its proposal as a dishonest or unethical practice rather than a recordkeeping requirement does not change this analysis. Also, while the Committee has stated that its proposal does not expressly require the maintenance of customer account information, a broker-dealer may be found to have violated the proposed rule if it fails to "obtain" the information. The amendments to Section 15(h) prohibit states from requiring broker-dealers to make any record not required under federal law. Presumably, under the Committee's proposal, the act of obtaining information would necessitate the recording and maintenance of such information. Otherwise, how could a broker-dealer demonstrate to a state examiner compliance with the

proposal?

18 We also find the phrase "to engage in such conduct" as it appears in this definition to be most confusing because the conduct referred to in the definition is that of a person recommending a transaction -- not the customer. And yet, as the phrase is used in this definition, it appears to be referring to some conduct on the part of the customer. Accordingly, we are unsure of the conduct to which this phrase refers.

19 Similarly, the Committee’s proposal fails to address those situations in which the investor has delegated its decision making responsibilities to the broker-dealer, a consultant, or someone else.

20 As discussed above, the definition of "customer" in the Committee’s proposal includes "consultants, advisers or individuals regularly relied upon by such person in making investment decisions ..." Notwithstanding this, Item (11) in the Committees laundry list of relevant facts requires a broker-dealer to obtain the customer’s "consultants, advisers, or individuals regularly relied upon by the customer in making investment decisions." Because "customer" as used in the proposal includes the persons listed in Item (11), we are uncertain as to the use of the term "customer" in Subsection 2(a) and the information a broker-dealer must obtain pursuant to Item 2(a)(11).

21 The Institute is not currently proffering any revisions to Subsection 2(a) because we believe that the proposed Statement of Policy would have to be rewritten in its entirety in order to properly address our concerns with the fact that the proposal fails to (1) distinguish between retail and institutional customers, (2) tailor the inquiry to the services sought by the customer, and (3) differentiate instances in which a client consults a third person for investment advise from those in which the investor delegates decision-making to a third person.

22 Also, we question how this provision is to be applied in situations in which a parent opens an account on behalf of its minor child. Whose investment objectives, investment experience, risk tolerance, age, income, etc. must be considered in order for the broker-dealer (or investment adviser) to assess the suitability of the transactions recommended?

23 You may recall that practical examples of the inappropriateness of this provision were discussed in detail with the Committee during its April 11, 1997 meeting in Vicksburg, Mississippi.
