

Letter on NASDR Request for Comment on the Need for a Risk Disclosure Rule, June 1997

June 30, 1997

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

Re: NASD Notice to Members 97-29 Relating to NASD Request for Comment on the Appropriateness of Adopting a Rule Governing Risk Disclosure (the "Notice")

Dear Ms. Conley:

The Investment Company Institute¹ appreciates the opportunity to respond to NASD Regulation, Inc.'s ("NASDR") request for comment regarding whether to adopt a rule that would require all NASD members or, in the alternative, those that sell both insured products and uninsured securities products, to disclose investment risks and the absence of guarantees or insurance related to investing in securities products (the "Proposed Rule").²

For the reasons discussed in detail below, the Institute believes that application of such a rule to NASD members other than those operating on the premises of a financial institution where retail deposits are taken is unnecessary and inappropriate. First, such a rule ignores the fact that special disclosure requirements applicable to sales of securities on bank premises have been adopted in response to specific concerns regarding potential customer confusion in such contexts. Second, existing disclosure requirements applicable to NASD members adequately address any potential confusion about insured versus uninsured products.

As the Notice indicates, the Proposed Rule would supplement pending amendments to proposed NASD Rule 2350, the rule that would regulate broker/dealer conduct on the premises of financial institutions (the "Bank Proposal").³ The Bank Proposal is designed to address concerns regarding customer confusion over the distinction between the insured deposit products of a financial institution and uninsured securities products sold by a broker/dealer operating in the same location.⁴ These concerns also formed the basis for the banking regulators' Interagency Statement.⁵ In each case, the rationale for concern was that sales of nondeposit investment products on bank premises where retail deposits are taken may give the impression that such securities are FDIC-insured or are obligations of the bank.⁶ Accordingly, special disclosure and other requirements were deemed necessary to protect customers from any misunderstanding or misperception regarding the applicability of federal insurance and bank guarantees to those investment products offered on bank premises.⁷ For similar reasons, mutual funds that are sold through banks are required to prominently disclose on the cover page of the prospectus that shares in the fund are not deposits or obligations of, or guaranteed or endorsed by, the bank, and that the shares are not federally insured by the FDIC, the Federal Reserve Board, or any other agency.⁸

The Institute wishes to note that it does not necessarily agree that all of the particular requirements that are currently imposed pursuant to the Interagency Statement and that would be imposed under the Bank Proposal are necessary to accomplish the goal of avoiding customer confusion. For example, the Interagency Statement requires, among other things, that oral disclosures regarding the lack of insurance and guarantees be given to the customer during any sales presentation and when investment advice concerning securities products is provided. In addition, during the account opening process, written acknowledgment must be obtained from customers evidencing their receipt and understanding of these disclosures. Moreover, bank advertisements and other promotional and sales materials, written or otherwise, about securities products sold to bank customers must also disclose these warnings.⁹ The Bank Proposal would impose similar requirements.¹⁰

Considered in toto, this extensive—and perhaps redundant—set of obligations appears to impose unnecessary burdens on participants in the bank channel. In fact, continuous visible and verbal admonitions may actually add to customer confusion by

incorrectly implying that it is more dangerous to purchase securities products in a banking environment than in other settings.

Regardless, however, of whether the requirements imposed under the Interagency Statement and the Bank Proposal are justified, the concerns that they are intended to address are not present when securities products are purchased at locations other than on bank premises. Indeed, the Notice provides no evidence that customers are confused as to the uninsured status of securities products when, for example, they purchase mutual fund shares in the office of a financial planner or in the branch office of a securities firm not located in a bank. Nor is there any evidence of confusion where an NASD member solely distributes affiliated mutual funds.

It appears that the NASD may be motivated by a desire simply to ensure that all NASD members are subject to uniform regulation. But it would be highly inappropriate to impose disclosure obligations on member firms in the absence of specific circumstances warranting such risk disclosure. Indeed, it was for this reason that the Institute recommended in its comment letter to the SEC on the Bank Proposal that the proposed disclosure rules not apply in situations where the likelihood of customer confusion is minimal, such as, for example, where a broker/dealer, who, while not on the premises, fields incoming calls through the bank's toll-free telephone lines from customers who may or may not be on the premises.¹¹

