

## COMMENT LETTER

January 18, 2012

# ICI Letter on Proposed Amendments to FINRA Advertising Rules (pdf)

January 18, 2012 Elizabeth M. Murphy Secretary Securities and Exchange Commission 100 F Street, NE Washington, DC 20549-1090 Re: FINRA Proposal to Adopt NASD Rules Regarding Communications with the Public as FINRA Rules 2210 and 2212 through 2216 (SR-FINRA-2011-035) Dear Ms. Murphy: The Investment Company Institute<sup>1</sup> welcomes the opportunity to express its views on the most recent set of proposed amendments to Financial Industry Regulatory Authority, Inc. ("FINRA") rules governing communications with the public.<sup>2</sup> The Proposed Final Rule would amend several requirements related to member communications with the public, including: (i) regulating internal communications intended to train registered representatives about a member's products or services under Rule 3010; (ii) excluding from FINRA's filing requirements retail communications that are posted on online interactive electronic forums; and (iii) excluding from FINRA's filing requirements certain closed-end fund press releases. The Proposed Final Rule would maintain the filing and review requirements for templates and the "reason to believe" standard currently employed in the definition of "institutional investor." <sup>1</sup> 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 \$12.47 trillion and serve over 90 million shareholders. <sup>2</sup> See FINRA Notice of Filing of Amendment No. 2 to Proposed Rule Change, as Modified by Amendment No. 1 to Adopt FINRA Rules 2210, 2212, 2213, 2214, 2215, and 2216 in the Consolidated FINRA Rulebook, 76 Fed. Reg. 82014 (December 29, 2011) ("Proposed Final Rule"). See also FINRA Notice of Filing of Partial Amendment No. 1 and Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change, as modified by Partial Amendment No. 1, to Adopt FINRA Rules 2210, 2212, 2214, 2215, and 2216 in the Consolidated FINRA Rulebook, 76 Fed. Reg. 68800 (November 7, 2011) ("November 2011 Proposal"); FINRA Notice of Filing of Proposed Rule Change to Adopt FINRA Rules 2210, 2212, 2214, 2215, and 2216 in the Consolidated FINRA Rulebook, 76 Fed. Reg. 46870 (August 3, 2011) ("July 2011 Proposal"); and FINRA Regulatory Notice No. 09-55 (September 2009) ("2009 Proposal"). Elizabeth M. Murphy January 18, 2012 Page 2 of 7 The Institute commends FINRA for undertaking the initiative to modernize its rules relating to public communications by member firms, and we support most aspects of the Proposed Final Rule. We are pleased that many of the recommendations we made to FINRA on the 2009 Proposal, July 2011 Proposal, and November 2011 Proposal are reflected in the Proposed Final Rule.<sup>3</sup> The Institute particularly supports FINRA's decision to regulate

internal communications intended to educate or train registered representatives about the member's products or services under Rule 3010 (rather than Rule 2210). We also support excluding from the pre-approval and filing requirements: (i) retail communications that are posted on online interactive electronic forums; and (ii) closed-end investment company press releases issued pursuant to the New York Stock Exchange's immediate release policy. We have one remaining significant concern with the Proposed Final Rule, one recommendation to enhance the efficiency of the registered principal review process of templates, and one request for clarification. For the reasons explained in detail below, we recommend that FINRA reconsider exempting shareholder reports from FINRA filing and content requirements. Such an exemption will reduce filing costs for FINRA members, without sacrificing investor protection. We also ask that FINRA permit risk-based review of updated narrative in templates, and clarify one aspect of the reason to believe standard. Exemption for Shareholder Reports Under the Proposed Final Rule, FINRA would maintain the current requirement that member firms file the Management's Discussion of Fund Performance ("MDFP") and any other sales material included in a fund's annual and semi-annual shareholder reports ("shareholder reports") if a member firm intends to use the shareholder reports as sales material with prospective investors. We discussed at length in our December Letter why layering FINRA filing and content requirements on top of the Commission's content and filing requirements and member firms' internal review processes and procedures would subject funds to duplicative, costly, and unnecessary oversight. FINRA did not make the recommended change, reasoning that it reviews shareholder reports more frequently than the Commission does, such review "does not impose a large burden on members relative to the benefit to investors by ensuring that the MDFP is fair, balanced, and accurate," and "this review serves a 3 See Letter to Marcia E. Asquith, Senior Vice President and Corporate Secretary, Office of the Corporate Secretary, FINRA from Dorothy M. Donohue, Senior Associate Counsel, Investment Company Institute, dated November 19, 2009; Letter to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission from Dorothy M. Donohue, Senior Associate Counsel, Investment Company Institute, dated August 24, 2011; and Letter to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission from Dorothy M. Donohue, Senior Associate Counsel, Investment Company Institute, dated December 7, 2011 ("December Letter"). Elizabeth M. Murphy January 18, 2012 Page 3 of 7 prophylactic purpose of discouraging funds from including content that is misleading or potentially harmful to investors."4 We do not disagree that, as a general matter, FINRA review of fund retail communications helps to ensure that these communications are fair, balanced, and accurate. However, the unique requirements that apply to shareholder reports distinguish them from other categories of fund retail communications and negate the need for FINRA review. These requirements, which are discussed below, serve the same purpose as FINRA review: to help ensure that shareholder reports are fair, balanced, and accurate, and discourage funds from including content that is misleading or potentially harmful to investors. Shareholder reports are subject to a robust certification process, designed to help to assure a complete and accurate discussion of the fund and the orderly flow of information to investors.5 In particular, a fund's principal executive and principal financial officers ("certifying officers") must certify that based on his or her knowledge the report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading.6 The certifying officers must certify that the fund's shareholder report fairly presents in all material respects the fund's financial condition, results of operations, and changes in net assets and cash flows. The certifying officers also are responsible for establishing and maintaining disclosure controls and procedures and must certify that they have: designed such disclosure controls and procedures to ensure that material information

