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Comment Letter on Broker-Dealer Recordkeeping Proposal, November 1998

November 9, 1998

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Reproposed Amendments to Broker-Dealer Books and Records Requirements (File No. S7-26-98)

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on the reproposed amendments to the broker-dealer books and records rules under the Securities Exchange Act of 1934.[2] The Institute previously commented on the original 1996 proposal to amend the broker-dealer books and records requirements.[3] We are concerned (and, frankly, somewhat puzzled) that, based on the absence of any reference to our previous letter in the Release and the fact that the reproposed rules were not modified to reflect our comments, our comments apparently were not considered by the Commission or its staff. Therefore, we will reiterate the comments made in our previous letter and urge that they be given the serious consideration they warrant.

As did our comments on the original proposal, the Institute's comments focus on requirements under proposed Rule 17a-3(a)(16)(i) that all broker-dealers maintain an account record for each customer, containing such information as the customer's investment objectives. This proposed requirement is illogical for broker-dealers that do not make investment recommendations, such as many underwriters of investment companies, and thus it should not apply to such broker-dealers. This letter also contains certain additional comments on other aspects of the current proposal. Specifically, investment company underwriters also should not be subject to the proposed requirement to maintain records of whether customers are associated persons of broker-dealers, since investment company shares do not raise the concerns with front-running that the requirement was intended to address. Additionally, the provision in proposed Rule 17a-3(a)(16)(ii) requiring broker-dealers to maintain separate records indicating whether the broker-dealer has complied with applicable state, self-regulatory organization ("SRO") or securities exchange rules governing information required when opening or updating a securities account should be deleted as unnecessary. Finally, the requirement in proposed Rule 17a-4(b)(4) to retain all communications of the broker-dealer related to its "business as such" should be clarified to allow broker-dealers to develop written record retention policies and procedures appropriate for the type of business conducted by the broker-dealer.

Each of these points is discussed further below.

Account Record Requirements

Under proposed Rule 17a-3(a)(16)(i), broker-dealers would be required to maintain an "account record" for each natural person customer account containing such information as the customer's investment objectives or risk tolerance. The Release states that this requirement would allow examiners to more effectively review for compliance with suitability requirements. A broker-dealer would have to update a customer's investment objectives at least once every 36 months. A broker-dealer also would have to furnish a customer's account record to the customer within 30 days of opening the account and thereafter at least once every 36 months or when the account record is otherwise updated. The Release states that these requirements would provide customers with the opportunity to verify and update the information in their records.

Broker-dealers that do not make investment recommendations to their customers should be exempt from the requirement to collect and maintain information on customers' investment objectives. In particular, broker-dealers that act as underwriters of investment

companies should be exempt because their activities are generally limited to the distribution of investment company shares, such as general marketing activities (e.g., print and media advertisements), and in some cases, direct sales of shares to customers.[4] Because these broker-dealers typically do not recommend securities, they do not make suitability determinations for their customers.[5] The purpose of the requirement to maintain records of customers' investment objectives – to allow examiners to more effectively review for compliance with suitability requirements – simply does not apply to these types of broker-dealers, including investment company underwriters. Moreover, requiring such broker-dealers to maintain records of investment objectives would be directly contrary to National Association of Securities Dealers, Inc. Rule 2310, which only requires collection of this information if a broker-dealer recommends a securities transaction to a customer.

Similarly, the proposal to require broker-dealers to provide each customer with a copy of his or her account record and to update such records at least once every 36 months also should not apply to broker-dealers that do not make investment recommendations, including investment company underwriters. The stated purpose of this requirement is to allow customers to periodically verify and update information in their records. Other than name, address, telephone number and social security (or other tax identification) number, the information that would be required under proposed Rule 17a-3(a)(16)(i) relates to the suitability of a customer's investments. Because these broker-dealers do not recommend securities to their customers, there is no need for customers to update this type of information. Moreover, investment company shareholders typically receive on at least a quarterly basis an account statement that includes such information as a customer's name, address, and social security number, and so shareholders will have the opportunity to verify and review this information on a periodic basis. Inasmuch as these broker-dealers do not make recommendations and therefore are not subject to suitability requirements, the significant costs that these requirements would impose are not justified.

Associated Person Records

The reproposed amendments also would require a broker-dealer to record whether the customer is an associated person of a broker-dealer. If an account were a discretionary account, the records would have to contain the dated signature of each customer granting the discretionary authority and the dated signature of each person to whom such authority is granted. The Release states that these requirements would assist examiners in identifying any trading or sales practice violations, such as churning or front-running.

Investment company underwriters also should be exempt from this requirement. The Release states that this requirement would assist examiners in identifying possible trading or sales practice violations, such as front-running. Because investment company shares represent interests in a diversified pool of securities, the risks of front-running do not exist in this context.[6]

In addition, apparently in recognition of the unique nature of investment companies, the Commission recently approved an exemption for brokerage accounts limited to investments in mutual fund shares from certain requirements of NASD Rule 3110 (which governs broker-dealer books and records). Among other things, such accounts are exempt from the requirement to maintain records of whether customers holding such accounts are associated persons of broker-dealers.[7] If Rule 17a-3 were amended to require broker-dealers to keep records of whether customers are associated persons of broker-dealers without exempting investment company underwriters, this change would run completely contrary to the Commission's recent approval of the amendments to NASD Rule 3110.

