INVESTMENT COMPANY INSTITUTE

Global

Comment Letter on NASDR Correspondence Rule Proposal, July 1997

July 14, 1997

Ms. Joan Conley
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, N.W.
Washington, D.C. 20006-1500

Re: NASD Request for Comment on Proposed Definition of Correspondence for Rules Regarding Communications with the Public
(NASD Notice to Members 97-37)

Dear Ms. Conley:

The Investment Company Institute[1] appreciates the opportunity to respond to NASD Regulation, Inc.'s ("NASDR") request for comment on proposed amendments to NASD Conduct Rule 2210 to require that written or electronic communications prepared for a single customer be subject to the general and specific standards requirements of Rule 2210 (the "Proposed Amendments").[2]

The Proposed Amendments would create a new definition of "correspondence," which would include any written or electronic communication prepared for delivery to a single customer and not for dissemination to multiple customers or the general public. The proposal also would subject all correspondence to the general and specific substantive requirements under paragraphs (d) and (f), but not the filing and review requirements under paragraph (c), of Rule 2210. The Proposed Amendments also would include correspondence within the category of "communications with the public," and thus would require all members' correspondence to conform to all applicable rules of the Securities and Exchange Commission ("SEC"). Although the Proposed Amendments and the accompanying discussion are not clear on this point, it appears that the Proposed Amendments would subject correspondence to the SEC advertising rules, including Rules 34b-1, 134, 135a, 156 and 482.[3]

For the reasons discussed in detail below, the Institute believes that the Proposed Amendments are unnecessary and inappropriate. First, existing NASD Conduct Rules governing member correspondence with individual customers are more than sufficient to curb any perceived wrongful conduct by NASD members. Second, imposing the requirements of Rule 2210 on correspondence would be highly inappropriate in many contexts. Third, the implementation of the Proposed Amendments would add another extremely costly and burdensome layer of regulation applicable to NASD members without any corresponding benefit to consumers. We strongly recommend that they not be adopted.

Existing NASD Conduct Rules are Sufficient to Govern Correspondence

NASD Conduct Rules already govern in many respects the use and content of member correspondence with customers. Rule 3010(d) requires each member to establish procedures for the review and endorsement by a registered principal in writing, on an internal record, of all transactions and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction. Thus, members are already required to review and approve correspondence which pertains to the solicitation or execution of securities. Rules 2210(f) and 3010(g)(2) also impose certain additional requirements on the use of letterhead and business cards.

NASDR proposed in December 1996 to amend Rule 3010(d) to broaden the scope and requirements of the rules governing the review of correspondence. [4] Under this proposal, every NASD member firm would be required to establish procedures for the supervision of all correspondence relating to the firm's business, as opposed to only correspondence relating to the solicitation or execution of a securities transaction. Firms would no longer be required to review each item of correspondence prior to use; however, the proposal would require that procedures for the review of correspondence be in writing and that members retain correspondence of their registered representatives relating to their business in accordance with Rule 3110. Where the procedures would not require pre-use review, they would be required to include provisions for the training of registered representatives as to the firm's procedures, documentation of such education and training, and surveillance and follow-up to ensure that such procedures are implemented and adhered to.

In addition to these existing and proposed NASD Conduct Rules which specifically govern the use of correspondence, there are a number of NASD rules that generally require members to act fairly with, and not defraud or manipulate, their customers. For example, Rule 2110 requires members to observe high standards of commercial honor and equitable principles of trade in the conduct of their business. Rule 2120 prohibits members from effecting any transaction in, or inducing the purchase or sale of, any security by means of any manipulative, deceptive or fraudulent device or contrivance. Rule 2310 requires that, in recommending to a customer the purchase, sale or exchange or any security, the member must have reasonable grounds for believing that the recommendation is suitable for the customer based on facts disclosed by the customer, and requires members to make reasonable efforts to obtain certain information from non-institutional customers prior to executing a recommended transaction. Members also have a fundamental responsibility to deal fairly with customers as set forth in IM-2310-2. Each of these general requirements and prohibitions apply to the use of correspondence with customers as well as in other contexts, and thus the content of correspondence is already subject to numerous restrictions.[5]

