



May 4, 2004

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W., Stop 6-9
Washington, D.C. 20459

Re: Disclosure for Transactions in Certain Mutual Funds and Other Securities; File No. S7-06-04.

Dear Mr. Katz:

NASD is pleased to submit the comments of its staff on the Securities and Exchange Commission's proposals to improve the information that broker/dealers provide to their customers in connection with transactions in certain securities, particularly investment company securities.

NASD shares regulatory responsibility with the Commission for ensuring that mutual funds are sold in a manner that serves the best interests of investors. Although lacking jurisdiction over investment companies or a fund's investment adviser, NASD regulates the sales practices of broker/dealers that sell funds to investors. In light of NASD's role in ensuring the integrity of the mutual fund sales process, the Commission's proposals are of vital interest to NASD and its staff.¹

NASD supports the Commission's proposals for point-of-sale and confirmation disclosure. The proposals represent an important step forward in the ongoing regulatory effort to ensure that investors receive appropriate information about the costs and conflicts associated with a mutual fund recommendation.

NASD staff also supports the Commission's decision to use investor focus groups, as it did before comprehensively revising Form N-1A in 1998, to assist its consideration of appropriate point-of-sale disclosure.² These focus groups may provide invaluable assistance to the Commission's efforts to mandate meaningful disclosure while avoiding undue complexity and practical difficulties that could increase costs to fund shareholders or undermine the disclosure's effectiveness.

¹ The comments provided in this letter are solely those of the staff of NASD and have not been endorsed by the Board of Governors of NASD or the Board of Directors of NASD Regulation. For ease of reference, this letter will use "NASD" and "NASD staff" interchangeably, but in all cases these terms refer to NASD staff.

² See Investment Company Act Release No. 23064 (March 18, 1998).

From time to time, the Commission has requested that NASD form a task force of industry experts to provide practical guidance regarding the feasibility and implementation of new regulatory requirements.³ NASD would be pleased to provide similar assistance to the Commission with regard to the point of sale and confirmation proposals, both of which would require significant operational and systems modifications. Our efforts would undertake to help ensure that any new requirements achieve the Commission's goals in the most useful and cost-effective manner possible.

In addition, NASD respectfully suggests that the Commission consider enhancements to its proposal that we believe would achieve the Commission's goals in a more efficient and comprehensive manner. Under the Commission's proposal, each time that a registered representative of a broker/dealer recommends a mutual fund to an investor, the representative would provide certain standardized disclosure that enables the investor to assess the costs and conflicts associated with a particular fund investment. Our enhancements would:

- Modify the written disclosure document to provide investors with a snapshot of *all* of the costs associated with an investment in the fund, not just distribution-related costs, as well as a description of the conflicts associated with the recommendation; and
- Require a broker/dealer to post on its website the disclosure documents for all of the funds that it offers, in a format that allows an investor easily to compare the recommended fund with all other funds offered by the broker/dealer.

A prototype for this type of point-of-sale disclosure is attached.

Background

On January 14th, the SEC proposed two new rules that would require brokers/dealers and municipal securities dealers to disclose certain mutual fund fees and expenses at the point of sale and in fund transaction confirmations. The Commission also proposed to improve prospectus disclosure of the costs and conflicts associated with fund investments.

- Proposed Rule 15c2-3 would require point of sale disclosure about certain distribution-related fees and costs by reference to the amount of purchase or, if the customer does not indicate how much he or she will invest, by reference to a hypothetical \$10,000 investment. The required disclosures would include the dollar amount of sales load and the estimated dollar amount of fees that would be paid within the first year following purchase pursuant to Rule 12b-1 of the Investment Company Act of 1940.
- Proposed Rule 15c2-2 would require similar and additional disclosure in the confirmation statement for a fund transaction. Both proposed rules would require disclosure of revenue sharing, differential compensation and portfolio brokerage arrangements.

³ In July 2003, NASD provided the Commission with the Report of the Joint NASD/Industry Task Force on Breakpoints, and in January 2004 submitted the Report of the Omnibus Account Task Force. After recent consultation with SEC staff, NASD is forming a new task force to assist the Commission's review of fund portfolio transaction costs and distribution arrangements.

- Proposed amendments to Form N-1A, the registration form for open-end management investment companies, are designed to improve investor awareness of the costs of mutual fund ownership. The amendments would modify sales load disclosure and mandate brief narrative disclosure of revenue-sharing arrangements.

NASD Recommended Enhancements

A. Point of Sale Disclosure

The Commission's point of sale and confirmation proposals would provide investors with improved information about the distribution-related costs and potential conflicts associated with a mutual fund investment. NASD staff respectfully suggests two enhancements that would strengthen the Commission's point of sale proposal. First, the proposal could be amended to mandate disclosure of *all* fund expenses, not only distribution-related costs and conflicts. Second, the Commission could require that the disclosure documents be posted on the broker/dealer's website, which would allow an investor easily to compare a recommended fund against all funds offered by the firm. These two enhancements would ensure that each potential investor in a mutual fund has access to a clear summary of all fund-related expenses for each fund offered by a broker/dealer.

