August 3, 2009

BY EMAIL TO: pubcom@finra.org

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

Re: FINRA Regulatory Notice 09-34 (June 2009),
Investment Company Securities

Dear Ms. Asquith:

The Private Client Legal Committee of the Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on the proposed consolidated FINRA rule governing investment company securities.[2] As a general matter, we laud FINRA's efforts as part of its process to develop a new consolidated rulebook to address its rules on the distribution and sale of investment company securities and its efforts to ensure that related disclosures may lead to better decision-making by clients and reduce the potential for conflicts of interest and abuse. We believe, however, that certain provisions of the proposed amendments to Conduct Rule 2830 (renumbered as Conduct Rule 2341) require reconsideration and that, more fundamentally, given the SEC's primacy in regulating mutual fund prospectus disclosure and the SEC's contemplation of further rule proposals on "point of sale" disclosure, FINRA should coordinate its rulemaking efforts with the SEC to avoid inconsistencies in disclosures, unnecessary and potentially duplicative costs on its members, and confusion among the investing public. Specifically, we offer the following comments and recommendations:

1. The Proposed Amendments Do Not Provide Additional Meaningful Disclosure and Will Confuse Investors

The proposed rule creates a disclosure regime that would require an investor to piece together and interpret information provided by two separate disclosure obligations, from two separate regulators, in two separate and possibly inconsistent formats. Such fragmented information streams will likely confuse and

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[1] SIFMA brings together the shared interests of more than 600 securities firms, banks and asset managers locally and globally through offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. More information about SIFMA is available at http://www.sifma.org.

[2] FINRA Regulatory Notice 09-34, "Investment Company Securities," available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p119013.pdf ("RN 09-34").

possibly mislead investors as to the financial relationship between a FINRA member and investment company offerors. Specifically, the proposed rule would require a member to disclose only a portion of the fees it receives from funds and their affiliates (*i.e.*, those fees not otherwise already disclosed in the prospectus fee table),[3] providing investors with an incomplete picture of a member's relationship with investment company offerors. An investor may not be able to discern, from a partial listing of fees received, the full context of the relationship between an investment company offeror and a FINRA member, which would inhibit rather than facilitate an investor's appreciation of the complexity of and any potential conflicts regarding the relationship.

In addition, requiring members to list offerors from whom they receive fees based on the amount of cash compensation received could also confuse or mislead investors. A mere list of one particular data point does not provide an investor with a basis to assess or distinguish the relative conflicts of interest, if any, between the member and the listed offerors. Moreover, a list in descending order by gross amount of compensation does not alert an investor as to which investment company has offered the most preferential arrangement vis-à-vis the member. In fact, it may merely signal the relative volume of business, which is not necessarily an indicator of a true conflict of interest. For example, a mutual fund family may provide a member with higher total support payments but may actually pay at a lower rate due to a volume discounting or some other factors. However, that fact would not be apparent to investors reviewing a list of offerors characterized by gross size of payment to the member. Such a list may, contrary to FINRA's intentions, confuse an investor with factual but irrelevant information, which may lead an investor to erroneously assign greater importance to the data than it merits. Additionally, such payments may be made by multiple payors with respect to the funds in a single fund family. A disaggregated listing of payments separately by payor may therefore confuse investors about the magnitude of a firm's financial relationship with a mutual fund organization. In contrast, we believe narrative web-based disclosure describing the nature and range of fees received by the member would be more appropriate, and is a measure that many member firms have already implemented as a best practice.

Further, it is unclear how broker-dealers would disclose information under the proposed rule where they act as introducing brokers to unaffiliated clearing brokers. In many business models, an unaffiliated clearing broker is interposed between the investment companies and the introducing brokers. This model presents unique challenges under the proposed rule as the clearing and introducing firms may share investment company fees under negotiated arrangements, but it is the introducing broker that has the direct relationship with the customer and, therefore, the potential conflict of interest. We request that FINRA clarify how the rule, if adopted, would apply in these circumstances.

2. The Rule Amendments Fail to Address Ambiguities in the Use of Defined and Undefined Terms

The proposed amendments fail to address, and in fact exacerbate, the ambiguities in the use of defined and undefined terms – an issue that has plagued the existing rule and ultimately led a hearing panel in 2007 to declare that the rule's prohibition of undisclosed "special cash compensation" was, in essence, void for vagueness. Specifically, in June 2007, an NASD Hearing Panel found a member broker-dealer not liable under Rule 2830(l)(4) for accepting payments from fund distributors in arrangements similar to ones for

[3] *See* Item 3 of Form N-1A.

which NASD had previously obtained enforcement settlements.[4] The Hearing Panel cited the history of the rule and comments on definitional ambiguities as the primary factors for disagreeing with the NASD Department of Enforcement's contention that "special compensation is any compensation that surpasses the usual compensation." According to the Hearing Panel, the undefined term resulted in inadequate notice for the broker-dealer such that the Hearing Panel could not find the Respondent liable for violating Rule 2830(l)(4). We agree with the Hearing Panel's conclusion, especially given the number of commenters that pointed out the definitional ambiguities.

