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August 3, 2009

Ms. Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 09-34: FINRA Requests Comment on Proposed Consolidated
FINRA Rule Governing Investment Company Securities

Dear Ms. Asquith:

The Investment Company Institute¹ appreciates the opportunity to comment on Proposed FINRA Rule 2341, and in particular the proposed revisions to the requirements regarding disclosure of cash compensation relating to the sale of investment company securities.²

ICI has long supported enhanced disclosure to help investors assess and evaluate a broker's recommendations.³ Indeed, we believe such disclosure should be required for *all* retail investment products sold by financial intermediaries, including variable annuity contracts, collective investment

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$10.5 trillion and serve over 93 million shareholders.

² See FINRA Regulatory Notice 09-34, Investment Company Securities (June 2009) (The "Notice"). The proposal also requires FINRA members to disclose that information about a fund's fees and expenses is available in the fund's prospectus. We support this requirement.

³ See, e.g., Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Joan C. Conley, Office of the Corporate Secretary, NASD Regulation, Inc., dated Oct. 15, 1997; Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Annette L. Nazareth, Director, Division of Market Regulation, and Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission, dated May 8, 2000; and Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Barbara Z. Sweeney, Office of the Corporate Secretary, NASD Regulation, Inc., dated October 17, 2003.

trusts and separate accounts – not just mutual funds.⁴ Certain compensation structures have the potential to influence financial intermediaries' recommendations to their clients, such as by creating incentives to inappropriately favor some products over others.⁵ We believe that investors would benefit from learning about such compensation arrangements.

As part of our recommended broader initiative to improve financial intermediary disclosure to investors, we support the proposed requirement that FINRA members make certain disclosures to investors regarding the receipt of cash compensation. In conjunction with these proposed disclosure requirements, we recommend that FINRA eliminate, rather than modify, the disclosures regarding cash compensation required in funds' prospectuses under FINRA's rules.⁶ This information is more appropriately provided to investors by their brokers. Further, in light of the proposed broker disclosures, the prospectus disclosure contemplated by proposed Rule 2341 would be redundant, and would not likely add to an investor's understanding of the broker's potential conflict of interest.

These comments, as well as a number of practical and technical comments on the proposal, are explained more fully below.

⁴ See Testimony of Paul Schott Stevens, President and CEO, Investment Company Institute, Before the Committee on Financial Services, United States House of Representatives, on "Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals," July 17, 2009, available at http://www.ici.org/policy/ici_testimony/09_reg_reform_jul_tmny; see also, e.g., Letter from Elizabeth R. Krentzman, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated April 4, 2005, available at <http://www.sec.gov/rules/proposed/s70604/ekrentzman040405.pdf>; Investment Company Institute, Submission to the Investor Advisory Committee of the U.S. Securities and Exchange Commission, dated July 19, 2009, available at <http://www.sec.gov/comments/265-25/26525-8.pdf>.

⁵ See *Notice to Members 03-54*, NASD (September 2003), a substantially similar rulemaking proposal that was never adopted, in which NASD explained the potential conflicts of interest presented by cash compensation arrangements:

Revenue sharing and differential cash compensation arrangements may create incentives to inappropriately favor some funds over others, or to favor funds over nonfund investments. These compensation arrangements can create conflicts of interest by encouraging members and their registered representatives to recommend certain funds to maximize their compensation, rather than to best meet their customers' needs. They may provide point-of-sale incentives that could compromise proper customer suitability considerations and may present a situation in which the salesperson's interests are not, in some circumstances, fully aligned with the interests of customers.

⁶ In its 2003 proposal, NASD asked whether the prospectus disclosure could be eliminated in light of the additional disclosure that would be required of brokers. See *id.* As discussed below, ICI supported this proposition. See Letter from Craig S. Tyle, dated October 17, 2003, *supra* note 3.

