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May 31, 2011

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: FINRA Proposal to Adopt NASD Rule 2830 as FINRA Rule 2341 (SR-FINRA-2011-018)

Dear Ms. Murphy:

The Investment Company Institute[1] appreciates the opportunity to comment on the Financial Services Regulatory Authority's ("FINRA") proposed Rule 2341, and in particular the proposed revisions to the requirements regarding disclosure of cash compensation relating to the sale of investment company securities.[2]

ICI has long supported enhanced disclosure to help investors assess and evaluate a broker's recommendations.[3] Certain compensation structures have the potential to influence financial intermediaries' recommendations to their clients, such as by creating incentives to inappropriately favor some products over others. To assess these incentives and enable investors to make better informed

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[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 $13.1 trillion and serve over 90 million shareholders.

[2] *See* FINRA Notice of Filing of Proposed Rule Change and Amendment No. 1 to Adopt NASD Rule 2830 as FINRA 2341 (Investment Company Securities) in the Consolidated FINRA Rulebook, 76 Fed. Reg. 26779 (May 9, 2011)("Notice").

[3] *See, e.g.,* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Marcia E. Asquith, Office of the Corporate Secretary, FINRA, dated Aug. 3, 2009; Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Barbara Z. Sweeney, Office of the Corporate Secretary, NASD Regulation, Inc., dated October 17, 2003; 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; and Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Joan C. Conley, Office of the Corporate Secretary, NASD Regulation, Inc., dated Oct. 15, 1997.

investment decisions, we believe relevant disclosure should be required for *all* retail investment products sold by financial intermediaries, including variable annuity contracts and separate accounts – not just mutual funds.[4] Failure to extend disclosure requirements to competing retail products could unfairly disadvantage mutual funds and provide perverse incentives for brokers to sell other, potentially less suitable products.

We strongly support many other aspects of the FINRA proposal and we appreciate FINRA's attention to many of the Institute's comments on the 2009 proposal of this rule.[5] In particular, we support the substance of the required disclosure, which will provide investors relevant information about the broker's conflicts of interests[6]; the elimination of related disclosure from a fund's prospectus, which an investor receives in connection with a purchase[7]; the proposed timing of the disclosure, which would be provided to customers prior to the purchase of investment company shares; and the ability of FINRA members to make the required disclosure available electronically.[8]

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[4] *See* Testimony of Paul Schott Stevens, President and CEO, Investment Company Institute, Before the Committee on Financial Services, United States House of Representatives, on "Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals," July 17, 2009, available at http://www.ici.org/policy/ici_testimony/09_reg_reform_jul_tmny. Congress appears to share our concern about selective application of such disclosure requirements – Section 919 of the Dodd-Frank Wall Street Financial Reform Act (the "Dodd-Frank Act") clarifies the SEC's authority to require broker-dealers to provide information to retail investors with respect to *any* product or service the investor may purchase. Further, as discussed below, Section 917 speaks broadly of "an investment product or service that is typically sold to retail investors, including shares of open-end companies…" The Department of Labor is also moving to require the same disclosure of fee information for all investment products used in employee benefit plans – mutual funds, variable annuities and insurance separate accounts, and collective investment trusts – regardless of type. DOL's regulation under Section 408(b)(2) of ERISA will require financial intermediaries to disclose to plan sponsors, at point of sale, all indirect compensation they will receive from plan investments, and DOL's participant disclosure regulation will ensure plan participants have comparable information about all the investments on their 401(k) plan menu. *See* Reasonable Contract or Arrangement under Section 408(b)(2) – Fee Disclosure, 75 Fed. Reg. 41600 (July 16, 2010); Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans, 75 Fed. Reg. 64910 (Oct. 20, 2010).

[5] *See* Letter from Karrie McMillan, dated Aug. 3, 2009, *supra* note 3.

[6] We presume that the final rule will allow broker-dealers to craft disclosure that is detailed enough to be meaningful but not so detailed as to overwhelm or confuse investors.