FINRA now proposes to change the term "special cash compensation" to "special sales charges or service fee arrangements" without having explained its rationale (the term is no more self-explanatory than the term it would replace) and without defining the new term in the body of the rule. FINRA now proposes to explain the meaning of the term in proposed Supplementary Material 0.2, which states that "[f]or purposes of this provision, 'special sales charge or service fee arrangement' means an arrangement under which a member receives greater sales charges or service fees than other members selling the same investment company securities." According to the proposal, "[t]his disclosure requirement applies even if an offeror would have made the same arrangement available to other members had they requested it."

The Supplementary Material then offers two examples:

- "For example, if a member receives the full gross sales charge imposed on the sale of investment company securities, while other members selling the same securities receive only a portion of the gross sales charge, the member receiving the full gross charge has entered into a special sales charge or service fee arrangement with an offeror that requires prospectus disclosure."

- "Similarly, if a member receives a cash payout in addition to the regular commission paid on the sale of investment company securities, and other members do not receive this additional cash payout, the member has entered into a special sales charge or service fee arrangement."

So explained, the concept of "special sales charge or service fee arrangement" raises many interpretive ambiguities, including whether a sales charge or service fee arrangement with a member is "special" if:

- The member receives greater absolute or aggregate amounts of sales charges or service fees than other members selling the same investment company securities solely by virtue of the fact that it distributes more of the mutual fund interests? (Presumably, not.)

- The member receives sales charges and service fees that together equal that received by other members but the sales charges are higher and the service fees are lower than the fees paid to other members (or vice versa)?

- The member provides additional services in exchange for which an additional service fee is paid?

[4] NASD Disciplinary Proceeding No. E8A2203062001, Hearing Panel Decision (Jun. 28, 2007).

- Another member disclaims or rebates the sales charges or service fees to which it is entitled or gives investors a corresponding credit against other fees it may charge?

- A given arrangement is different with regard to the service obligations of a particular member?[5]

The presumption proposed in the explanation – that "[g]enerally a member should assume it has entered into a special sales charge or service fee arrangement if it is receiving sales charges or service fees from an offeror in addition to the standard dealer reallowance or commission described in an investment company's prospectus, unless the prospectus is clear that this additional compensation is being paid to all members that sell the investment company's securities" – is likewise unclear. Specifically, what is meant by "unless the prospectus is clear that this additional compensation is being paid to all members that sell the investment company's securities"? What level or specificity of disclosure does FINRA contemplate (*e.g.*, general ranges of additional compensation)? What is the impact if additional compensation is not paid to all members because, as in the illustration above, they effectively disclaim or rebate it?

The use of other undefined terms, and interchangeable use of defined and undefined terms, injects substantial ambiguity in the text of the new rule. Paragraph (l)(4)(B) would require that any member that has within the previous 12 months received from an offeror any form of "cash compensation, other than sales charges or service fees disclosed in the prospectus fee table," must make certain disclosures about such compensation.[6] Among other things, the member must disclose, that the member receives "cash payments" (not defined)[7] from an offeror, "other than sales charges or service fees disclosed in the prospectus fee table," the "nature" (not defined) of any such "cash payments" received in the past 12 months, and the name of each offeror that made such a "cash payment," listed in descending order based upon the amount of "compensation" received from each offeror." So drafted, the provision is ambiguous in a number of key respects:

- RN 09-34 is not clear on the types of fees that need to be described and captured for reporting in descending order to clients. Specifically, do firms need to include fees received for omnibus processing and similar service provider fees with traditional revenue sharing?

- Although the term "sales charge" as defined in paragraph (b)(8) appropriately excludes "charges and fees for ministerial, recordkeeping or administrative activities and investment management fees," these items are not excluded from the defined terms "compensation" and "cash compensation" or the undefined term "cash payments." As a result, a member receiving any such fees would be required to comply with the new disclosure requirements, even those these fees are not sales charges.

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[5] Moreover, the operation of the term "special sales charge or service fee arrangement" in the body of the proposed rule could foster more questions. This is because, as noted, "special sales charge or service fee arrangement" is explained as covering any "arrangement under which a member receives greater sales charges or service fees than other members selling the same investment company securities," while the body of the rule, in paragraph (l)(4), refers to "arrangements are not made available on the same terms to all members who distribute the investment company securities of the offeror."

