The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

April 10, 1997

Comment Letter on 1997 Conference on Federal-State Securities Regulation, April 1997

April 10, 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 Statement of Policy on Mutual Fund Unethical Sales Practices

Dear Ms. Scott:

The Investment Company Institute 1 appreciates your providing us a copy of the Statement of Policy recently proposed by the NASAA Broker-Dealer Sales Practices Committee on "Dishonest or Unethical Business Practices by Broker-Dealers and Agents in Connection with Investment Company Shares" (the "proposed Statement of Policy"). The Institute was very pleased to see that many of the recommendations that we had made in connection with the earlier version of this statement of policy, which were intended to ensure greater conformity with the rules and interpretations of the NASDR, have been incorporated into the current version. Based upon these changes, the Institute is, in large part, supportive of the Committee's proposal. We do, however, recommend a few additional changes.

Because of the nationwide nature of mutual funds sales, it is critical that conduct that is acceptable in one jurisdiction or to one regulatory body not be found by another to be deficient or unacceptable. For this reason, we strongly encourage the Committee to make the few additional changes to its proposed Statement of Policy that are recommended herein to ensure that the adopted version of the Statement substantially conforms to the NASDR's standards. We believe that the NASDR's standards, which are consistently applied throughout the United States, have served investors well and should be accorded great deference by brethren of the NASDR that choose to regulate in the same or similar areas.

Summary

In general, the Committee's proposed Statement of Policy would only apply in situations in which there is a recommendation or solicitation made to purchase or sell a mutual fund (or other investment company product). The Institute believes that limiting the applicability of

the proposed Statement of Policy to such situations is wholly appropriate. We therefore are most concerned about provisions in Sections A and D that would seem to apply to the transaction irrespective of whether it involves a solicitation or recommendation. For the reasons that are discussed in detail below, the Institute recommends that these Sections be revised to limit their applicability to transactions involving a solicitation or recommendation. In addition, the Institute recommends that the Committee revise its proposal to:

Clarify that mutual funds with a 12b-1 fee may be referred to as "no load" if such fee does not exceed 25 basis points (Section A(2));

Only require the disclosure of breakpoints or sales charge discounts if relevant to the transaction (Section A(3));

Delete the provision that seems to discourage diversification of funds and that would make the determination of suitability contingent upon whether an investor owns one or more than one fund (Section (B));

Limit the prohibition about sharing with investors information in dealer-use-only material to instances in which the only source of such information is the dealer-use-only material (Section C(5)); and

Delete the Prospectus portion of the proposal as contrary to the existing securities laws and precedents, or, alternatively, substantially revise it to carefully tailor it to the specific concern discussed by the Committee in its accompanying Analysis—instances in which there is a material discrepancy between the oral representations made to an investor and those contained in the prospectus (Section D).

Each of these recommendations is discussed in detail below.

II. Specific Comments

A. Section A—Sales Load Communications

In the Committee’s previous draft of this proposal, Subsection 1, which governs disclosure of sales charges, was limited to instances in which there was a "solicitation" of the investment company shares. 2 In the current version, "solicitation" has been replaced with "offer or sale." The Institute strongly recommends that Subsection 1 be revised to its previous version and only apply in instances in which there is either a solicitation or a recommendation made.

Securities transactions are typically characterized in one of two ways—solicited or unsolicited. As recognized in the rules and regulations governing the offer and sale of securities, the nature of these transactions differs greatly.3 Broker-dealers effecting solicited transactions or transactions in which they make a recommendation to the client may be required to provide investors more detailed information concerning the transactions and are traditionally required to obtain more detailed information from the client in order to ensure that the transaction is suitable for the client.4 The same onus for providing additional information to and obtaining additional information from an investor is not usually imposed on persons effecting unsolicited transactions or persons not recommending specific transactions (e.g., discount brokers and others who merely process a client’s unsolicited order). By failing to limit its scope to solicited or recommended transactions,

Subsection 1 appears to impose on all persons offering and selling mutual fund shares those duties that traditionally have only been imposed on persons making recommendations or soliciting transactions. We think this is inappropriate and should be corrected by limiting the scope of Subsection 1 to only those instances in which a recommendation is made to a client.