regarding the fund is made known to them; evaluated the effectiveness of the fund's disclosure controls and procedures within 90 days of the report's filing date; and presented their conclusions about the effectiveness of the disclosure controls and procedures. In addition, the certifying officers are responsible for establishing and maintaining internal controls over financial reporting and must disclose any material change in internal controls over financial reporting that occurred subsequent to the prior period end. With respect to the control 4 See Letter to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission from Joseph P. Savage, Vice President & Counsel, Investment Companies Regulation, FINRA, dated December 22, 2011 ("FINRA December Letter") at p. 12. 5 See Rule 30a-2 under the Investment Company Act. See also Securities Exchange Act Release No. 47262 (January 27, 2003) (adopting the rules requiring certification of shareholder reports) at pp. 5 and 19. 6 The Commission made clear in the release adopting the certification requirements that certification was not limited to financial information but rather was required with respect to all of the information in the shareholder report. See Securities Exchange Act Release No. 34-47262 (January 27, 2003) at p. 5. Any certifying officer providing a false certification potentially could be subject to: (i) Commission action for violating Section 13(a) or 15(d) of the Exchange Act; (ii) both Commission and private actions for violating Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5; and (iii) criminal liability, including fines and imprisonment. See e.g., Securities Exchange Act Release No. 34-46427 (August 28, 2002) at p. 9 and Section 906 of the Sarbanes-Oxley Act of 2002. Elizabeth M. Murphy January 18, 2012 Page 4 of 7 structure, the certifying officers must certify that they have disclosed to the fund's auditors and board audit committee significant deficiencies in the design or operation of internal controls that could adversely affect the fund's ability to record, process, summarize and report financial data and also have identified to the fund's auditors and board audit committee any fraud involving management or employees with a significant role in the fund's internal controls. Moreover, shareholder reports, including the MDFP, are subject to specific content requirements under Commission rules, the antifraud standards of the federal securities laws, and Commission review. Finally, auditors also review annual shareholder reports.<sup>7</sup> FINRA has recognized in other contexts that filing sales material with FINRA is unnecessary given the existence of other protections. In particular, the Proposed Final Rule provides exclusions from filing for fourteen different types of communications, the most analogous to shareholder reports being the exclusion for prospectuses, preliminary prospectuses, fund profiles, offering circulars and similar documents that have been filed with the Commission.<sup>8</sup> Filing shareholder reports with FINRA entails significant costs. We estimate that a significant number of Institute member firms pay more than \$20,000 in fees annually to file shareholder reports with FINRA and believe that this cost should be seriously evaluated in the context of the many requirements applicable to shareholder reports that protect investors.<sup>9</sup> For these reasons, we strongly urge FINRA to reconsider the need for the current filing requirement particularly when balanced with the associated filing costs. In our view, the additional costs imposed on firms being required to file of shareholder reports far exceeds any benefit to investors, given the protections investors already receive as a result of the combination of certification requirements, auditor review, and Commission content and review requirements. 7 See Public Accounting Oversight Board Interim Standard 550, Other Information in Documents Containing Audited Financial Statements (AU 550.04) (stating, among other things, that auditors should read information other than that which appears in the financial statements and consider whether such information is materially inconsistent with the information in the financial statements). 8 See Rule 2210(c)(7)(A)-(N). 9 A complex that files one hundred shareholder reports twice a year at FINRA's minimum filing fee would pay \$20,000 in filing fees. The precise amount of the filing fees depends on the number of funds in a complex. Thirty-one Institute member firms have more than one

hundred funds in their complexes. FINRA's filing fees vary depending on the length of the filing and the type of review requested. Members pay a minimum of \$100 for a filing (i.e., a regular review of the first ten pages of material filed). Elizabeth M. Murphy January 18, 2012 Page 5 of 7