[6] *See* Proposed Rule 2341(l)(4)(B)(ii).

[7] The undefined term "cash payments" is used several other times, including in paragraph (l)(4)(D).

- Although the trigger for the new disclosure requirements would be the receipt of "cash compensation" and "cash payments," the listing of offerors is to be based on "compensation" received from each offeror, which as defined in paragraph (b)(1)(B), includes both cash compensation *and non-cash compensation* (which FINRA separately acknowledges is hard to value).[8]

Another key but undefined term is "revenue sharing payments," which RN 09-34 states "member firms would be required to disclose . . . pursuant to the rule." In a footnote, RN 09-34 states that revenue sharing payments can take many forms, including "the form of other cash payments, such as an offeror helping to pay the cost of a firm's annual sales meeting."[9] Stating that revenue sharing payments can take the form of "other cash payments" (which could include many of the transaction-oriented fees collected by member firms, such as transfer agent fees and omnibus fees as well as fees that are explicitly excluded from the term "sales charge") is an overbroad expansion of what is commonly understood to be revenue sharing payments. Additionally, an offeror's contribution to the cost of a firm's annual sales meeting has historically been treated as a form of non-cash compensation and not as revenue sharing.[10] The re-classification of a form of non-cash compensation as revenue sharing represents an important departure from current standards and warrants clear regulatory guidance. The re-definition of the term is also of particular concern because it directly conflicts with the SEC's use of the same term in a way that explicitly excludes non-cash compensation.[11] We recommend that if FINRA's intent is to expand the definition of revenue sharing payments – and a member's related disclosure obligations – it should do so explicitly and include a clear definition in the text of the rule, one that provides an exhaustive list of the forms that such payments may take.[12]

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[8] We also note that the proposal would delete the phase "if known" from paragraph (l)(3) with respect to valuing non-cash compensation for recordkeeping purposes. Although RN 09-34 states that firms would be able to estimate this value, the rule should state this explicitly, for example by providing: "The records shall include the names of the offerors, the names of the associated persons, the amount of cash, and the nature and value, if known or a reasonable estimate of the value if unknown, of non-cash compensation received."

[9] *See* RN 09-34 at Footnote 7.

[10] *See* Conduct Rule 2830(l)(5)(C).

[11] The definition of "revenue sharing" advanced by RN 09-34 conflicts with the SEC's definition of "revenue sharing" as "arrangements by which payments are made to broker-dealers from the assets of [a fund adviser and distributor] relating to the sale of [mutual fund shares] and/or assets maintained by the mutual fund other than (i) dealer concessions, 12b-1 fees, shareholder servicing payments, or sub-accounting payments or (ii) non-cash compensation arrangements as expressly permitted by NASD Rule 2820(g) or Rule 2830(l)(5) (or any successor to either such rule)." *See* SEC Rel. No. 52420 *available at* www.sec.gov/litigation/admin/34-52420.pdf.

[12] We are confused by FINRA's comment in RN 09-34 that "[o]ther types of cash compensation, such as revenue sharing payments, would not require prospectus disclosure," and request that FINRA clarify this statement, which seems to run contrary to the thrust of the proposed amendments. We would also point out that, while we believe it is the SEC that should dictate the requirements for prospectus disclosure in this area, broker-dealers typically rely on mutual fund prospectus disclosure to satisfy confirmation disclosure requirements for certain mutual fund related compensation, including revenue sharing, under SEC Rule 10b-10. See Brief of the SEC, Amicus Curiae (February 2000), in *Press v. Quick & Reilly, Inc., et al.*, 218 F.3d 121 (2d Cir. 2000) ["SEC Brief"] (stating the SEC's position that "a confirmation does not have to disclose third-party payments that are adequately disclosed in a prospectus that is delivered to customers"); Investment Company Institute, SEC Staff No-Action Letter (April 18, 1979) (granting no-action relief under Rule 10b-10 if a confirmation did not disclose "the sales load or any other charges in connection with the transaction," provided the customer had received a prospectus that

These ambiguities are of substantial concern when the interpretation of defined and undefined terms places a disproportionate burden on members. For example, a member may be unable to determine if and when it is receiving a “special sales and service fee” (defined by the proposed amendments as any fee greater than what the offeror pays to other members, regardless if other members would have received the same fees if requested) given that in practice the sources or streams of payments may not be directly identified and visible.[13] Even if members were able to impose on offerors the obligation to inform them if any sales and service fee is “special” – which members are almost never able to do in practice – the offeror, in turn, would be placed in the position of making a highly subjective value judgment on whether a payment is a “special sale or service fee” based on multiple factors relative to the type and level of service being provided by a particular member. Such factors may vary widely from member to member, and may not lend themselves to an easy or fair comparison. Given the regulatory risk of misjudging whether the compensation qualifies as a “special sale or service fee,” prudence may dictate disclosure of more information, which would have the unintended effect of diluting the intended benefit of the heightened disclosure requirement by exponentially increasing the number of disclosed arrangements. If a significant number of relationships are disclosed by firms as possibly involving “special sale or service fees,” in seeking to avoid regulatory risk, the information becomes of diminished value to an investor.

