

## COMMENT LETTER

December 24, 2010

# ICI Files Comment Letter with FINRA on FINRA's Disclosure Document Proposal (pdf)

December 24, 2010 Ms. Marcia E. Asquith Office of the Corporate Secretary FINRA 1735 K Street, NW Washington, DC 20006-1506 Re: Proposed FINRA Disclosure Document Dear Ms. Asquith: The Investment Company Institute<sup>1</sup> appreciates the opportunity to comment on FINRA's "Concept Proposal to Require a Disclosure Statement for Retail Investors at or Before Commencing a Business Relationship."<sup>2</sup> The Institute has long supported disclosure that would provide investors with meaningful information regarding investment products and professionals and we encourage FINRA to pursue rulemaking in this area. Because of the variety of issues such a rulemaking would raise, we also commend FINRA for seeking views on its proposal prior to drafting rule language. As discussed in more detail below, while we support FINRA's initiative, we recommend that FINRA appropriately tailor the rulemaking to situations in which the contemplated disclosure will be meaningful to investors. To avoid imposing disclosure requirements that provide investors more, but not more meaningful, disclosure, FINRA's rule should recognize differences among FINRA's variety of members and provide an exception or exemption where, because of the nature of the FINRA member's business and its interaction with retail customers, the disclosure document would not enhance the investor's knowledge of the broker-dealer and its products, services, fees, and conflicts of interest. For the reasons explained in detail below, principal underwriters of mutual funds are a prime example of

1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$12.33 trillion and serve over 90 million shareholders.

2 See FINRA Regulatory Notice No. 10-54 (October 2010) (the "FINRA Notice"). Ms. Marcia E. Asquith December 24, 2010 Page 2 FINRA members that should be excluded or exempted from the contemplated disclosure requirements.

3 I. PRINCIPAL UNDERWRITERS OF MUTUAL FUNDS A. Differences Between Mutual Fund Underwriters and Retail Broker-Dealers Principal underwriters of mutual funds differ significantly from retail broker-dealers in many respects. Unlike retail broker-dealers that are hired by an investor and compete with one another for business based on their product lines, services, fees, and experience, mutual fund underwriters are not retained as financial professionals by retail investors, nor do they compete with one another for retail business.

4 Unlike retail broker-dealers, mutual fund underwriters typically do not have their own websites. Instead, communications regarding the mutual funds and how to purchase and sell shares through

the fund's underwriter are typically available on the fund's website. Also, mutual fund underwriters do not offer investors a variety of different products and services, nor do they have different account or service fees as contemplated by FINRA's proposal. Indeed, as discussed in more detail below, much of the information that would be required to be disclosed in the document is wholly irrelevant to the business of the mutual fund underwriter, though it would be relevant to an investor interacting with a retail broker-dealer. There are several instances in which current law recognizes and accommodates how very different the underwriter's business is from the retail distributor's business. For example, mutual fund underwriters have lower net capital requirements than retail distributors,<sup>5</sup> they are not required to be members of the Securities Investor Protection Corporation (SIPC),<sup>6</sup> and they are not required to include settlement dates on their confirmations.<sup>7</sup> Also, mutual fund underwriters are subject to very rigorous pricing rules under the Investment Company Act that are not imposed on retail broker-dealers. So, unlike retail broker-dealers, it is likely that mutual fund underwriters' processing systems and protocols would be adversely impacted by the document's proposed delivery requirements. For these reasons, and the reasons discussed below, we strongly recommend that FINRA exclude or exempt <sup>3</sup> While there may be other classes of FINRA members that warrant a similar exclusion or exemption, our comments are limited to FINRA's members that hold retail customer accounts and whose business is limited to that of a mutual fund underwriter. <sup>4</sup> Mutual fund underwriters do not advertise their services to retail customers. In fact, an investor interacting with the fund's underwriter likely does not even know that the underwriter is a separate legal entity from the mutual fund. <sup>5</sup> The net capital requirement for a mutual fund principal underwriter is \$5000. A retail distributor of mutual funds must have net capital of at least \$250,000. <sup>6</sup> See Section 3(a)(2)(4)(ii) of the Securities Investor Protection Act. <sup>7</sup> See FINRA Rule 2232. Ms. Marcia E. Asquith December 24, 2010 Page 3 from the proposed disclosure requirements any mutual fund underwriter whose business consists exclusively of distributing mutual fund shares. <sup>8</sup> B. Retail Accounts Held by Mutual Fund Underwriters A retail investor opening an account with a mutual fund's underwriter has already determined, without reliance on the underwriter's advice or recommendation, which funds to purchase. To the investor, the account is being opened and maintained with the fund<sup>9</sup> and all relevant information about the fund and its underwriter (and other service providers) is provided to the investor in the fund's prospectus. Generally speaking, a shareholder's account may be maintained by a mutual fund's principal underwriter because: (1) the customer contacted the underwriter directly to purchase shares; (2) a broker-dealer that opened the account has abandoned the account and the account was subsequently transferred to the books and records of the fund's underwriter; or (3) the customer obtained an application from a retail broker-dealer to open a mutual fund account and mailed the application directly to the underwriter with a check (known as a "check and application" account) rather than submitting the application through the broker-dealer. The unique nature of the underwriters' business warrants an exclusion or exemption from the proposed disclosure requirements. To the extent that FINRA does not exclude or exempt mutual fund underwriters from having to deliver the disclosure document, this unique nature couple with the underwriter's relationship with the account holder will present challenges in connection with the document's delivery, which would need to be addressed as part of FINRA's rulemaking. FINRA should ensure, in resolving these challenges, that the timing of the document's delivery is both realistic and not disruptive to existing, long-standing processing protocols used by mutual fund underwriters. It should also ensure that delivery of the document does not delay or inconvenience the account opening process or run afoul of provisions regarding the processing of customer transactions, as discussed in more detail below. <sup>1</sup> An Investor Who Opens an Account Directly with the Fund's Underwriter An investor may deal directly with a