Moreover, requiring NASD members not operating on bank premises to disseminate additional "generic" risk disclosures, either written or oral, would provide little, if any, additional useful information to investors. Indeed, such disclosures could detract from risk disclosure that is more specific to a particular investment and thus more meaningful. In the case of mutual funds, requiring such disclosures would run directly contrary to the approach the SEC has taken in its pending prospectus disclosure reform initiatives. For example, the proposed amendments to Form N-1A (the form used by mutual funds to register with the SEC), "seek . . . to focus prospectus disclosure on essential information about a particular fund that would assist an investor in deciding whether to invest in that fund."¹² Among the specific changes the SEC has proposed to help accomplish this goal is requiring narrative risk disclosure to focus on the risks to which a fund's particular portfolio as a whole is subject.¹³ It would be inappropriate for NASDR to adopt requirements that could frustrate the SEC's stated policy objectives, especially where the need for such requirements has not been demonstrated.

Finally, to the extent that any customer confusion concerns might arise with respect to securities products sold by NASD members not located on bank premises, existing regulatory requirements sufficiently address them. The Notice, in fact, notes some of these requirements in its discussion of members' disclosure obligations under NASD rules.¹⁴ With respect to mutual funds in particular, federal securities laws require mutual fund prospectuses to contain appropriate and complete discussions of all relevant risks. In addition, all money market fund prospectuses must include a cover page legend that the fund is not insured or guaranteed by the U.S. government or any agency thereof. Thus, rather than trying to fashion an overly-broad rule, the NASDR instead should continue to remind NASD members of their existing disclosure obligations.

We appreciate the opportunity to comment on this important issue. If you have any questions about this matter, please contact the undersigned (202)/326-5923) or Frances Stadler (202)/326-5822).

Sincerely,

Barry E. Simmons
Assistant Counsel

cc: R. Clark Hooper
Senior Vice President
Office of Disclosure and Investor Protection
NASD Regulation, Inc.

Mary N. Revell
Assistant General Counsel
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ENDNOTES

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 6,543 open-end investment companies ("mutual funds"), 445 closed-end investment companies, and 11 sponsors of unit investment trusts. Its mutual fund members have assets of about \$3.849 trillion, accounting for approximately 95% of total industry assets, and have over 59 million individual shareholders.

² NASD Notice to Members 97-29 (May 1997).

³ 62 Fed. Reg. 19378 (April 21, 1997).

⁴ Id. See also 61 Fed. Reg. 11913, 11915 (March 22, 1996).

⁵ Interagency Statement on Retail Sales of Non-deposit Investment Products (February 15, 1994). The concern about customer confusion with respect to securities sales activities occurring on bank premises was reiterated in a joint statement prepared by the banking regulators interpreting the Interagency Statement. See Joint Interpretation of the Interagency Statement on Retail Sales of Nondeposit Investment Products (September 12, 1995).

⁶ See Interagency Statement at 10 (February 15, 1994) and 61 Fed. Reg. at 11917 (March 22, 1996).

⁷ For this reason, in addition to imposing disclosure requirements, the Bank Proposal would require the physical separation of broker/dealer activities from deposit-taking activities, as well as clear delineation of the NASD member's name from that of the financial institution where the securities products are being sold. See 62 Fed. Reg. 19378 (April 21, 1997).

⁸ See Letter to Registrants, from Barbara J. Green, Deputy Director, Division of Investment Management, Securities and Exchange Commission ("SEC") (May 13, 1993).

⁹ See Interagency Statement at 7 (February 15, 1994).

¹⁰ See 62 Fed. Reg. at 19378 (April 21, 1997).

¹¹ See Letter from Barry E. Simmons, Assistant Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated May 12, 1997. To further minimize confusion and to lessen the burden on NASD members operating on bank premises, the letter also recommended the disclosure rules delete the FDIC risk disclosure reference to "other deposit insurance" and recommended that NASD members be given flexibility in satisfying the customer written acknowledgment requirement, thereby allowing, for example, NASD members to provide customer acknowledgment disclosures on an application to open an account. Id. at 4.

¹² SEC Release No. IC-22528 (February 27, 1997) at 1.

¹³ Id. at 21.

¹⁴ See, e.g., Notices to Members 91-74 (Nov. 1991), 93-87 (Dec. 1993) (discussing a member's obligations to disclose the material differences between the risks of uninsured securities products and insured depository products to a customer seeking to invest the proceeds of a guaranteed or government-insured depository product), and Notice to Members 94-16 (March 1994), and Special Notice to Members 95-80 (Sept. 1995) (reminding members of their obligations to disclose all material information to customers when recommending transactions in mutual funds).