3. **The Burdens and Costs to Provide the Additional Disclosure Required by the Proposed Amendments are not Justified by Any Additional Protections They Intend to Provide.**

Compliance with the proposed rule represents an unjustified burden for both members and investment companies alike. Specifically, the proposed rule assigns to the member selling mutual fund interests the obligation to disclose detailed information[14] that it does not know first hand and that it must rely on third parties to provide. For example, members may charge a single fee for the services they provide to offerors, which may be paid in a variety of ways – from investment company assets or by the investment company’s adviser, principal underwriter or service providers. A member is not necessarily privy to the exact source or sources of the monies used by an investment company and its affiliates (which may vary from time to time) to pay the member’s fees, but it nevertheless carries the regulatory burden to disclose such information. Even if a member is able to contractually bind the offeror to provide the required information, the member is not discharged from its duty under the rule and such a contractual provision would not provide adequate assurance that the member would be in compliance with the proposed amendments.

Further, the proposed rule requires members to make substantial amendments to their contracts relating to the distribution of investment companies and monitor and evaluate the quality of prospectus disclosures to validate compliance with offerors’ contractual obligations. Investment companies may be required to undergo the expense of modifying their prospectus disclosure and create compliance systems to monitor

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disclosed ”the precise amount of the sales load or other charges or a formula that would enable the customer to calculate the precise amount of those fees.”).

[13] *See* RN 09-34 at 26.

[14] *See* Proposed Rule 2341(l)(4)(B)(ii).

and fulfill their reporting obligations to members. These costs are burdensome and unnecessary, relative to the limited, if any, value the proposed amendments provide.

Moreover, the interpretive and definitional ambiguities discussed above make it difficult for investment companies and their offerors to determine what compensation arrangements should be "described" or "disclosed" in their prospectus and what level of specificity is required. Various and different approaches to disclosure will only complicate the hard judgments members will have to make on whether an arrangement involving the receipt of compensation is "special" and is appropriately "described" or "disclosed" in their prospectus.

The proposal to require disclosure by members of the specific dollar amounts of service agreements or other types of agreements is also a significant burden. Compiling and updating this information would require substantial work for member firm, yet, it is unlikely that this level of detail would actually be helpful or meaningful to the investor. Instead, the investor is likely to be overwhelmed by the volume of information, which would seem to be at odds with the presumed goals of the proposal. We recommend that FINRA establish a clearer standard for this requirement by, for example, requiring members to disclose the type or category, as opposed to the "nature," of payments received.

Requiring a member firm to update information about special compensation arrangements every six months is an unnecessarily arduous requirement, especially considering that the terms of a given special compensation arrangement are unlikely to change more than once per year. In addition, updating revenue sharing disclosures every six months (and having to include specific dollar amounts) would constitute a significant expansion of current practice. Such a requirement would be expensive both in terms of staff hours and document production costs. We recommend an annual update as a reasonable alternative. Annual updates (based on prior twelve month or the prior calendar year) would be more accurate and complete due to uneven billing and payment practices over the short term. In any case, member firms should be given the option of providing the list to clients through their websites or in response to client requests through a toll-free telephone number. Requiring that member firms provide clients at account opening with a written listing of revenue sharing fund families organized by amount of compensation received would also increase printing costs without commensurate benefits. If, however, FINRA determines it necessary and in the public interest that members update the information every six months, we recommend that FINRA provide that if information has not changed within a given six-month cycle, the member has no additional disclosure obligations for that particular six-month period.

As noted at the outset, given the SEC's contemplation of further rule proposals on point of sale disclosures and Rule 12b-1, we recommend that FINRA coordinate its rulemaking efforts with the SEC to avoid imposing unnecessary and potentially duplicative costs on its members.