mutual fund's underwriter when the fund distributes its own shares. In such instances, in order to purchase a fund's shares, the customer would initiate contact with the fund and interact with the fund's underwriter<sup>10</sup> by phone, mail, or on-line to open an account. 8 FINRA should also clarify, in connection with mutual fund underwriters, that the disclosure would not apply to those underwriters that do not hold customer accounts. 9 As noted above, in such situations, the investor believes it is contacting "the fund" and is likely unaware of the separate legal entity – principal underwriter or transfer agent – that is opening the account and processing the investor's unsolicited transactions. 10 It is not uncommon for investors to contact the fund's transfer agent rather than the underwriter. Obviously FINRA's disclosure document would not apply to transfer agents and other entities that are not FINRA members; nor would it apply to principal underwriters that do not have retail customers. Ms. Marcia E. Asquith December 24, 2010 Page 4 and effect transactions. With such direct accounts, it may be impossible for the fund's underwriter to deliver the disclosure document prior to or at the time of commencing a business relationship with the customer without inconveniencing the customer or adversely impacting account processing systems. 2. Orphaned Accounts Orphaned accounts are mutual fund accounts that were originally opened on the broker-dealer's books and records but that, at some point in time, were transferred to the mutual fund whose shares are held in the account. This might occur because the broker-dealer determines that it is no longer willing or able to support the account. When the account is transferred to the mutual fund, the fund either opens or re-registers the account in the name of the investor and maintains the account either without a broker-dealer of record or with the mutual fund's underwriter as the default broker-dealer of record. Aside from ensuring compliance with legal requirements – e.g., sending out account statements, annual reports, tax reports, reinvesting dividends (if applicable), and the like – the fund and the underwriter do not proactively engage with the customer regarding the account. As with the directly-held accounts discussed above, requiring delivery of the disclosure document when the orphaned account is transferred to the underwriter's books and records could adversely impact the investor or run afoul of the underwriter's processing requirements.<sup>11</sup> 3. The "Check and Application" Account A "check and application" account results from a customer of a broker-dealer obtaining the forms necessary to open a mutual fund account from a retail broker-dealer and transmitting them directly to the underwriter (or the fund's transfer agent). Because the forms were distributed by the broker-dealer and contain identifying information about the broker-dealer, when the mutual fund opens the account, it records the investor as a customer of the broker-dealer and pays any sales compensation due to the broker-dealer.<sup>12</sup> Because the account holder is a customer of the broker-dealer being compensated for the account, we presume that the underwriter maintaining the account would have no obligation to deliver the proposed disclosure document. Instead, this obligation should be placed on the broker-dealer distributing mutual fund applications because the investor obtained the account application from the broker-dealer, the broker-dealer is being compensated by the mutual fund for the trade, and it is the retail broker-dealer – not the mutual fund's underwriter – that may have conflicts of interest or be incentivized by compensation arrangements to have recommended or offered 11 In light of the distinctive circumstances associated with these accounts, even if mutual fund underwriters are not excluded or exempted from the rule, their orphaned accounts should be excluded or exempted. 12 This situation differs from funds that distribute their shares directly to the investing public in that directly-distributed funds do not have a retail broker-dealer of record on the account and there is no broker-dealer compensated for the accounts. Ms. Marcia E. Asquith December 24, 2010 Page 5 one fund (or one fund's application) over another. FINRA's proposing notice should confirm this is how the rule would work with check and application accounts. C. Disruptions Resulting from

Underwriters' Delivery of the Document In each of the above discussed situations involving the opening of accounts with the mutual fund underwriter, it is likely that the underwriter has no contact with an investor prior to the investor either opening an account to purchase fund shares or prior to the account being orphaned by a retail broker-dealer. As such, it may be difficult for the underwriter to deliver the document when contemplated by FINRA without adversely impacting the investor, disrupting processing systems, or encumbering the underwriter's compliance with the federal securities laws. From an investor's point of view, delaying the account opening to accommodate delivery of the document would likely frustrate the investor who has already determined which funds to buy and through which distribution channel (i.e., from the fund rather than from the retail broker-dealer). From a systems point of view, requiring underwriters to deliver a disclosure document prior to opening the account would be very disruptive to current processing protocols that are designed to comply with regulatory requirements. These regulatory requirements include those provisions of the Investment Company Act of 1940 governing pricing of fund shares<sup>13</sup> and the provisions of the Securities Exchange Act of 1934 governing settlement of transactions<sup>14</sup> and the processing of "as of" transactions.<sup>15</sup> As noted above, unlike mutual fund underwriters, retail broker-dealers would not be impacted by these very rigorous regulatory requirements relating to the pricing of fund shares so presumably the delivery requirements would not disrupt their business. For all of these reasons, we strongly encourage FINRA to exclude or exempt from the proposed disclosure any mutual fund underwriter whose business consists exclusively of distributing mutual fund

13 See Rule 22c-1 under the Investment Company Act of 1940, which requires forward pricing of fund shares. 14 E.g., Rule 15c6-1 under the Securities Exchange Act of 1934, which governs processing of transactions. This rule precludes transactions settling beyond a specified period "unless otherwise expressly agreed to by the parties at the time of the transaction." The nature of a shareholder's interaction with the fund's underwriter would preclude such agreement. Unlike transactions effected with a retail broker-dealer where there is a delay between the trade date and the settlement date, the trade date and settlement date are typically identical for transactions effected with the mutual fund's underwriter. For a discussion of mutual fund settlement dates and how they differ between mutual fund underwriters and retail broker-dealers, see, Letter from the undersigned to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, commenting on FINRA's proposed Rule 2232, relating to customer confirmations (October 9, 2009). 15 "As-of" transaction processing occurs when a fund transaction is processed after its receipt date but "as of" the date required by Rule 22c-1 under the Investment Company Act. These transactions are a by-product of the forward-pricing requirement of Rule 22c-1. Because a mutual fund investor must receive the price next determined after the transaction is received, a delay in processing - as may be occasioned by having to deliver the disclosure document - will result in an as-of transaction. Such transactions may result in a loss to the fund if the price of the fund is lower on the as-of date than on the date the transaction is actually processed. Ms. Marcia E. Asquith December 24, 2010 Page 6 shares. Should FINRA not provide such an exclusion or exemption, its proposal should discuss in detail how the rule's delivery requirements would apply to the business of a mutual fund's principal underwriter in connection with each of the types of accounts discussed above.<sup>16</sup> FINRA should also ensure that any perceived benefit to a mutual fund underwriter's account holder from the disclosure outweighs the foreseeable adverse consequences associated with the document's delivery.

## II. THE DOCUMENT'S CONTENTS

### A. Relevant Information

About a Retail Broker-Dealer Crucial to the document's use and success is that its contents are meaningful to its recipient. To provide investors meaningful information about a FINRA member, FINRA expects the document to include, among other information: the types of brokerage accounts and services provided to customers; the scope of services provided,

products offered, and fees; financial incentives; conflicts of interests; and limitations on the duties the firm owes to its customer. We agree that, for retail broker-dealers, this scope is appropriate because it would capture those issues that are not required to be disclosed today but that an investor may need to know to adequately evaluate such broker-dealer. This information would be important both to those investors considering which competing financial services firm to retain and to those who have a relationship with a FINRA member but may be unaware of this information. We are particularly pleased that FINRA is contemplating including information regarding incentive compensation. Even though differing payout rates or differential compensation may influence a broker-dealer or its representative to recommend one product over another, absent this disclosure, the customer would be unaware of this conflict of interest.<sup>17</sup> The FINRA Notice also contemplates requiring the disclosure document to include information regarding compensation paid in connection with investment company securities. We support this portion of the proposal. To the extent such compensation incentivizes a retail broker-dealer to sell one mutual fund over another, an investor contemplating which mutual fund to purchase should know and consider this information as part of his or her investment decision.

**B. Inapplicability of Information to Mutual Fund Underwriters** While the contemplated content requirements would capture the key information that should be communicated by retail broker-dealers to investors, the vast majority of the proposed contents would be either irrelevant or not meaningful to those mutual fund shareholders who hold accounts.<sup>16</sup> In addition, FINRA should clarify that, for those networked mutual fund accounts in which the customer is viewed under the federal securities laws as a customer of the retail broker-dealer and not the mutual fund, the retail broker-dealer has sole responsibility to deliver the disclosure document.<sup>17</sup> Mutual fund underwriters do not have differential compensation arrangements. Ms. Marcia E. Asquith December 24, 2010 Page 7 directly with the fund's underwriter. Of the eleven items of disclosure described in the FINRA Notice,<sup>18</sup> the only items that may be applicable are: a list of the mutual funds the principal underwriter offers for sale on behalf of a fund complex; that the principal underwriter may be affiliated with those funds; and any fees charged by the underwriter on the shareholder's account (assuming such fees are charged). Unlike other investment products offered by retail broker-dealers, all of this information is currently disclosed to investors either in the mutual fund's prospectus or sales literature.<sup>19</sup> The remaining information in this list – which would be meaningful to investors contemplating opening a brokerage account or purchasing products from a retail broker-dealer (including mutual fund shares) – would not apply in connection with an account at a mutual fund underwriter. Accounts held by the underwriter would not be “brokerage” accounts. There would be no “fees associated with a brokerage account.” The cash/non-cash compensation disclosure would not apply to the principal underwriter since it receives no such compensation. Mutual funds do not pay compensation for referrals, nor do they typically have payouts for employees processing mutual fund transactions.<sup>20</sup> Also, there would be no conflicts of interest between the principal underwriter and the retail client. We are unsure how the “limits on the firm's duty to its customers” would apply, unless it requires the mutual fund's underwriter to disclose to its customers that it only distributes the fund complex's shares and not other securities – which would seem to be meaningless information to an investor who contacts a mutual fund's underwriter to purchase mutual fund shares. Excluding or exempting mutual fund underwriters from FINRA's rule proposal would address our concerns with the irrelevance of the document's contents to the underwriters' account holders. To the extent FINRA does not exclude or exempt mutual fund underwriters, FINRA's proposing notice should explain how the content requirements will apply to such persons. In particular, FINRA needs to detail whether such underwriters will be required to provide a document that is primarily comprised of negative (and meaningless) disclosure for the bulk