Separate Records of Compliance with Securities Regulatory Rules

Proposed Rule 17a-3(a)(16)(ii) would require a broker-dealer to create a record indicating whether it has complied with applicable state, SRO and securities exchange rules governing information required when opening or updating a customer account. The Release states that this requirement would assist Commission staff and state securities regulators in reviewing for compliance with such rules relating to customer information and sales practice violations.

This requirement should be deleted. If a broker-dealer is subject to a state, SRO or exchange rule, then by law the broker-dealer must comply with its requirements. Requiring a separate record of such compliance under Rule 17a-3 simply adds to a broker-dealer's regulatory burden without any additional benefit. Assuming examiners are familiar with such requirements, they will be able to review a broker-dealer's books and records to determine compliance with these rules without the broker-dealer having to produce a separate record indicating it has complied.

Communication Retention Requirements

Proposed Rule 17a-4(b)(4) would require a broker-dealer to preserve originals of all communications received and copies of all communications sent by the broker-dealer "relating to its business as such," including any written approvals of communications sent and any written procedures it uses for reviewing the communications received or sent relating to its business as such. Although the

"business as such" standard exists under current Rule 17a-4(b)(4), this standard has caused much confusion in the industry as to which communications the rule applies, particularly with respect to electronic mail.[8] The Commission should use this opportunity to clarify how Rule 17a-4(b)(4) applies to both written and electronic communications, including e-mails and Internet communications.

In particular, the Commission should revise Rule 17a-4(b)(4) to make it more consistent with the approach taken by the NASD in its recent amendments to NASD Rule 3010(d) with respect to the review of customer correspondence. Under revised NASD Rule 3010(d), an NASD member is required to develop written procedures that are "appropriate to its business, size, structure, and customers for the review of incoming and outgoing written and electronic correspondence with the public relating to its investment banking or securities business." As explained in the NASD Notice to Members adopting these rule changes, members have substantial flexibility in drafting these review policies and procedures based on guidelines contained in that Notice.[9] Rule 17a-4(b)(4) should be amended to allow a broker-dealer to adopt a similar approach with respect to the retention of communications received and sent by the broker-dealer.

Thus, Rule 17a-4 should provide a broker-dealer with the flexibility to draft written policies and procedures on retaining communications relating to its investment banking or securities business received or sent by the broker-dealer that are appropriate to its business, size, structure and customers. This flexibility will allow a broker-dealer to examine the types of communications that various persons within its organization are sending and receiving, and draft communication retention policies that are consistent with its operations. A broker-dealer's policies will still be subject to examination and review by the Commission and other securities regulatory authorities in order to ensure that the broker-dealer is retaining necessary communications.

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We appreciate the opportunity to comment on the reproposed amendments to the broker-dealer books and records rules. If you have any questions regarding our comments, please call me at (202) 326-5819.

Sincerely,

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Associate Counsel

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ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 7,335 open-end investment companies ("mutual funds"), 451 closed-end investment companies, and 9 sponsors of unit investment trusts. Its mutual fund members have assets of about $4.837 trillion, accounting for approximately 95% of total industry assets, and have over 62 million individual shareholders.

[2] Securities and Exchange Commission Release No. 34-40518 (Oct. 2, 1998), 63 Fed. Reg. 54404 (Oct. 9, 1998) (the "Release").

[3] See Letter from Amy B.R. Lancelotta, Associate Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (December 20, 1996); see also Securities and Exchange Commission Release No. 34-37850 (Oct. 25, 1996), 61 Fed. Reg. 55593 (Oct. 28, 1996).

[4] Some broker-dealers that serve as fund underwriters may also engage in other activities. To the extent a broker-dealer that serves as an investment company underwriter performs full-service brokerage functions, including recommending securities to customers, it should be subject to the customer account record-keeping requirements with respect to only those customer accounts for which such functions are performed.

[5] Investment company underwriters generally distribute fund shares either through broker-dealers (which may be independent of the underwriter or part of its sales force) or directly to the public. When shares are sold directly to the public, investors typically contact the fund's underwriter directly to obtain information about the fund and make their own investment decisions; consequently, the fund's underwriter makes no recommendations. Where fund shares are sold through broker-dealers or other financial intermediaries, any recommendation would be made by persons associated with those entities, rather than the fund's underwriter.

[6] Because investment company underwriters do not exercise discretionary authority over shareholders' investments, the requirements governing discretionary accounts would not apply to them.

[7] NASD Rule 3110 generally requires NASD member broker-dealers to make reasonable efforts to obtain certain information with respect to customer accounts, including whether the customer is an associated person of another broker-dealer. The Commission recently approved a rule change exempting from this requirement accounts in which investments are limited to mutual fund shares not recommended by the member or its associated persons. See NASD Notice to Members 98-47 (July 1998).

[8] This confusion has increased since the issuance of SEC Release No. 34-38245 (Feb. 5, 1997), in which the Commission stated specifically that Rule 17a-4 requires broker-dealers to retain all e-mails and Internet communications that relate to their "business as such."

[9] See NASD Notice to Members 98-11 (Jan. 1998).