I. CASH COMPENSATION DISCLOSURE

A. Information Provided by Brokers

ICI supports the proposed requirement that FINRA members provide information regarding cash compensation to their customers.⁷ As noted above, we have long advocated requiring additional disclosures at or before the point of sale regarding arrangements that could create a conflict of interest – or the perception of a conflict of interest – for brokers. These arrangements include revenue sharing and other cash compensation arrangements captured by the proposed rule. While some information about these arrangements is currently provided to investors in funds’ prospectuses or statements of additional information (“SAIs”),⁸ we believe that detailed disclosure is more appropriately provided by brokers.⁹

As explained in an earlier NASD rulemaking proposal, “[d]isclosure of revenue sharing and differential cash compensation arrangements would enable investors to evaluate whether a registered representative’s particular product recommendation was inappropriately influenced by these arrangements.”¹⁰ To make such an evaluation, an investor would be best served by knowing the full range of a broker’s cash compensation arrangements, not just those with a recommended fund. This information is only available from the broker. Moreover, there is a personal relationship between investors and brokers. Investors trust brokers to assist them with their financial needs.¹¹ Any arrangements that may cause an investor to question a broker’s recommendation should be provided up front by the broker, so that this trust is not violated.

⁷ We note that, over the past several years, brokers have generally enhanced the disclosure they provide to investors about their cash compensation arrangements with investment companies. In fact, much of the information proposed to be required under Rule 2341 is already being provided on broker Web sites. This is likely the result, in part, of enforcement actions brought concerning broker compensation arrangements with mutual funds. *See, e.g., In the Matter of Edward D. Jones & Co., L.P.*, SEC Administrative Proceeding File No. 3-11780 (December 22, 2004).

⁸ As explained in the Notice, FINRA staff has interpreted existing requirements regarding cash compensation in a fund’s prospectus to permit such disclosure in a fund’s SAI. *See* Notice at n. 5. As a practical matter, this is typically where such information is disclosed.

⁹ This is consistent with the SEC’s view that “broker-dealers must... disclose information about revenue sharing arrangements for the sale of mutual funds.” *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, SEC Release Nos. 34-51523, IA-2376 (Apr. 12, 2005), 70 FR 20423 (Apr. 19, 2005) at n. 93.

¹⁰ NASD Notice to Members, *supra* note 5. *See also Report of the Mutual Fund Task Force: Mutual Fund Distribution*, NASD (November 11, 2004).

¹¹ *See Mutual Fund Point of Sale Disclosure Investor Research Findings*, Prepared for NASD by Applied Research & Consulting LLC (March 23, 2005) (“respondents generally demonstrate a great deal of trust towards their brokers – such trust being part of a successful ongoing relationship”).

B. Information Provided in Fund Prospectuses

In conjunction with the proposal to require broker disclosure regarding cash compensation arrangements, the proposal would modify, but not eliminate, the disclosure regarding these arrangements required to be contained in funds' prospectuses under FINRA rules.¹² If, as we recommend, the proposed broker disclosure requirements are adopted, we believe such prospectus disclosure is no longer necessary, and should be eliminated.

We understand that the proposed broker requirement to disclose "any form of cash compensation" other than sales charges and service fees disclosed in the fund's prospectus fee table is intended to encompass any "special sales charges or service fee arrangements." Thus, the prospectus disclosure would be redundant of the broker disclosure, offering no additional information.

Moreover, as discussed above, because such disclosures relate to potential *broker* conflicts, and may exist across multiple funds sold by the broker, we believe they are more appropriately provided to an investor by the broker.¹³ Consistent with this view, the SEC's recent amendments to Form N-1A require funds to include a general statement regarding financial intermediary compensation in the summary section of each mutual fund prospectus, and in a summary prospectus, if used. In adopting this requirement, the SEC explained that the disclosure "is intended to identify the existence of compensation arrangements with selling broker-dealers or other financial intermediaries, alert investors to the potential conflicts of interest arising from these arrangements, and direct investors to their salespersons or the financial intermediary's Web site for further information."¹⁴ The adopting release

¹² The proposal would limit the disclosure required in prospectuses to "special sales charges and service fees." According to the Notice, this is intended to exclude disclosure regarding revenue-sharing payments. If this requirement is maintained in the final rule, we request that FINRA clarify, in the rule text, that revenue-sharing arrangements are excluded from the definition of "special sales charges and service fees." We further request clarification that earlier guidance on the definition of "service fees," including NASD Notice to Members 93-12 (February 1993) (which, in Q&A #17, lists several categories of services which are excluded from "service fees"), is not superseded by this rule. Finally, we note an ambiguity in Supplementary Material .02. The statement that "if a member receives a cash payout in addition to the regular commission...and other members do not receive this payout, the member has entered into a special sales charge or service fee arrangement" is overly broad, because "cash payout" is not limited to payments relating to sales charges or service fees. We do not believe this statement was meant to capture payments to members for subtransfer agency, subaccounting or administrative services, among other things.