Taken together, the existing NASD Conduct Rules that specifically or generally govern the use and content of customer correspondence are more that sufficient to curb any possible abuses by members. In its discussion of the Proposed Amendments, NASDR cited four disciplinary proceedings over approximately the last two years that concerned correspondence containing information that could be considered exaggerated, unwarranted, or misleading.[6] Given the thousands of pieces of correspondence that members generated during this period, the need for imposing a new and burdensome requirement does not seem pressing in light of the apparent low incidence of abuse. Moreover, members that have sent correspondence to customers that contained misleading, unwarranted or exaggerated information would appear to be in violation of a number of existing rules with respect to the content of such letters, such as Rules 2110, 2120 and IM-2310-2, as well as the requirements to review and approve correspondence under Rule 3010(d). Additional rules and layers of regulation, such as those found in Rule 2210 with respect to advertising and sales literature, are completely unnecessary to prevent such conduct. To the extent that NASDR believes that it needs to take additional steps to prevent such behavior by members, it would appear to be more useful for NASDR to increase its enforcement of existing rules and regulations, rather than adding a whole new set of requirements.

Imposing the Requirements of Rules 2210(d) and (f) on Correspondence Would be Inappropriate in Many Contexts

The requirements of paragraphs (d) and (f) of Rule 2210 are intended to apply to member advertising and sales literature. Thus, they address the risks that can arise when communications are directed to large audiences, particularly where the purpose of the communication is to encourage the audience to purchase or sell securities. Unlike advertising or sales literature, correspondence typically is directed to a single individual (or select group of individuals) and often has purposes other than encouraging the purchase of sale of securities. Accordingly, the application of the requirements of paragraphs (d) and (f) in these contexts is inappropriate and may in fact be counterproductive.

For example, a customer may send an e-mail to an employee of a member with a question about her automatic investment plan, since she recently switched banks and would like to know how to institute the plan with her account at the new bank. Under the Proposed Amendments, the member presumably would be required to include in the responding e-mail a lengthy disclosure that the plan does not assure a profit, does not protect against loss in declining markets, and discuss at length the principles of dollar-cost averaging pursuant to Rule 2210(d)(2)(I). This verbiage would greatly increase the length of the e-mail response without benefiting the customer or the member. In fact, the customer may be more confused as a result of these disclosures, because all she wanted to know was how to implement her already existing automatic investment plan with her new bank. Since presumably she already had been given these disclosures with any advertising or sales literature that she received before she originally initiated her plan, we fail to see any benefit from imposing the requirements of Rule 2210 in this context.

Another common use of correspondence is when a member responds to an inquiry from a mutual fund shareholder regarding the amount of distributions per share for a particular calendar quarter. Typically these letters are short and to the point: they simply inform the shareholder of the amount of the quarterly distributions and perhaps briefly discuss the fund's performance during the quarter. Under the Proposed Amendments, such correspondence might be construed as being subject to SEC rules regarding the advertising of performance.[7] Thus, the Proposed Amendments could be construed as requiring any such correspondence to include not only the information regarding the amount of quarterly distributions, but also the one-, five-, and ten-year and since inception performance figures of the fund, plus all of the usual disclosures that past performance is no assurance of future results, and that the investment return and principal value will fluctuate, so that the investor's shares, when redeemed, may be worth more or less than their original cost. Accordingly, the Proposed Amendments conceivably could convert what is currently a short, commonly used letter into a lengthy performance report. Given that investors normally already receive this information in a fund's quarterly report to shareholders, as well as in their quarterly account statements, this application of Rule 2210 and the SEC advertising rules seems to be completely unnecessary and regulatory overkill.

Moreover, many customers who write distributors or investment advisers of mutual funds are sophisticated investors that have specific questions regarding the performance of a fund or the distributor's or the adviser's view of the stock market or the economy in the coming months. Currently, members may tailor correspondence in response to such inquiries based on the relative sophistication of the customer. The advertising rules, however, require numerous specified disclosures. [8] Thus, under the Proposed Amendments, members might be required to include all of the disclosures, including, as discussed above, standardized performance figures if the correspondence contains any performance information, required under the NASD and SEC rules. Such disclosure would be neither necessary nor appropriate in a letter to, for example, a portfolio manager of a large pension fund. The Proposed Amendments, however, could eliminate a member's discretion to determine under what circumstances such disclosures are needed.