[7] As we noted in our 2009 letter, because such disclosures relate to potential broker conflicts, and may exist across multiple funds – or other products – sold by the broker, we believe they are more appropriately provided to an investor by the broker. An investor may wish to understand the potential conflicts associated with all of the products sold by his or her broker. By contrast, detailed prospectus disclosure of a fund's cash compensation arrangements with different broker-dealer firms would be largely irrelevant to any given investor, whose interest would be limited to the arrangements with his or her broker. *See id.*

[8] ICI strongly supports the use of the Internet to provide important disclosures to investors. *See, e.g.,* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Nancy Morris, U.S. Securities and Exchange Commission, dated Feb. 28, 2008, available at http://www.ici.org/pdf/22290.pdf. Our research shows that the vast majority of mutual

Despite this strong support for much of what is in the FINRA proposal, we are mindful of how the proposal fits into the larger landscape of broker disclosure to retail investors—a topic that is under active regulatory review from many perspectives. The Institute strongly supports a holistic, well-considered, and thorough approach to disclosure by broker-dealers that informs retail investors of a broker's full range of product offerings and services, as well as any related conflicts of interest – not just those resulting from cash compensation arrangements. Two studies enumerated by the Dodd-Frank Act require a thorough consideration of such broker disclosures. FINRA itself recently issued a concept proposal on the disclosure of a broker's services, conflicts, and duties.[9] We recommend that the Commission consider whether the current proposal can be absorbed readily into one or more of these broader initiatives, or whether it may soon be rendered moot, duplicative, or in need of extensive revisions, based on their results.

Should the SEC decide to move forward with this rulemaking during the pendency of these other related efforts, we have several recommendations for revisions to the final rules. Most importantly, we urge that the rule's scope be better defined so that it is limited appropriately to those brokers providing services to retail investors and does not inadvertently extend to principal underwriters. The purpose of this disclosure is to inform those investors of possible conflicts their brokers may have. Principal underwriters generally do not make investment recommendations and thus do not have the same potential conflicts. They should not be required to make what would be meaningless disclosures pursuant to this rule.

Our concerns and recommendations are discussed in more detail below.

**Other Broker Disclosure Initiatives Currently Underway**

As the Notice explains, the proposed cash compensation disclosure is intended to "further inform investors of the potential conflicts of interest that can arise from the sale of investment company securities" and "enable investors to better evaluate whether a member's particular product recommendation was influenced" by certain cash compensation arrangements. As noted above, while we support the intent of this disclosure, we urge that FINRA and the SEC take a comprehensive approach to disclosure by broker-dealers that would include information regarding both the products and services offered by the broker, as well as any related conflicts of interest. Several initiatives are currently underway that would support the development of just such an approach.

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fund shareholders have access to and frequently use the Internet, including for financial purposes. *See, e.g., Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet,* 2010, Investment Company Institute, available at http://www.ici.org/pdf/fm-v19n6.pdf.

[9] *Disclosure of Services, Conflicts and Duties,* FINRA Regulatory Notice No. 10-54 (October 2010) ("2010 Concept Release").

Section 917 of the Dodd-Frank Act requires the SEC to conduct a study regarding financial literacy among investors. The Section specifically requires the Commission to identify, among other things: 1) "methods to improve the timing, content, and format of disclosure to investors with respect to financial intermediaries"; 2) "the most useful and understandable relevant information that retail investors need to make informed financial decisions before engaging a financial intermediary or purchasing an investment product or service that is typically sold to retail investors"; and 3) "methods to increase the transparency of expenses and conflicts of interests in transactions involving investment services and products." A report is due to Congress by July 2012.

Additionally, Section 913 of the Dodd-Frank Act requires the SEC to conduct a study to consider potential harmonization of the obligations of broker-dealers and investment advisers. The report from this study, which was conducted by the Commission's staff, was delivered to Congress in January 2011. The study examined the relative disclosure obligations of broker-dealers and investment advisers and recommended that the Commission "facilitate the provision of uniform, simple and clear disclosures to retail customers about the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest" and "consider the utility and feasibility of a summary disclosure document containing key information on a firm's services, fees, and conflicts and the scope of its services."[10] In a comment letter to the Commission, FINRA supported this approach. It recommended that the Commission require broker-dealers to provide to investors, at the time of account opening, a document "that provides essential information about the nature of the broker-dealer's products and services, including any activities that could conflict with its duty to act in the best interests of the customer."[11]

Consistent with this recommendation to the SEC, in October 2010, FINRA issued a Concept Release to explore "the contours of a proposal that would require each firm to timely provide to retail customers a statement of services, conflicts and duties."[12] As envisioned by the Concept Release, this "statement" would include, among other information, the types of brokerage accounts and services provided to customers; the scope of services provided, products offered, and fees for each product and service; financial or other incentives that a firm or its registered representatives have to recommend certain products, strategies or services over similar ones; any conflicts of interest that may arise between a firm and its customers, as well as those that may arise in meeting the competing needs of multiple customers; and any limitation on the duties the firm owes to its customers. In other words, the Concept Release contemplated a customer statement that would include some of the same information

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[10] U.S. Securities and Exchange Commission, *Study on Investment Advisers and Broker Dealers*, January 2011, at 117.

[11] Letter from Marc Menchel, Executive Vice President and General Counsel, FINRA, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated Aug. 25, 2010.

[12] 2010 Concept Release, *supra* note 9.

that would be required by FINRA's current proposal. FINRA sought comment on the scope, form, content, delivery method, and timing of such a disclosure document in December 2010.[13]

With all of the attention currently being given to improving the content, timing, and method of disclosure by broker-dealers to retail investors, we question whether it is appropriate for FINRA to move forward with the current proposal at this time. We recommend that the Commission consider whether this proposal can be readily incorporated into the larger landscape of broker disclosures currently being contemplated by the SEC and FINRA, or whether it is likely to be rendered moot, duplicative, or in need of extensive revisions, based on their results.

**Recommended Revisions to the Current Proposal**

Should the SEC move forward with this rulemaking, we recommend changes to the rule in several respects. First, the scope of the rule should be defined appropriately so that disclosures are made to retail investors by their broker-dealers; the rule should not apply to principal underwriters. The purpose of this disclosure is to inform retail investors of possible conflicts their brokers may have. Principal underwriters do not have the same potential conflicts, and should not be required to make meaningless disclosures pursuant to this rule. Second, broker-dealers should be required to use names readily identifiable with the funds sold rather than the names of specific *offerors*—a technical concept that could be confusing to many investors. Third, FINRA should clarify that the mandated disclosures will not be deemed advertising or sales literature for purposes of Rule 2210, which governs broker-dealer communications with the public. Finally, the final rule should provide firms with one year to modify their compliance systems in light of the new disclosure. Each of these recommendations is explained in more detail below.

*Scope of the Rule.* As noted above, the disclosure contemplated by this rule is meant to "enable investors to better evaluate whether a member's particular product recommendation was influenced" by certain cash compensation arrangements. As is clear throughout the Notice, the intended beneficiaries of this disclosure are the retail investors who look to their broker-dealers for investment recommendations and who may be unfamiliar with the compensation arrangements that may influence those recommendations. Institutional investors likely would not find these disclosures to be of any practical value and, in any event, easily could obtain the relevant information for themselves.

To clarify that the disclosure is intended for retail investors, we recommend that FINRA define the term "retail customer" in the rule and amend paragraph 2341(l)(4)(B) to read: "(B) The disclosure required by subparagraph (A) shall be delivered <u>to retail customers</u> in paper or electronic form…." We suggest using the term "retail customer" to be consistent with the 2010 Concept Release, which is also

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[13] *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute to Marcia E. Asquith, Office of the Corporate Secretary, FINRA, dated December 24, 2010.

intended to benefit retail investors.[14] Indeed, FINRA contemplates that the disclosure statement, when implemented, would include the disclosures required by Rule 2341.[15] To avoid any inconsistency between the two rules, both should require disclosures to be made to the same universe of retail investors.

We also strongly recommend that FINRA expressly exclude principal underwriters from the rule to the extent they are not making investment recommendations to retail customers. We appreciate that the Notice recognizes that "a principal underwriter of a no-load mutual fund that sells shares directly to investors, and does not receive or enter into an arrangement to receive any cash compensation beyond what is described in the fund's prospectus fee table, would not be subject to the disclosure requirements of paragraph (l)(4)." A technical reading of the rule as proposed, however, might require principal underwriters to provide the disclosure. In both the no-load and load distribution models, principal underwriters may serve as the contracting party to service providers, including selling broker-dealers. As such, the principal underwriter may receive amounts that could constitute additional cash compensation from the fund's adviser, which it then pays out to the relevant service providers. Technically, this type of arrangement could trigger disclosures under paragraph 2341(l)(4)(A), because a member (the principal underwriter) receives additional cash compensation from an offeror (the fund's adviser) in connection with the sale of investment company securities.