¹³ By contrast, detailed prospectus disclosure of cash compensation arrangements with different broker-dealer firms would be largely irrelevant to any given investor, whose interest would be limited to the arrangements with his or her broker. *See, e.g.*, Letter from Craig S. Tyle, dated October 17, 2003, *supra* note 3. Further, because such disclosure relates to broker conflicts, ICI members firmly believe that it should not be their legal obligation. Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Nancy Morris, U.S. Securities and Exchange Commission, dated February 28, 2008, available at <http://www.sec.gov/comments/s7-28-07/s72807-92.pdf> at 41.

¹⁴ *See Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies*, SEC Release Nos. 33-8998 and IC-28584 (Jan. 13, 2009), at 49.

further explains that the Commission considered and rejected a requirement that the summary disclosure enumerate the types of compensation that may be provided, deciding that it was sufficient to alert investors generally to the payment of compensation and potential conflicts, and direct them to their salesperson or intermediary's Web site for more information. Finally, the adopting release states that the Commission continues to consider requiring additional disclosure *from financial intermediaries* about broker and intermediary compensation and conflicts of interest.¹⁵ This approach is consistent with the Commission's oft-repeated view that a fund's prospectus is intended to "provide essential information about the *Registrant*" (emphasis added).¹⁶

Finally, as we have indicated before, we believe the SEC should have sole responsibility for determining the appropriate content of fund registration statements.¹⁷

For all of these reasons, we recommend that FINRA eliminate, rather than modify, the requirement that funds make disclosures regarding cash compensation in their prospectuses.

C. How Information Should be Provided to Investors

ICI has frequently emphasized that it is critical for proposed regulations to take into account the manner in which intermediaries sell investment products (*i.e.*, typically by telephone or over the Internet, rather than in face-to-face meetings), in order to avoid imposing unwarranted burdens on the sales process. These burdens could discourage brokers from selling mutual funds, and incentivize them to recommend other investment products not subject to the same requirements, even when those products do not offer the same level of regulatory protection and other benefits for investors.¹⁸ We therefore applaud FINRA for considering the practical import of its proposal by soliciting comment on how such disclosures should be made.

¹⁵ *Id* at 64.

¹⁶ Registration Form Used by Open-End Management Investment Companies, SEC Release No. IC-13436 (Aug. 12, 1983), 48 Fed. Reg. 37928 (Aug. 12, 1983) (adopting Form N-1A); *see also* Registration Form Used by Open-End Management Investment Companies, SEC Release Nos. 33-7512, 34-39748, and IC-23064 (March 13, 1998), 69 Fed. Reg. 13916 (March 23, 1998).

¹⁷ *See, e.g.*, Letter from Craig S. Tyle, dated October 17, 2003, *supra* note 3; Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Joan C. Conley, Office of the Corporate Secretary, NASD Regulation, Inc., dated February 12, 1999.

¹⁸ As noted above, we further believe that disclosures regarding potential conflicts of interest should be required for all retail investment products sold by brokers. *See supra* note 4 and accompanying text.