4. The Prospective Amendments Put a Strain on the Existing Regulatory Disclosure Framework

At a time when FINRA is highly committed to and engaged in rule consolidation and harmonization, the proposal puts a strain on the regulatory disclosure framework for investment companies and creates a dual – and competing – disclosure regime with separate and not necessarily consistent obligations. The proposal runs counter to the SEC's framework for Form N-1A prospectus disclosure, particularly in view

of the SEC's most recent amendments to Form N-1A that require mutual funds to provide a general statement in the summary section (and summary prospectus, if used) regarding financial intermediary compensation. Form N-1A amendments reflect the SEC's efforts to streamline prospectus disclosure consistent with its view that a prospectus should provide the "essential information" about an investment company registrant.[15] The SEC clarified that the required disclosure served to identify the existence of compensation arrangements with selling broker-dealers and other financial intermediaries, alert investors to the potential conflicts of interest, and direct investors to the broker-dealer's website for more information.[16] The SEC contemplated, but rejected, a proposal to require the prospectus to enumerate the types of compensation that may be provided, in favor of a general statement alerting investors to the payments and any potential conflicts.

Because it is the SEC, and not FINRA, that reviews the content of a mutual fund's registration statement, a lack of harmony in the disclosure standards would expose members to uncertainty as to whether they will be able to comply with the proposed rule. If enacted, the rule would require members to contract with investment companies for the inclusion of specific content, for which they would ultimately have no control. It is extremely difficult for broker-dealers to have meaningful discussions with mutual funds about the substantive content of prospectuses, where the investment company's disclosure decisions are subject to review by a different regulator and subject to different standards. In addition, even where a mutual fund is willing and able to accommodate a broker-dealer's comments on its prospectus and SAI disclosures, more weight may be given to the broker-dealer with the more prominent sales channels than to smaller broker-dealers. As a result, smaller broker-dealers might have a legitimate need given their own arrangement with a mutual fund organization for a disclosure adjustment, but the mutual fund company may weigh that change against other competing changes demanded by broker-dealers with more market and economic leverage.

Finally, using the proposed rule to dictate the substance of mutual fund prospectuses forces broker-dealers that distribute mutual fund shares to continuously monitor the prospectuses and SAIs for the mutual funds they distribute to make sure those prospectuses and SAIs contain required disclosures and to assess any changes in those disclosures against compliance with the FINRA requirements. This involves a substantial investment of time and resources for broker-dealers.

Accordingly, we recommend that FINRA coordinate its rulemaking efforts with the SEC to avoid imposing conflicting and inconsistent requirements that would create an unnecessary compliance burden on members.

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[15] *See* Registration Form Used by Open-End Management Investment Companies, SEC Rel. No. IC-13436 (Aug. 12, 1983). *See also* Registration Form Used by Open-End Management Investment Companies, SEC Rel. Nos. 33-7512, 34-39748, and IC-23064 (Mar. 13, 1998).

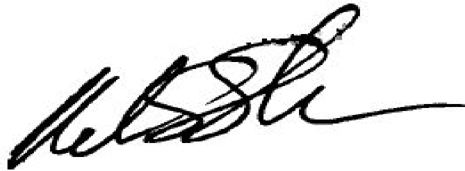
[16] *See* Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, SEC Rel. Nos. 33-8998 and IC-28584 (Jan. 13, 2009).

5. **The Proposed Rule Should Include Comprehensive Guidance on Non-Cash Compensation**

The Supplementary Material to the proposed rule announced that the proposed text supersedes all prior guidance regarding the definition of cash compensation.[17] We seek clarification as to whether this statement amends specific guidance provided by FINRA (formerly NASD) regarding non-cash compensation, particularly with respect to prospecting trip expenses.[18] We understand that this Notice to Members generally addresses questions about non-cash compensation arrangements, but the answer to Q #15 directs the member to comply with the prospectus disclosure requirements of Rule 2830(l)(4). Since FINRA is proposing significant changes to subsection (l)(4), we recommend FINRA harmonize previous guidance with the current rule proposal or provide new guidance regarding prospecting trip expenses.

Thank you for giving SIFMA's Private Client Legal Committee the opportunity to comment on the proposed consolidated FINRA rule governing investment company securities. If you have any questions regarding this comment letter, please contact the Committee's staff advisor, Kevin Carroll, at 202.962.7382 (kcarroll@sifma.org), or outside counsel, Steven Stone, at 202.739.5453 (sstone@morganlewis.com).

Sincerely,



Mark Shelton
Chair, SIFMA Private Client Legal Committee

cc: Joe Savage, Vice President and Counsel, Investment Companies Regulation, FINRA
Stan Macel, Assistant General Counsel, Office of General Counsel, FINRA

[17] *See* RN 09-34 at 25.

[18] *See* Notice to Members No. 99-55 (July 1999) at Q#15.