of the information items that must be included in the document (e.g., “We do not offer products other than mutual funds of ABC complex”). Alternatively, FINRA may determine that an underwriter may limit its document’s contents to only 18 These eleven are: types of brokerage accounts offered; scope of services provided and limitations; scope of products offered to retail clients; that the firm may be the sponsor of certain products and may act as a distributor for a fee from the issuer for other products; all fees associated with each brokerage account; cash/non-cash compensation paid to the broker-dealer; arrangements in which the firm receives an economic benefit from someone else for providing a product or service; compensation for referrals; differential payouts for representatives; conflicts of interest between the firm and its customers; and limits on the firm’s duty to its customers. 19 The fund’s prospectus would disclose the affiliation between the underwriter and the funds and any fees and expenses charged in connection with the shareholder’s account. Typically it would not disclose all funds within the fund complex, but rather focus on the fund the investor has purchased or is considering purchasing. Information regarding the variety of funds available through the fund or its underwriter would typically appear in the sales literature for the fund complex. 20 To the extent the underwriter sells a mutual fund with a load directly to an investor, the underwriter may retain that load. Ms. Marcia E. Asquith December 24, 2010 Page 8 those items of information that would be relevant to the customer based on its business.21 In considering these issues, FINRA should remain mindful of the costs associated with producing a document that is either not meaningful to investors or duplicative of information the investor already receives from the mutual fund or its underwriter.22

### III. THE DELIVERY MEDIA

The Institute strongly recommends that, regardless of which FINRA members are required to deliver the document, the rule’s delivery requirements accommodate the variety of electronic media that customers use today to communicate with and research their financial professionals. This will ensure that investors receive the information through media they are most comfortable with. It will also maximize efficiencies while minimizing expenses associated with the new document. It would also enable broker-dealers to update their disclosures more frequently. In particular, we recommend that FINRA’s proposal expressly permit broker-dealers to post the new disclosure document on the broker- dealer’s website and refer investors to the disclosure. This delivery mechanism would be consistent with the NASD’s endorsement in 2005 of using web-based delivery for a point-of-sale mutual fund disclosure document.23 For those investors who would prefer a hard copy of the document, FINRA should preserve the ability of investors to request delivery of a paper document.

### IV. UPDATING THE DOCUMENT’S CONTENTS

FINRA has also sought comment on how frequently the information in the disclosure document should be updated. The Institute recommends that, any time there is a material change to the information previously provided to the customer that may impact the customer or the customer’s account, the broker-dealer should be required to provide the customer notice of the changes prior to the changes applying to the customer’s account. So, for example, if the changes will result in increasing the fees the customer must pay in connection with its brokerage account, the broker-dealer should be required to inform the customer of the increased charges and provide the investor a reasonable period of time within which to close or move its account prior to being subjected to the fee increase. Similarly, if changes are made to the broker-dealer’s compensation arrangements that might incentivize the broker-dealer to sell one product over another, an investor purchasing a product on or after the date of 21 Unless FINRA requires a document filled with mostly negative disclosure, the underwriter’s document may be more akin to a buck slip than a brochure. 22 When it proposes a rule, FINRA should also provide that the document is not subject to the filing and fee requirements imposed under FINRA Rule 2210, which governs communications with the public, unless the document includes disclosure beyond that mandated by FINRA. (Such documents would, however, be subject to the

antifraud rules under the Securities Exchange Act of 1934.) This clarification will reduce the costs associated with the document and the timeliness of its production and distribution and updating. 23 See “NASD Endorses Concise, Web-Based Point of Sale Mutual Fund Disclosure,” NASD Press Release (April 4, 2005). Ms. Marcia E. Asquith December 24, 2010 Page 9 the change should be aware of the new compensation arrangements. In situations where there have been no material changes to the broker-dealer’s disclosure, updating should be consistent with that of the SEC’s brochure rule for investment advisers, Rule 204-3 under the Investment Advisers Act of 1940. As such, a broker-dealer should be required, no less frequently than annually, either to provide a current copy of the disclosure document, advise its customers of the availability of the disclosure on the broker-dealer’s website, or inform the investor how it may obtain a hard copy of the document. ♦ ♦ ♦ ♦ ♦

♦ The Institute commends FINRA for exploring a disclosure document that will provide retail investors relevant information regarding their relationship with their retail broker-dealer at a point in time when this information can influence the investor’s decisions. By providing investors a fuller picture of their financial service providers, FINRA’s document would better enable investors to make more informed decisions about who they do business with and at what price. For these reasons, we support FINRA moving forward with its proposal and we encourage it, as part of this undertaking, to address in any rule proposal the unique circumstances posed by mutual fund principal underwriters. Sincerely, /s/ Tamara K. Salmon Senior Associate Counsel