As discussed in our comment letter on the 2010 Concept Release, principal underwriters to mutual funds and other registered investment companies differ significantly from retail broker-dealers, notably in their relationship to retail customers.[16] Generally speaking, a fund's principal underwriter would have a direct relationship with a retail customer in one of three ways: (1) the fund is a direct distributor of its shares; (2) an account is "orphaned" by a retail broker to the fund's underwriter; or (3) the account is opened through a "check and application" process. None of these scenarios warrant the disclosure contemplated by this rule because principal underwriters do not have the conflict faced by retail broker-dealers—they distribute the shares of a single fund complex and are not compensated to sell one complex's funds over another. Moreover, in both the second and third scenarios, the customer

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[14] The 2010 Concept Release proposed to define a "retail customer" as "a customer that does not qualify as an institutional account under NASD Rule 3110(c)(4)." The definition of "institutional account" under that rule consists of a bank, savings and loan, insurance company, registered investment company, registered investment adviser or any entity (which includes natural persons) with total assets of at least $50 million. Alternatively, FINRA may wish to consider using the definition of "retail customer" in Section 913(g) of the Dodd-Frank Act, which defines the term to mean "a natural person, or the legal representative of such natural person, who— (A) receives personalized investment advice about securities from a broker, dealer, or investment adviser; and (B) uses such advice primarily for personal, family, or household purposes." In either case, FINRA should apply the same definition in both rulemakings.

[15] Notice, at footnote 7.

[16] We described the significant differences between retail broker-dealers and fund principal underwriters in detail in our comment letter on the 2010 Concept Release. *See* Letter from Karrie McMillan, dated December 24, 2010, *supra* note 13.

has (or had) a relationship with a retail broker-dealer.[17] If the rule is adopted, that broker-dealer will be required to make the necessary disclosures. In contrast, in all three of these contexts, the principal underwriter does not make any recommendation to purchase fund shares, has no suitability or similar requirements to the customer, and has no conflicts of interest that would warrant the types of disclosure contemplated by Rule 2341. As a result, the required disclosure would not be relevant or meaningful to the customer. Accordingly, we recommend that FINRA clarify that the disclosure obligations do not apply to principal underwriters of mutual funds and other registered investment companies, unless the principal underwriter is making an investment recommendation to a retail customer for which suitability and other similar FINRA requirements apply.

*Disclosure of the Names of Specific Offerors.* As proposed, Rule 2341 would require broker-dealers to list the names of the offerors that have paid, or entered into an arrangement with the broker-dealer to pay, the additional cash compensation.[18] In our 2009 comment letter, we recommended that FINRA modify the proposed rule to require identification of the sponsor/primary adviser of the fund complex, rather than requiring disclosure of each individual offeror. FINRA did not take that comment, and does not address the issue in the Notice.

We continue to believe that requiring broker-dealers to list each individual offeror may make the disclosure less understandable for many investors. The term "offeror" is defined in Rule 2341(b)(1)(E) to mean "an investment company, an adviser to an investment company, a fund administrator, an underwriter and any affiliated person (as defined in Section 2(a)(3) of the Investment Company Act) of such entities." The payments covered by Rule 2341 typically are made by a fund's investment adviser or principal underwriter or their affiliates. In some cases, broker-dealers may receive payments by more than one entity with respect to funds in a single fund complex. Listing each of these entities separately likely will be confusing to many investors. It would be clearer if the broker-dealer simply listed the relevant fund sponsor, complex, or other name readily identifiable with the funds sold. Accordingly, we reiterate our recommendation that FINRA revise the rule to address and clarify this issue.

*Application of Rule 2210 to the Disclosures.* In the final rule, FINRA should clarify that the mandated disclosures will not be deemed advertising or sales literature for purposes of Rule 2210, which governs broker-dealer communications with the public. The filing and fee requirements under Rule 2210 would add needless delays and costs to the production, distribution, and updating of the disclosure.

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[17] In an "orphaned" account situation, the retail broker resigns as the broker of record on the customer account holding the fund shares, and the fund's underwriter or transfer agent maintains and services the account. In a "check and application" account situation, the retail broker or customer submits an account application in writing with a customer's check. When the transfer agent opens that account, it records the customer as a customer of the retail broker-dealer and pays any sales compensation due to the broker of record on the account.

[18] Rule 2341(l)(4)(C)(iii).

*Compliance Date.* The Notice states that "FINRA will announce the implementation date of the proposed rule change in a Regulatory Notice to be published no later than 90 days following Commission approval. The implementation date will be no later than 365 days following Commission approval." While we appreciate that "FINRA will take into account that firms would need to modify their compliance systems in light of the new required disclosure," the final rule should allow firms at least one year to comply. We believe that given the range of new regulatory requirements both related and unrelated to the Dodd-Frank Act, one full year will be necessary to enhance systems, develop related compliance procedures, and train personnel.

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ICI appreciates the SEC's attention to our comments. If you have any questions, please contact me at 202/326-5815, Bob Grohowski at 202/371-5430, or Mara Shreck at 202/326-5923.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

cc: The Honorable Mary L. Schapiro
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
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