

Comment Letter on NASDR Proposed Rule Amendments Regarding Review of Customer Correspondence, May 1998

May 12, 1998

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

**Re: Proposed Rule Change by the NASD Regulation, Inc. to Implement the Effective Date of Recently Approved Amendments to Rules 3010 and 3110
(File No. SR-NASD-98-31)**

Dear Mr. Katz:

The Investment Company Institute¹ appreciates the opportunity to comment on NASD Regulation, Inc.'s ("NASDR") proposal to implement the effective date of recently approved amendments to NASD Rules 3010 and 3110, which govern the supervision, review and record retention of correspondence by member firms (the "Proposal").² The Institute commends NASDR generally for adopting more flexible procedures for the review and supervision of associated person correspondence. As discussed below, however, the Institute has concerns with the provision of the Proposal that would require NASD members to review all incoming non-electronic correspondence directed to registered representatives and related to a member's investment banking or securities business (the "Incoming Correspondence Provision"). This provision would be extremely burdensome and costly to members without providing any corresponding benefits to investors. Accordingly, the Institute opposes this provision and strongly recommends that it not be implemented.

Background

NASDR initially proposed to amend the provisions of Rules 3010 and 3110 governing supervision, review and record retention of member correspondence in December 1996, and the SEC published for comment revised amendments to these rules in May 1997.³ Both the initial and the revised proposed amendments would have required NASD members to establish written procedures for the supervision of written and electronic correspondence of its registered representatives relating to the business of the member. Member firms no longer would have been required to review each item of its registered representatives' correspondence. Neither the initial nor the revised proposal indicated that the proposed changes would have required members to review all incoming non-electronic correspondence directed to registered representatives related to the member's investment banking or securities business, or that current Rule 3010(d) required such review.

The indication that member firms would be required to review all incoming non-electronic correspondence directed to registered representatives did not appear until the Commission's December 31, 1997 release announcing its approval of the proposed rule change.⁴ The Commission acknowledged, however, that the text of the rule language does not contain the Incoming Correspondence Provision and that this provision is set forth only in NASDR's Notice to Members accompanying the rule change.⁵ As a result of concerns raised by NASD members over the Incoming Correspondence Provision, NASDR has proposed to delay the effectiveness of this provision until July 7, 1998, in order to solicit further comment. For the following reasons, the Institute opposes implementation of the Incoming Correspondence Provision.

The Incoming Correspondence Provision is Unnecessary to Protect Investors

The changes to Rules 3010 and 3110 regarding review, supervision and record retention of correspondence that recently became effective, when combined with existing NASD rules, are more than sufficient to protect investors and to provide for a system of comprehensive oversight of the correspondence activities of an NASD member's associated persons and employees. Under this new regime, a member firm must adopt procedures that specify in detail its policies for reviewing different types of correspondence (including, presumably, incoming correspondence).⁶ Member firms also are required under Rules 3070(a)(2) and (c) and 3110(d) to review and report to the NASD customer complaints and keep detailed records of all customer complaints received in either electronic or non-electronic form.

Although member firms may not necessarily review each and every piece of correspondence, they are required to develop policies to ensure that registered representatives and other employees use correspondence appropriately. These requirements also allow a member firm to tailor its supervisory policies to address the most critical issues associated with that firm's correspondence based on its business, size, structure and customers. For instance, correspondence that recommends certain securities may require greater scrutiny from a firm's principals than correspondence that simply provides routine customer account information.

The Incoming Correspondence Provision lacks this flexibility and logic, since it would require review of every piece of a firm's incoming non-electronic correspondence directed to a registered representative and related to that firm's securities business, regardless of the purpose or content of the correspondence. This review responsibility would extend well beyond the prior requirements under Rule 3010(d), which arguably did not apply to incoming correspondence at all, and in any case only applied to correspondence pertaining to the solicitation or execution of securities transactions.

