The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

July 5, 2001

Comment Letter on NASDR Rule Modernization Proposal, July 2001

July 2, 2001

Ms. Barbara Z. Sweeney
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, N.W.
Washington, DC 20006-1500

Re: Special NASD Notice 01-35—Request for Comment

Dear Ms. Sweeney:

The Investment Company Institute 1 welcomes the opportunity to respond to Special NASD Notice to Members 01-35—Request for Comment. The Request for Comment is a continuation of a 1998 NASD Regulation review of NASD rules to determine whether any NASD rules or by-laws: (1) should be repealed because they are obsolete or otherwise unnecessary; (2) should be modernized in light of technological or industry developments; or (3) should distinguish between retail and institutional customers in their application. In particular, in its recent notice, NASD Regulation has asked all interested parties to suggest rules that should be the focus of its review, to include specific explanations of the burdens imposed by a rule, and to provide specific comments about ways that consumer protection can be assured through alternative regulatory approaches.

In response to the 1998 NASDR review, the Institute submitted a comprehensive comment letter that described the Institute's general recommendations, which related to differentiation between institutional and retail customers, mutual fund prospectus disclosure, and the NASD rulemaking process.2 The letter further discussed our specific recommendations for changes in the areas of: advertising and sales literature; confirmations; forwarding proxy materials; the corporate financing rule; selling concessions; and cash compensation.

Since we filed the 98-81 Comment Letter, NASDR has taken action on some, but not all, of our recommendations. The balance of this letter will update and supplement our previous comments.

I. General Recommendations

A. Differentiation Between Institutional and Retail Customers

Our 98-81 Comment Letter supported the concept of differentiating between retail and institutional investors under NASD rules, and suggested specific advertising rules under which such differentiation would be warranted. We were pleased that amendments to the NASD's advertising rules proposed in 1999 reflected many of our suggestions, and we submitted a comment letter that included additional recommendations that we believe would further improve the effectiveness of the advertising rules and facilitate members' compliance.3 The status of our specific 1998 recommendations is discussed in Section II.A of this letter, below.

B. Mutual Fund Prospectus Disclosure Requirements

The Institute continues to maintain that the NASD should refrain from adopting rules that have the practical effect of requiring disclosure to be made in mutual fund prospectuses. Although the NASD does not regulate mutual funds directly, several NASD rules condition NASD members' ability to engage in certain activities involving funds on the existence of related fund prospectus disclosure.4 The Institute believes that the Securities and Exchange Commission should be the exclusive source of fund prospectus disclosure requirements, and that the NASD should not issue rules in this area. To the extent that the NASD determines that additional disclosure might be necessary, the NASD should recommend such changes to the SEC rather than impose such changes through NASD rules.

C. The Rulemaking Process

Our 98-81 Comment Letter also recommended that the NASD work with the SEC to consider ways to improve the usefulness of information contained in SEC releases seeking public comment on NASD rule proposals. In addition, to facilitate efforts to provide detailed, substantive and well-considered comments on significant NASD proposals, we proposed that the NASD recommend, and the SEC provide, comment periods that are longer than 21 days.

Unfortunately, since we filed our 98-81 Comment Letter, inadequate comment periods have continued to be a problem. For example, after a several-year effort on the part of market participants to develop the Nasdaq Order Display Facility (SuperMontage) proposal, these same participants (and other interested persons) were afforded only 21 days to comment upon the actual proposal in 1999.

Moreover, earlier this year, the SEC proposed a new rule, Rule 19b-6, which would amend the requirements applicable to self-regulatory organization ("SRO") filings of proposed rule changes with the SEC.5 As noted in our comment letter to the SEC,6 we have serious reservations regarding several aspects of the proposed rule, including the new category of rules eligible for immediate effectiveness. In addition, we were extremely disappointed that the SEC left untouched the 21-day comment period concerning SRO proposed rule changes.

We continue to urge the NASD to work with the SEC to provide reasonable comment periods in order to insure that interested parties have the opportunity to develop and submit detailed, substantive and well-considered comments. Such comments serve to assist the NASD, on a prospective basis, in assessing the burdens and benefits that would result from proposed rules.

