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INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

June 29, 2009

Institute Files Comment Letter on FINRA's Proposed Revisions to the NASD's Suitability and "Know Your Customer" Rules (pdf)

June 29, 2009 Ms. Marcia E. Asquith Office of the Corporate Secretary FINRA 1735 K Street, NW Washington, DC 20006-1506 Re: FINRA Notice 09-25 Relating to Suitability and Know-Your-Customer Obligations of Members Dear Ms. Asquith: The Investment Company Institute1 is writing to comment on FINRA's proposed consolidated rules relating to suitability and know-your-customer obligations.2 As proposed, new FINRA Rule 2111 would consolidate and revise existing NASD Rule 2310 and NYSE Rule 405 relating to suitability, while new FINRA Rule 2090 would address members' know-you-customer responsibilities. The Institute supports the consolidation of these rules and the adoption of proposed Rules 2111 and 2090. We recommend, however, that Rule 2111 be revised to retain a provision relating to money market mutual funds that has been part of NASD's suitability rule since its original adoption almost 20 years ago. In addition, we recommend that FINRA clarify in the Supplementary Material to proposed Rule 2111 that suitability determinations will remain the province of the member. Each of these recommendations is discussed in more detail below. 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 $10.18 trillion and serve over 93 million shareholders. 2 See FINRA Notice to Members 09-25, Consolidated FINRA Rules Governing Suitability and Know-Your-Customer Obligations (May 2009). Ms. Marcia E. Asquith June 29, 2009 Page 2 of 4 MONEY MARKET FUNDS In August 1990, the SEC approved amendments to a rule that that required NASD members to make reasonable efforts to obtain additional information pertaining to customer accounts.3 Importantly, these amendments expressly excluded transactions and accounts in which investments were limited to money market mutual funds. While neither of the 1990 releases proposing and adopting4 this requirement explains the basis for this exception, both expressly mention its existence. As proposed, Rule 2111 would eliminate this exception for money market funds. FINRA's notice, however, fails to discuss or explain the elimination of this exception, and thus we are unable to determine whether it was inadvertent or deliberate. If deliberate, we are at a loss to understand the basis for its omission, particularly in the absence of objective evidence warranting a change to this long- standing exception. Had there been a history of problems with members making

unsuitable money market mutual fund recommendations or making recommendations relating to money market mutual funds on the basis of insufficient information, we could perhaps understand FINRA requiring members to obtain additional information to address these concerns. Similarly, if FINRA had commenced enforcement proceedings, undertaken other actions, or communicated to members their concerns with members' use or abuse of this exception, its proposed elimination may be better understood. To our knowledge, there have not been any such proceedings, actions, or public statements in the almost 20 years this provision has been part of the NASD's rules that would warrant its elimination. In the absence of objective evidence warranting its elimination, we recommend that the exception for money market mutual funds be retained in proposed FINRA Rule 2111(b). We also note that, every time FINRA or any other regulator imposes a new or additional duty on a member – regardless of how minor or minimal the duty appears – it will result in additional costs to members. For example, eliminating the money market fund exception will require FINRA members to revise their policies and procedures to begin collecting information from those customers who limit their investments to money market mutual funds – and FINRA has proposed to expand the types of information members must collect. The rule will also necessitate changes to the forms members use, the procedures used to review such completed forms, and the systems that process and maintain customer account information. Over time, the aggregation of seemingly insubstantial costs associated with individual regulatory proposals can be substantial. While elimination of the exception for money market funds may seem minor to FINRA, it will result in real costs to the industry, and the Notice fails to include any mention of the benefits sought to be achieved. Any costs associated with eliminating this exception should be affirmatively considered to determine whether they outweigh any supposed benefit to investors. 3 See NASD Notice to Members 90-52 (Aug. 1990). This rule later became NASD Rule 2310. The suitability rule was originally adopted as an amendment to Article III, Sections 2 and 21(c) of the NASD's Rules of Fair Practice. 4 See NASD Notice to Members No. 90-52 (Aug. 1990). Ms. Marcia E. Asquith June 29, 2009 Page 3 of 4 RESPONSIBILITY FOR SUITABILITY DETERMINATIONS We support FINRA consolidating in proposed Supplementary Material .02, "Components of Suitability Obligations," the three elements that have long comprised a member's suitability obligations.5 We recommend, however, that FINRA affirm in this Supplementary Material that the responsibility for analyzing these three elements lies with the member and not FINRA. This clarification seems appropriate in light of FINRA's recent notice relating to suitability determinations in connection with "non-traditional ETFs," which appears to replace the ability of members to make determinations concerning the suitability of these products with the value judgment of a Government- registered association. In particular, FINRA Regulatory Notice 09-31 (June 2009), which was issued to remind "firms of sale practice obligations relating to leveraged and inverse exchange-traded funds," states in relevant part: "inverse and leveraged ETFs that are reset daily typically are unsuitable for retail investors who plan to hold them for longer than one trading session, particularly in volatile markets." [Emphasis added.] Such a definitive statement appears to usurp a member's ability to determine whether these products, or an investment strategy utilizing these products, are, in fact, suitable for a particular investor. We recommend that, as with previous notices issued by the NASD relating to suitability, instead of declaring certain products as per se unsuitable for certain classes of investors, FINRA instead clarify that suitability determinations remain the responsibility of the member. To the extent FINRA has concerns regarding recommendations involving specific types of securities, as in the past,6 FINRA could provide members guidance regarding issues they should consider or due diligence they should conduct to fulfill the member's suitability determinations, rather than defining such securities as per se unsuitable for certain classes of investors. We additionally recommend that FINRA withdraw Regulatory Notice 09-31 and, if necessary, instead issue a

notice that both recognizes the responsibility of the member to make suitability determinations and provides meaningful guidance relating to recommendations involving non-traditional ETFs. ■ ■ ■ ■ 5 These three suitability obligations are reasonable-basis suitability, customer-specific suitability, and quantitative suitability. 6 See, e.g., NASD Regulatory & Compliance Alert (Summer 2000) (providing members guidance of the factors to consider when recommending multi-class funds); NTM 03-07 (Feb. 2003) (reminding members of issues to consider in conducting reasonable-basis suitability and customer-specific suitability when recommending hedge funds); NTM 95-80 (Sept. 1995) (reminding members of their obligations in recommending the purchase of mutual funds); and NTM 94-16 (reminding members of suitability considerations when selling mutual funds to elderly, retired, or first-time investors). Ms. Marcia E. Asquith June 29, 2009 Page 4 of 4 For all of the above reasons, the Institute respectfully recommends that proposed Rule 2111 be revised to retain the existing, and long-standing, exception for transactions with customers where investment are limited to money market mutual funds. We additionally recommend that the proposed Supplementary Material .02 be revised to affirm that the responsibility for making suitability determinations lies with the member. Sincerely, /s/ Tamara K. Salmon Tamara K. Salmon Senior Associate Counsel

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