If the Incoming Correspondence Provision were implemented, a member firm would be required to review each and every piece of written correspondence covered by the provision, regardless of which aspect of the member's securities business it addressed. Thus, for example, it would appear that even an investor letter directed to a registered representative that merely requested a fund prospectus or a change of a brokerage account address would require member review.⁷ This requirement seems ironic and illogical in light of the fact that the amendments to Rules 3010(d) and 3110 otherwise appropriately permit members to implement procedures for selected review of all outgoing correspondence and all incoming electronic correspondence. The costs of requiring member firms to review these types of letters are not justified given the lack of benefits to investors.

The issues raised by the Commission to justify implementation of the Incoming Correspondence Provision—namely, notice of sales practice problems and proper handling of customer funds—can easily be addressed through existing rules. If a customer complains about a registered representative's sales practices, the member firm is already required under Rules 3070(a)(2) and (c) and 3110(d) to report the complaint to the NASD and to keep detailed records of such complaints.

The concerns over proper handling of customer funds also can be addressed without implementing the Incoming Correspondence Provision, particularly with respect to member firms serving as mutual fund underwriters. In contrast to firms conducting a general brokerage business, broker-dealers that serve only as mutual fund underwriters generally do not handle customers' funds or securities in the course of their business. When a customer purchases shares directly from a mutual fund, the fund's transfer agent typically issues the shares to the customer against receipt of the purchase money and sends the money to the fund's custodian bank. When fund shares are sold through intermediaries, such as retail broker-dealers, the purchase money is typically transmitted by that intermediary directly to the fund's transfer agent. In rare situations where the customer's funds or shares do come into possession of the mutual fund underwriter, the underwriter merely acts as a conduit and typically holds the funds or shares for less than one business day. Thus, the risk of mutual fund underwriters or their registered representatives misappropriating customer funds is largely non-existent.

As for member firms that do handle customer funds, this issue can be addressed through more targeted policies adopted under new Rule 3010(d). For example, depending on its structure and operations, a member firm may require that all incoming correspondence that includes customer funds be forwarded to a particular division of the firm, such as its accounting department. Additionally, member firms will still be required to review at least a selected sample of incoming non-electronic correspondence even without implementation of the Incoming Correspondence Provision.⁸ Requiring member firms to review every single piece of incoming non-electronic correspondence is unnecessary and overly burdensome.

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We appreciate the opportunity to comment on this proposed rule change. If you have any questions, please contact the undersigned at (202) 326-5819.

Sincerely,

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cc: Richard R. Lindsey
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ENDNOTES

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 7,024 open-end investment companies ("mutual funds"), 438 closed-end investment companies, and 9 sponsors of unit investment trusts. Its mutual fund members have assets of about \$4.932 trillion, accounting for approximately 95% of total industry assets, and have over 62 million individual shareholders.

² Securities and Exchange Commission Release No. 34-39866 (April 14, 1998), 63 Fed. Reg. 19778 (April 21, 1998).

³ See NASD Notice to Members 96-82 (Dec. 1996) (initial proposed amendments); Securities and Exchange Commission Release No. 38548 (April 25, 1997), 62 Fed. Reg. 24147 (May 2, 1997) (revised proposed amendments).

⁴ See Securities and Exchange Commission Release No. 34-39510 (Dec. 31, 1997), 63 Fed. Reg. 1131 (Jan. 8, 1998). The release stated that "Rule 3010(d) will continue to require review of all incoming non-electronic correspondence directed to registered representatives" and that "this requirement may provide a broker-dealer with early notice of sales practice problems and help ensure proper handling of customer funds."

⁵ See *id.* at 1134 n.18; see also NASD Notice to Members 98-11 (Jan. 1998).

⁶ A member must, among other things, identify how supervisory reviews will be conducted and documented, identify what types of correspondence will be pre- and post-reviewed, identify what positions within the firm will be responsible for review of correspondence, specify the minimum frequency of reviews, monitor the implementation and compliance with the policies, and periodically re-evaluate the effectiveness of the firm's policies and procedures.

⁷ We assume, however, that any correspondence related to the business of a mutual fund transfer agent that is not an NASD member, including mutual fund accounts held with the transfer agent, would not be subject to these requirements.

⁸ If review of non-electronic correspondence is deemed necessary, we recommend that this requirement be limited to non-electronic correspondence directed to registered representatives that have a history of violations of SEC or NASD rules relating to the handling of customer funds or sales practices.