With respect to Subsection 2, which proscribes referring to certain mutual funds as "no load," we find the phrase, ". . . a SEC Rule 12b-1 fee or a service fee which exceeds .25% of average net fund assets per year, . . ." to be ambiguous. In particular, we are concerned that, as drafted, this provision could be read to prohibit referring to any fund with a 12b-1 fee as "no-load." To clarify that such conduct is not proscribed, we recommend that "which" be replaced with "if either fee." Additionally, we recommend that any Analysis accompanying this provision expressly clarify this point.

Subsection 3, which would require disclosure of sales charge discounts, appears to be overly broad. First, it includes in its coverage letters of intent. It is worth noting that letters of intent are not expressly included in the rules of the NASDR governing disclosure of sales charge discounts. They were also not included in the Committee's previous version of this provision. It is our understanding that discounts that may be available through letters of intent are not commonly disclosed in connection with the offer and sale of investment company shares, lest such disclosure be viewed by a customer as subtle pressure to make regular investment company share purchases on an ongoing basis. Consistent with common practice and the rules of the NASDR, we strongly recommend that the reference to letters of intent be deleted from this provision.

Additionally, by use of the phrase "any available sales charge discount," this Subsection could be read to require disclosure of sales charge discounts in instances in which they are not relevant—e.g., instances in which the investment is not close to a breakpoint. Disclosing breakpoints that far exceed the amount being invested is not apt to be relevant information and could even be considered by some investors as a suggestion that they significantly increase their investment. To ensure that this proposal not be read to require such disclosure, we recommend that this Subsection be amended in part as follows:

3. In connection with the offer or sale of investment company shares, failing to disclose to a customer any relevant sales charge discount on the purchase of shares in dollar amounts at or above a breakpoint.

B. Section B—Recommendations

The two provisions under Section B of the proposed Statement of Policy each appear to be superfluous of existing suitability requirements, which are imposed on broker-dealers without regard to the type of security being sold.5 Because we understand that the existing requirements would continue to apply to broker-dealers notwithstanding the proposed Statement of Policy, we believe Section B is unnecessary to protect investors. Additionally, we are concerned that Subsection 1 of Section B, which would prohibit unsuitable diversification among similar funds, could be interpreted as implying that diversifying among fund portfolio managers is bad.6 In fact, this type of diversification may often be in the client's best interest, assuming the investments are otherwise suitable. We are also concerned that Subsection 1 will be subject to varying subjective interpretations by the states as to what specific conduct is proscribed and will, as a result, result in inconsistent conclusions. For example, would states enforcing this provision find two equity funds, each having long-term capital appreciation as their objective, to be considered to have similar

objectives if one only invests in blue-chip U.S. companies and the other in small-cap issuers in emerging markets overseas? We respectfully submit that two different state examiners reviewing this issue may reach conflicting conclusions, thereby leaving broker-dealers and their representatives in a quandary as to what is permitted and what is not. Because of the uncertainty of the exact prohibitions of Subsection 1, we recommend that it be deleted. We believe that in view of existing suitability standards, it is unnecessary and its deletion would have no adverse impact on investors.

C. Section C—Disclosure Statements

Subsections 1-4 of Section C of the proposed Statement of Policy, which would govern disclosure, appear to be consistent with requirements of the NASDR. With respect to Subsection 4, however, the Institute recommends that Paragraph (ii), which relates to disclosure of long-term capital gains, be moved from Subsection 4 to Subsection 1, which would govern disclosure of yield, income, and return.