We strongly support the use of the Internet to provide important disclosure to investors.¹⁹ ICI research shows that the vast majority of mutual fund shareholders have access to and frequently use the Internet, including for financial purposes.²⁰ Therefore, consistent with our earlier recommendation to the SEC on its point of sale disclosure proposal, we recommend permitting brokers to provide the required disclosure by providing generalized disclosure, either in paper or by email, referring investors to information on the broker's Web site.²¹

II. OTHER COMMENTS

As noted above, FINRA's current proposal is substantially similar to amendments proposed by the NASD in 2003. Accordingly, we reiterate the following recommendations from our comment letter on the 2003 proposal:²²

A. The Nature of Payments

As proposed, subdivision (l)(4)(B)(ii) would, in part, require disclosure of "the nature of such cash payments." It is not clear what is intended by this requirement. We recommend that FINRA clarify that broker-dealers can satisfy this requirement by providing generic disclosure of the types of cash compensation²³ received (*e.g.*, marketing support fees), and that a description of each type of payment on an offeror-by-offeror basis is not required. Requiring a description of *each* type of payment by *each* offeror this could result in extremely voluminous disclosure that would not be meaningful to investors.

B. The Listing of Offerors

Proposed subdivision (l)(4)(B)(ii) would also require a broker-dealer to disclose the name of each offeror that made a cash payment to the broker-dealer during the period covered, in descending order based upon the amount of compensation received from each offeror. ICI believes that technical compliance with this provision as currently drafted would produce odd and inappropriate results in some circumstances.

¹⁹ See, *e.g.*, Letter from Karrie McMillan, *supra* note 13.

²⁰ See, *e.g.*, *Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2008*, Investment Company Institute, available at <http://www.ici.org/pdf/fm-v17n6.pdf>.

²¹ See Letter from Elizabeth R. Krentzman, *supra* note 4.

²² See Letter from Craig S. Tyle dated October 17, 2003, *supra* note 3.

²³ We also recommend that the wording of this provision be revised to refer to "cash compensation" rather than "cash payments." Alternatively, if the reference to "cash payments" is intended to have a different meaning than the defined term "cash compensation," FINRA should clarify what it intended by "cash payments."

The term “offeror” is defined in Rule 2341(b)(1)(E) to mean “an investment company, an adviser to an investment company, a fund administrator, an underwriter and any affiliated person (as defined in Section 2(a)(3) of the Investment Company Act) of such entities.” The payments covered by the proposal typically are made by a fund’s investment adviser or principal underwriter or their affiliates. In some cases, payments that would be subject to the disclosure requirement may be made by more than one entity with respect to funds in a single fund complex. It would not make sense to view each of these entities separately for purposes of the listing requirement; indeed, this could distort the information and be confusing to investors.

The purpose of the proposed disclosure requirement would be better served if, rather than requiring disclosure relating to each individual offeror, the rule applied to the aggregate payments from all offerors in connection with the sale or distribution of funds in a single fund complex²⁴ and required identification of the sponsor/primary adviser of those funds. We recommend that FINRA revise the rule to address and clarify this issue.

C. A *De Minimis* Standard

When the NASD proposed identical amendments to Rule 2830 in 2003, it sought comment on whether the rule should establish a *de minimis* threshold below which disclosure of cash compensation payments would not be required. As in 2003, ICI continues to support a *de minimis* threshold because it is unlikely that relatively small payments would have the potential to improperly influence a broker-dealer’s investment recommendations. We therefore recommend that, when payments with respect to funds in a single fund complex that otherwise would trigger disclosure are one percent (1%) or less of the aggregate cash compensation payments received by the broker-dealer during the period covered, they should be excluded from the disclosure requirement.

D. Deletion of a Superfluous Provision

Finally, proposed subdivision (l)(4)(B) would require any member that has received cash compensation, “other than sales charges or service fees disclosed in the prospectus fee table,” to provide investors specified disclosure. Notwithstanding this, proposed subdivision (l)(4)(E) states in its entirety: “The requirements of Rule 2341(l)(4)(B) shall not apply to cash compensation in the form of a sales charges or service fee disclosed in the prospectus fee table of the offeror’s investment company.” Because the provisions of subdivision (l)(4)(E) seem entirely redundant of the carve-out in subdivision (l)(4)(B), we recommend that subdivision (l)(4)(E) be deleted.

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²⁴This should include any covered payments by a subadviser to those funds.

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We appreciate the opportunity to provide our views to FINRA on proposed Rule 2341. If you have any questions concerning these comments, or would like any additional information, please contact me at 202/326-5815.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel