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ICI VIEWPOINTS

APRIL 21, 2016

To the SEC and FINRA: It's Your Move

By David Blass

Earlier this month, I wrote about the wide-ranging benefits of the proposed Securities and Exchange Commission (SEC) rule to give U.S. regulated funds the option of making online access to shareholder reports their default method for informing their shareholders. The rule has great potential to save fund shareholders billions of dollars, to reduce the fund industry's environmental footprint, and to align the delivery of these reports with shareholder preferences—all while preserving shareholder choice in how to receive them.

Yet that potential might go unrealized if a powerful firm gets its way. The leading vendor delivering fund shareholder reports on behalf of brokers plans to interpret an arcane New York Stock Exchange (NYSE) rule governing "processing fees" for delivering these reports in a way that would dramatically increase the amount funds pay for delivery.

Our analysis of the vendor's interpretation shows that the processing fees charged to broker-sold funds that opt for online delivery would more than quadruple. Funds would end up paying more *not* to deliver paper shareholder reports than they currently pay to deliver them. The prospect of this warped outcome would—surprise!—discourage funds from opting to deliver shareholder reports online, and thwart one of the Commission's main goals in proposing the rule in the first place: saving shareholders money.

A Pressing Concern

This alarming prospect throws light on a more pressing, present-day concern. The NYSE rule and the treatment of processing fees for the delivery of fund materials are in desperate need of a shake-up.

The best I can say about the NYSE rule is that it's imprecise. Designed for the distribution of proxy materials for operating companies, it doesn't clearly specify how the fees apply to the delivery of any fund materials. Nor does it make any mention of how they would apply to online delivery of fund shareholder reports.

At its worst, the NYSE rule promotes abusive practices. The schedule sets maximum fees that a broker can charge a fund for delivering a shareholder report—but because the broker has no incentive to charge anything less than the maximum fees, they act as an obligatory standard in practice. If the broker can negotiate with the vendor to deliver a shareholder report at a cost that is lower than what the broker has charged the fund, the broker might well pocket the difference, in what amounts to a kickback.

The Good News

The good news is that fixing this fee structure—so that funds that opt for online delivery can pass massive cost savings to shareholders—should not be terribly difficult. As a first step, the SEC must explain in its rule's adopting release how the NYSE fees apply to the online delivery of fund shareholder reports. That explanation must reject the vendor's interpretation—and, in keeping with the Commission's mandate to protect investors, maximize cost savings for fund shareholders. The SEC also should extend the same online-delivery treatment to summary prospectuses and full online delivery to closed-end funds' so-called Section 19 notices.

As a second step, the Financial Industry Regulatory Authority (FINRA) should take responsibility for the rules governing fees for the delivery of fund materials. There is no apparent reason for the NYSE to have any regulatory interest in maintaining a fee schedule for mutual fund shareholder report delivery. But as the primary self-regulatory organization overseeing broker-dealers—with protecting investors as an integral part of its mandate—FINRA is uniquely equipped to take over the job of scrutinizing delivery fees charged by brokers to funds. A separate, specially tailored fee schedule designed by FINRA would untangle our industry from the current proxy-distribution paradigm designed for operating companies, and allow fund shareholders to pay no more than the fair fees they deserve.

The SEC's smart, forward-thinking rule—if adopted with ICI's recommended improvements—would save shareholders nearly $2 billion over the next decade alone. But without clarification from the Commission on how processing fees should apply under the rule, and without intervention from FINRA, the delivery vendor's interpretation will reign by default—meaning that those savings will never materialize.

ICI already has submitted letters to both the SEC and FINRA urging them to move on these concerns. Now it's their turn to act. The interests of more than 90 million fund shareholders are at stake.

David Blass was General Counsel of ICI.