The Institute is concerned that Subsection 5, which would prohibit making representations to a customer that are based in whole or part on information contained in dealer-use-only material that has not been approved for public distribution is unnecessarily broad. While we agree that it is inappropriate, and inconsistent with the NASDR's requirements, for a dealer to disseminate to the general public dealer-use-only material, there may be substantial ambiguities in applying the proposed provision. For example, if the dealer-use-only material discusses a fund's performance, the provision could be read as prohibiting the dealer's representative from informing clients of this information, even if the representative did not provide a copy of the material to the customer and even if the information were publicly available elsewhere or was consistent, in whole or part, with information that under federal law may be publicly disseminated. The mere inclusion of publicly available information in dealer-use-only material, does not cause it to lose its character as public information.

We strongly recommend that proposed Subsection 5 be amended to prohibit the dissemination of information contained in dealer-use-only material if the only source of the information is the dealer-use-only material and such material has not been approved for public distribution. We believe this approach would fulfill the interest of the Committee in addressing the abuses discussed in the Committee's Analysis of this provision, while, at the same time, make it consistent with the requirements of the NASDR.

D. Section D—Prospectus

According to the Analysis accompanying the proposed Statement of Policy, this Section is intended to ensure that broker-dealers not use the delivery of a prospectus as a safe harbor to protect them from any false or misleading oral representations that were made or implied in connection with an offer or sale of mutual funds. The Institute is most concerned that the Committee, through a rule purporting to govern unethical and dishonest conduct, is attempting to reverse an entire body of case law relating to the significance of prospectus disclosure vis-à-vis oral disclosure or representations. Most recently, the United States Court of Appeals for the Second Circuit held in Oxley et al. v. Hyperion 1999 Term Trust, Inc., 1996 U.S. App LEXIS 26784 (October 15, 1996), held:

Since the plaintiffs' claims are contradicted by the disclosure of risk made on the face of each prospectus, no set of additional facts could prove the plaintiffs' claims. Representations made by the defendants at the roadshows are immaterial since they are contradicted by plain and prominently displayed language in the prospectuses. See Dodds

v. Cigna Sec., Inc., 12 F.3d 346, 351 (2d Cir. 1993) ("Nor can a plaintiff rely on misleading oral statements to establish [a Section 10(b)] unsuitability claim when the offering materials contradict the oral assurances"), cert. denied, 114 S.Ct. 1401 (1994) . . . This court has consistently affirmed Rule 12(b)(6) dismissal of securities claims where risks are disclosed in the prospectus. [Emphasis added.]

As prudently noted by the court in the Hyperion case, "Not every bad investment is the product of misrepresentation." The fact that the Committee may find prospectuses to be written in "impenetrable prose," as stated in the Committee's Analysis of Section D, does not change their significance under existing law.7

The Institute strongly recommends that the Committee delete Section D from its proposal inasmuch as it (1) is contrary to case law governing the relevance of prospectus disclosure vis-à-vis oral representations; (2) will result in conduct that is not fraudulent under the federal securities laws being proscribed under state securities laws; and (3) attempts to convert non-fraudulent conduct into deceitful or unethical conduct.

Should the Committee disagree with our recommendation, we would additionally point out that the Section D, as proposed, makes no distinction between solicited (or recommended) transactions and unsolicited ones. For the reasons previously discussed under Section A, we believe this distinction is very relevant and should be taken into consideration in the proposal. It is quite possible that no oral representations are made in connection with a mutual fund transaction, for example, when shares are purchased through a discount broker. Notwithstanding this, pursuant to Section D a broker-dealer could be found to have engaged in unethical conduct by failing to gratuitously volunteer to the client information required by the provisions in the proposed Statement of Policy.8 Moreover, the proposal's failure to recognize the varying distribution channels of mutual fund shares may disserve investors by requiring they receive oral information (which they may liken to a sales presentation) in which they have no interest.9 It may also unduly burden sellers of mutual funds who are required to provide such information.10