Templates Under the Proposed Final Rule, retail communications based on templates that previously have been filed with FINRA would be excluded from filing, as long as the changes are limited to updates of statistical or other non-narrative information. In our December letter, the Institute recommended that FINRA additionally exclude from filing those retail communications that are based on templates that were previously filed with FINRA if the only change is a narrative factual update provided by certain entities. FINRA declined to follow this recommendation, stating, among other reasons, that review of narrative updates ensures that members' retail communications are fair, balanced, and accurate and that this goal is best ensured through filing of updated material. The Institute agrees that narrative updates to templates should be fair, balanced and accurate. We appreciate FINRA's concern and desire to review material changes to the narrative that appears in templates. We remain interested, however, in seeking a modified review process for templates that will allow for previously approved narrative information to be updated in a more timely and efficient way. A great deal of information about funds is made available through the use of templates. For example, mutual fund fact sheets provided on fund companies' websites provide information about the fund's investment objectives and strategies, identity of fund managers, performance information, and minimum initial investment requirements. Under current requirements, a registered principal must review and approve all material narrative changes to templates before their dissemination. Currently, some firms batch for approval a number of narrative updates regarding fund information received from third-party vendors. While this allows for more practical and efficient review by registered principals, this process delays the publication of updates to fund information (such as fund manager changes or changes in a fund's objective or strategy). Our recommendation, as discussed below, is intended to reduce these delays and also would have the benefit of reducing the costs associated with the publication of fact sheets and other information for the great number of funds provided through retirement, mutual fund supermarket, and other types of platforms. We respectfully request that FINRA couple the filing requirement with a risk-based principal review process, thereby no longer requiring prior registered principal approval for each and every material update to narrative in a template. FINRA could require firms to develop policies and procedures appropriate for their business structure.<sup>10</sup> For example, firms that support mutual fund supermarket type platforms could tailor their review policies and procedures in a way that would be informed by the type of information being updated and its source. This alternative would help ease the administrative burdens inherent in the current pre-use registered principal approval model and allow firms to publish updated content in a more timely fashion. At the same time, our recommended approach preserves FINRA's ability to monitor these materials, both through review via filing and through spot checks and targeted examinations. <sup>10</sup> See, e.g., Proposed Final Rule 2210(b)(1)(D). Elizabeth M. Murphy January 18, 2012 Page 6 of 7

Reason to Believe Standard Under both current Rule 2211 and the Proposed Final Rule, the definition of "institutional investor" provides that "[n]o member may treat a communication as having been distributed to an institutional investor if the member has reason to believe that the communication or any excerpt thereof will be forwarded or made available to any retail investor."<sup>11</sup> In its December Letter, FINRA stated that FINRA does not intend to impose an affirmative obligation on members to inquire whether an institutional communication will be forwarded to retail investors every time such a communication is distributed. Rather, members should have policies and procedures in place reasonably designed to ensure that institutional communications are not forwarded to retail investors, and make appropriate efforts to implement such policies and procedures. FINRA provided

as an example that firms may wish to get periodic assurances from institutional investors that they will not forward institutional communications to retail investors. Many funds are sold through intermediary broker-dealer firms, and the intermediary firm may use institutional communications prepared by the fund's principal underwriter with its associated persons. In these circumstances, we believe that that it would be the recipient broker-dealer that would be responsible for assuring that its associated persons limit use of the communication to institutional investors. This is a practical approach that responds to FINRA's regulatory concerns without creating duplicative compliance burdens. It also would be consistent with FINRA's approach in another context where an intermediary firm uses sales material prepared by a fund underwriter.<sup>12</sup> We request that FINRA clarify this in any regulatory notice accompanying any final rules. \* \* \* The Institute appreciates the opportunity to comment on this significant proposal. If you have any questions or need additional information, please contact me at (202) 218-3563. Sincerely, /s/ Dorothy M. Donohue Senior Associate Counsel

11 See Rule 2211(a)(3) and Proposed Rule 2210(a)(4)(F). 12 See Regulatory Notice 03-38 (March 2008) (where FINRA eliminated a "compliance redundancy" by not requiring registered principal approval of sales material at an intermediary firm that uses certain sales material approved by a registered principal at another broker-dealer firm). Elizabeth M. Murphy January 18, 2012 Page 7 of 7 cc: Thomas Selman, Executive Vice President Thomas A. Pappas, Vice President and Director, Advertising Regulation Joseph P. Savage, Vice President and Counsel, Investment Companies Regulation Financial Industry Regulatory Authority, Inc. David Blass, Chief Counsel Lourdes Gonzalez, Assistant Chief Counsel Division of Trading and Markets Susan Nash, Associate Director Division of Investment Management U.S. Securities and Exchange Commission

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