An additional example of problems which the Proposed Amendments could create is in the context of a member's response to a request for proposal ("RFP") circulated by an institutional investor, such as the sponsor or administrator of a 401(k) or other employee retirement plan. Typically, such RFPs include specific questions regarding fund performance and in some cases request performance comparisons with competing funds. If NASDR adopts the Proposed Amendments and deems them to subject correspondence to the advertising rules, responses to RFP questions would be weighted down with extraneous information (e.g., performance results for other time periods) which the requesting institutional investor did not seek. Moreover, members conceivably could be barred from comparing their funds' performance with the performance of their competitors' funds, since such comparisons normally are not permitted in advertising and sales literature. This consequence could give non-member firms (such as banks offering unregistered collective investment funds) a competitive advantage over member firms responding to the same RFP, as non-member entities are not subject to the NASD rules.

The Proposed Amendments Would be Costly and Burdensome

The Proposed Amendments also would add significant costs and burdens to members' operations. Currently, members are required to have principals review and approve correspondence pursuant to Rule 3010(d). Assuming that the changes proposed in NASD Notice to Members 96-82 are adopted, members would also be required to adopt written procedures appropriate to the member's business, size, structure and customers for the review of written and electronic correspondence. If the Proposed Amendments are adopted, all correspondence would also have to comply with the general and specific requirements of Rule 2210, as well as the requirements of SEC Rules 34b-1, 134, 135a, and 482 (as applicable). This would greatly complicate the process of reviewing correspondence and place increased and unwarranted demands on member training programs, as presumably all personnel who send correspondence to customers would be charged with knowledge of the intricacies of the SEC and NASD advertising rules.

The imposition of the SEC advertising rules on correspondence also could add costs that could spread over to a member's preparation and distribution of mutual fund prospectuses and statements of additional information. If the Proposed Amendments are adopted, then presumably each letter and e-mail message will be required to qualify as a Rule 134 "tombstone" advertisement, a Rule 135a generic advertisement, a Rule 482 omitting prospectus, or supplemental sales literature. In many cases, correspondence will include information that falls outside the limitations of Rule 134 and the substance of the correspondence will not be included in a fund's prospectus or SAI. Thus, members would be forced either to include a prospectus with the correspondence (either as an e-mail attachment or as a hard copy), or to constantly "sticker" fund prospectuses and SAIs to keep up with the content of correspondence. This process would be enormously time-consuming, costly, and extremely difficult to administer. Moreover, sending multiple updated prospectuses and SAIs with various extraneous information to shareholders and other customers would be of no benefit to the recipients.

We appreciate the opportunity to comment on this important issue. If you have any questions about this matter, please contact the undersigned (202/326-5819).

Sincerely,

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ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 6,456 open-end investment companies ("mutual funds"), 440 closed-end investment companies, and 10 sponsors of unit investment trusts. Its mutual fund members have assets of about $3,677 billion, accounting for approximately 95% of total industry assets, and have over 59 million individual shareholders.

[2] NASD Notice to Members 97-37 (June 1997).

[3] 17 C.F.R. §§ 270.34b-1, 230.134, 230.135a, 230.156 and 230.482, respectively.

[4] NASD Notice to Members 96-82 (December 1996). In May 1997, the SEC solicited comment on this proposed rule change. 62 Fed. Reg. 24147 (May 2, 1997).

[5] Additionally, rules adopted by the SEC under the Securities Exchange Act of 1934, which apply to all NASD members, impose similar duties and prohibit manipulative or fraudulent conduct by broker-dealers. See, e.g., 17 C.F.R. § 240.10b-5.

[6] See In the Matter of Peter Stuart Bevington, Complaint No. C8A940021 (Mar. 5, 1997); In the Matter of William Stafford Thurmond, Complaint No. C06930051 (Feb. 1, 1996); In the Matter of Jeffery Steven Stone, Complaint No. C06940036 (Feb. 1, 1996); and In the Matter of Micah C. Douglas, Complaint Nos. C06920046 and C06930068 (Sept. 19, 1995).

[7] We assume that this issue would not arise if such correspondence were from a non-member entity, such as a transfer agent that is not a registered broker-dealer. In such cases, the NASD rules presumably would not apply.

[8] Rule 2210(d)(1)(D)(ii) provides that, in judging whether a communication is misleading, a member may consider the audience to which a communication is directed; however, this provision does not relieve the member of disclosure requirements of Rule 2210 and the SEC advertising rules.