Finally, as stated above, according to the Analysis accompanying this proposal, it was intended to address situations in which oral representations made in connection with a sale of investment company shares were false and misleading and not consistent with disclosure in the prospectus. While this may have been the intent of this provision, it does not appear to be what provision proscribes. In fact, there is no mention in Section D of any false or misleading statements made in connection with the offer or sale. Instead, Section D provides that delivery of the prospectus shall not be dispositive that the broker-dealer "has fulfilled the duties set forth" in the proposed Statement of Policy. As a result, the applicability of this provision is not limited to instances in which there is a discrepancy between any oral statements made by the broker-dealer and the printed prospectus delivered by the issuer. If the Committee's goal is to ensure the consistency between the spoken and printed word, we believe the proposal goes far beyond the goal. Should the Committee determine not to delete this provision, to remedy our additional concerns with it we recommend that Section D be rewritten to address only those instances with which the Committee expressed concern—i.e., where an oral representation is made that is materially different from information printed in a prospectus. Towards this end, we offer the following for the Committee's consideration:

E. Prospectus

In the event there is a material difference between the information appearing in a

prospectus and any oral representations made by the broker-dealer or its agent in connection with the offer or sale of investment company shares, the delivery of a prospectus, in and of itself, shall not be dispositive of whether the broker-dealer or its agent provided the investor full and fair disclosure of all material facts in connection with such offer or sale.

The Institute appreciates your consideration of these comments. I understand that this proposal will be discussed during the Committee's upcoming meeting in Vicksburg on April 11th. I have made arrangements to attend that meeting and will be happy to address any questions at that time. In the meantime, however, if the Committee has any questions regarding our comments our would like any additional information, please do not hesitate to contact me at 202/326-5825.

Sincerely,

Tamara Cain Reed
Associate Counsel

NOTES

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 Subsection A.1. of the current draft appeared as Subsection l in the previous Committee draft.

3 We note that, where relevant, other provisions within the proposed Statement of Policy are limited to situations in which a recommendation is made.

4 See, e.g., NASDR Rule of Conduct 2310, which requires broker-dealers making a recommendation to a client to obtain information in order to determine whether the transaction is suitable for the client.

5 See Paragraph 1.c. of NASAA's "Dishonest or Unethical Business Practices" (April 23, 1983), which provides that it is contrary to high standards of commercial honor for a broker-dealer to recommend to a customer "the purchase, sale or exchange of a security without reasonable grounds to believe that the recommendation is suitable . . ."

6 We are unclear as to what specific unethical conduct the Committee is trying to proscribe by this provision. For instance, if each of several mutual fund investments owned by an investor is suitable for the investor, is it the view of the Committee that this provision could be read to reach a different conclusion as to suitability when the investor's mutual funds holdings are viewed collectively, and, if so, on what basis? If the Committee determines not to delete this provision, we recommend that this issue be expressly clarified.

7 Also, in its Analysis of this provision the Committee states that "Brokers and agents assert that the printed word should override direct oral statements." We recommend that this note also disclose that such assertions have been consistently upheld by courts of law.

8 For example, assume a discount broker-dealer receives an unsolicited order to purchase a mutual fund, the mutual fund is sold to the client with no substantive discussion between the dealer’s representative and the client about the fund’s features, including sales charges, and the client receives a prospectus along with the confirmation, which explains in detail the various sales charges. While this is a perfectly lawful sequence of events, under the proposed Statement of Policy the dealer could be found by a state regulator to have engaged in an unethical practice for failing to discuss in detail the sales charges, even though the transaction was unsolicited and placed through a discount broker and notwithstanding that all material disclosure was contained in the prospectus provided to the client.

9 From the perspective of a customer who has chosen to utilize the services of a discount broker, the information required by the proposed Statement of Policy to be provided could be viewed as an unwelcome intrusion into the investor’s investment decision.

10 In fact, the proposed Statement of Policy may have unintended consequences for certain broker-dealers (e.g., discount broker-dealers) and any representatives licensed as "order takers." For example, if the order taker provides the disclosure required by Section A, which as proposed must be provided in connection with every offer or sale, and the investor has questions about the information, the order taker may not be qualified (registered) to answer such questions. Alternatively, if upon the receipt of such disclosure the investor chooses not to purchase the particular fund and instead inquires about other funds, the order taker may not be qualified in a capacity that would permit it to provide such information.