II. Specific Recommendations

A. Advertising and Sales Literature (Rule 2210)

Our 98-81 Comment Letter contained several recommendations concerning changes to NASDR rules governing communications with the public. We were pleased that NASDR in Request for Comment 99-79 proposed certain amendments to these rules that reflected many of our suggestions. These proposed amendments would: (1) differentiate between retail and institutional customers; (2) eliminate the pre-use and filing requirements applicable to sales material sent only to institutional investors; (3) exclude from the filing requirements press releases concerning investment companies that are made available only to members of the media; (4) eliminate the current specific standards applicable to recruiting advertisements; (5) simplify the provisions concerning disclosure of member names; and (6) treat form letters (and group e-mail) sent to existing retail customers and fewer than 25 prospective retail customers as correspondence subject to supervisory and review requirements, rather than as advertisements.7

The proposal, however, did not include other changes recommended by the Institute. For example, NASDR did not propose to allow the electronic filing of sales material, citing possible regulatory and technological constraints. In addition, the NASDR did not propose, but requested further comment upon, exempting from the filing requirements shareholder reports and "generic" advertising under Rule 135a, and eliminating the current requirement to file backup material supporting mutual fund rankings to the extent this information is readily available to NASDR staff.

For the reasons set forth in full in its 98-81 and 99-79 Comment Letters, the Institute continues to believe that implementation of these remaining recommendations would further improve the effectiveness of the advertising rules and facilitate members' compliance. The accommodation of electronic filing would also enhance the efficiency and quality of the review function.

B. Confirmations (Rule 2230)

NASD Conduct Rule 2230 requires that NASD members provide written notification of specified information to customers at or before the completion of transactions with customers. In 1999, we recommended the repeal of this rule, because it overlaps with, and duplicates in part, the confirmation requirements set forth in Rule 10b-10 under the Securities Exchange Act of 1934. No action has been taken concerning this recommendation.

Rule 2230 is a perfect example of a rule that should be repealed because it is unnecessary. The rule does not provide any investor protection beyond that already provided by Rule 10b-10. The fact that it is not identical to Rule 10b-10, however, creates a potential for confusion. Such confusion may impose unnecessary burdens upon NASD members and NASD staff. For these reasons, we continue to believe that NASDR should repeal Rule 2230.

C. Forwarding Proxy Materials (Rule 2260)

The Institute also recommended an amendment to Rule 2260 to expand the categories of persons to whom NASD members may forward proxy and other materials, noting that this change would allow such materials to be provided to authorized persons in a more timely and less costly manner. Under the current regulatory regime, the member in many instances must send these materials to an investment adviser, even though the beneficial owner has designated a proxy voting service or other person to vote on its behalf. In its

current form, therefore, the rule imposes a burdensome two-step process that unnecessarily delays the authorized voter’s receipt of proxy materials. No action has been taken concerning this recommendation.

In order to assure that the appropriate entity receives these materials in a more timely and cost-efficient manner, we urge NASDR to amend Rule 2260 in order to accommodate arrangements in which materials are sent to an entity other than the beneficial owner or his or her "designated investment adviser." Specifically, we recommend, as one possible approach, rule language that would provide that a member may forward materials to the beneficial owner, the beneficial owner’s designated investment adviser or any other recipient designated by the beneficial owner.

D. Corporate Financing Rule (Rule 2710)

NASD Conduct Rule 2710 contains filing and review requirements designed to allow the NASD to evaluate underwriting terms and arrangements associated with public offerings of securities. In our 98-81 Comment Letter, we recommended that certain closed-end investment companies be extended the same exemption from these requirements applicable to open-end investment companies, in light of the similarities in their distribution and compensation arrangements.

NASDR amended Conduct Rule 2710, effective June 20, 2000, to exempt closed-end funds that make periodic repurchase offers pursuant to Rule 23c-3(b) under the Investment Company Act and offer their shares on a continuous basis pursuant to Rule 415(a)(1)(xi) under the Securities Act of 1933. Although the Institute supported these changes, we do not believe that the amended rule goes far enough in two respects. As described in detail in the comment letter that we filed when these changes were proposed,8 NASDR should extend the exemption to (1) funds that make periodic self-tenders in compliance with Rule 13e-4 and Schedule 13E-4 under the Securities Exchange Act of 1934 ("tender offer funds"); and (2) interval funds that offer their shares on a delayed basis pursuant to Rule 415(a)(1)(xi). The expansion of this exemption would eliminate unnecessary filings by these funds and allow NASDR staff to focus upon those issuers whose distribution and compensation arrangements truly require review.

E. Selling Concessions (Rule 2740)

NASD Conduct Rule 2740 generally prohibits NASD members, in connection with the sale of securities that are part of a fixed price offering, from granting selling concessions or discounts to anyone other than a broker or dealer engaged in the investment banking or securities business. This rule bars registered investment companies and other large volume purchasers from receiving any concessions or discounts in a fixed price initial public offering. In our 98-81 Comment Letter, we suggested that NASDR revise (or interpret) Rule 2740 to permit NASD members to offer discounts on large purchases of securities through scheduled breakpoints in the stated public offering price.

To date, no action has been taken concerning this recommendation. The Institute urges NASDR to take action on this proposal, which would benefit mutual funds and their shareholders, as well as other large purchasers of securities in fixed price offerings, in recognition that the relative costs associated with large purchases of securities are lower than those of small purchases.

F. Cash Compensation (Rule 2830)

In our 98-81 Comment Letter, we recommended that NASDR continue to pursue a

disclosure approach to regulating cash compensation paid to broker-dealer firms. More specifically, under our proposal, fund prospectuses would include general disclosure about cash compensation arrangements and broker-dealer firms would provide general written disclosure about cash compensation arrangements to investors before or when they purchase fund shares. Although we urged NASDR to move forward on this matter, subsequent developments dictate that NASDR should await possible SEC action that might eliminate the need for an NASD requirement in this area.

Specifically, last year, the SEC filed an amicus brief with the United States Court of Appeals for the Second Circuit in two cases. In its brief, the SEC addressed the issue of whether disclosures made about payments that the defendant broker-dealers received from investment advisers to money market funds in which the broker-dealers invested their customers' money (cash compensation), complied with Rule 10b-10 under the Exchange Act. The SEC concluded that the payments were subject to disclosure under Rule 10b-10. While the disclosures made in these cases were deemed sufficient, the SEC noted that it had directed its staff to make recommendations as to whether additional disclosure should be required or current disclosure further refined.

The Institute has since urged the SEC staff to propose amendments to Rule 10b-10 to clarify the nature and location of disclosure of cash compensation payments required by the rule. 9 We suggest that NASDR refrain from further action regarding cash compensation until such time as the SEC amends Rule 10b-10. If the SEC amends Rule 10b-10 in the manner we recommended, the NASD's current requirement for disclosure of cash compensation (set forth in Conduct Rule 2830(l)(4)) will no longer be needed and should be withdrawn.

* * *

The Institute appreciates the opportunity once again to provide its views on NASD rules that should be repealed, modernized or otherwise improved. We support NASDR's efforts to estimate the burdens of certain rules and evaluate the benefits of such rules so as to identify those that should be changed or eliminated, and we stand ready to provide any further information that would aid in your analysis. If you have questions about our comments, you may contact me at (202) 371-5432, or Frances Stadler at (202) 326-5822.

Sincerely,

Kathy D. Ireland
Associate Counsel

Enclosure

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ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,598 open-end investment companies ("mutual funds"), 504 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.991 trillion, accounting for approximately 95% of total industry assets, and over 83.5 million individual shareholders.

2 See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Ms. Joan Conley, Secretary, NASD Regulation, Inc., dated February 12, 1999 (commenting on NASDR Request for Comment 98-81) ("98-81 Comment Letter") (copy enclosed).

3 See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Ms. Joan Conley, Secretary, NASD Regulation, Inc., dated October 29, 1999 (commenting on NASDR Request for Comment 99-79) ("99-79 Comment Letter").

4 See, e.g., NASD Conduct Rule 2830(l)(4).

5 Securities Exchange Act Release No. 43860 (January 19, 2001), 66 Fed. Reg. 8912 (February 5, 2001).

6 See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated April 6, 2001.

7 For our specific comments on these proposed rule amendments, see 99-79 Comment Letter. We continue to urge NASDR and the SEC to expedite the adoption of these proposals.

8 See Letter from Kathy D. Ireland, Associate Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated April 27, 2000.

9 See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Annette L. Nazareth, Director, Division of Market Regulation, and Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission, dated May 8, 2000.