In making investment decisions, we believe that investors would benefit from ready access to a means to easily compare costs across funds. Because all point of sale disclosure would be presented by reference to a hypothetical investment and each firm would post this information on its website, our recommendations would facilitate such comparisons. Moreover, because NASD's enhancements would provide point of sale disclosure based on a standard hypothetical investment amount, the disclosure may be more economical and easier for broker/dealers to administer, resulting in cost savings to investors.

The attached prototype could serve as a useful model of how to present all of the costs of fund ownership in an easy to understand one-page document. This one-page statement would provide, for each fund class offered:

- A "What You Pay" table that would present the actual dollar amounts of fund expenses paid per year, using a hypothetical \$10,000 investment (or other appropriate amount). The table would include both amounts deducted from the shareholder's account, such as maximum charges on purchases and redemptions, and amounts deducted from fund assets, such as management fees and Rule 12b-1 fees.
- A "What We Receive" table that discloses the compensation to the firm, stated as a percentage of all maximum charges that are received by the selling firm. This section also would disclose the estimated dollar amount, per hypothetical investment, of revenue-sharing payments or payments from fund assets, including Rule 12b-1 fees and subaccounting fees, received by the selling broker/dealer.⁴

⁴ NASD staff appreciates the difficulties that may be encountered in mandating actual dollar amount disclosure of fees and expenses that a potential investor may encounter during the first year of ownership, as well as the practical issues that must be addressed in allocating revenue-sharing payments to a hypothetical investment. NASD staff would be pleased to assist the Commission and its staff in its consideration of these issues.

- A ranking of the size of revenue-sharing payments received by the firm from the fund's sponsor, compared to other fund sponsors whose funds are offered by the firm.
- A statement that, in addition to its operating expenses, the fund pays portfolio transaction costs whenever it buys and sells securities and that these costs reduce the fund's asset value. The statement would include the fund's current portfolio turnover rate and alert investors that a higher portfolio turnover rate generally is associated with higher portfolio transaction costs.
- A statement, if applicable, that the investor's registered representative receives higher compensation for the sale of the fund than for the sale of another fund in the same category (*e.g.*, if the registered representative recommends a global equity fund, whether he or she receives more compensation for the sale of that fund versus other global equity funds offered by the broker/dealer).
- A statement, if applicable, that the broker/dealer receives soft dollar payments from the fund, and a brief description of what these payments are.

Under the SEC proposal, if a sale were made in person, the firm would have to provide the required disclosures both in writing and orally. If a sale were made over the telephone, a firm would only have to give the disclosures orally. In the case of telephone orders, NASD recommends that the Commission also permit a broker/dealer to satisfy its delivery requirement by referring an investor to the disclosure documents posted on the firm's website. Our proposed modifications thus would allow a broker/dealer to provide the disclosure document in writing, by e-mail, or, in the case of telephone orders, orally or by referring the investor to the broker/dealer's website. NASD staff also recommends that the SEC require firms to update the disclosure semi-annually and consider imposing similar disclosure requirements with respect to the sale of variable annuity products.

In developing its prototype, NASD considered including in the "What You Pay" table the dollar amount of portfolio transaction costs that reasonably may be attributed to a hypothetical \$10,000 investment over twelve months. NASD determined not to include this disclosure at this time, in light of the Commission's ongoing analysis of the best manner in which to achieve greater transparency of mutual fund portfolio transaction costs.⁵ Pending Commission action on these issues, NASD's prototype would require disclosure of a fund's current portfolio turnover rate, along with brief disclosure of the nature of portfolio transaction costs and the fact that a higher turnover rate generally is associated with higher overall portfolio transaction costs.

⁵ See Investment Company Act Rel. No. 26313 (Dec. 18, 2003). Under current Commission requirements, a fund must disclose in its Statement of Additional Information the dollar amount of total brokerage commissions paid during the fund's three most recent fiscal years. In addition, a fund must disclose in its prospectus its portfolio turnover rate for each of its past five fiscal years. The concept release indicates that the Commission is considering ways to quantify other perceived portfolio transaction costs, including spreads, market impact and opportunity costs. As the Commission is aware, explicit methodology for calculation and careful definitions of these costs is essential in order to ensure that these costs are not conveyed in a misleading manner.

We applaud the Commission's initiative to improve investor awareness of portfolio transaction costs and look forward to its recommendations on these critical issues. NASD also understands that the Commission may be studying the continued appropriateness of the safe harbor set forth in Section 28(e) of the Securities Exchange Act of 1934, and supports the Commission's efforts to ensure that soft dollar practices serve the interests of investors.⁶

B. Confirmation Statement

NASD staff believes that the requirements set forth in proposed Rule 15c2-2 would be an informative complement to NASD's proposed point of sale disclosure document. NASD's point of sale document, by reference to a hypothetical investment amount, would set forth costs and conflicts in a manner that easily allows an investor to make comparisons across funds and assess the level of conflict that may be presented by a particular recommendation. In contrast, proposed Rule 15c2-2 would require confirmations to set forth the actual dollar amounts of sales loads paid or payable within the first year following purchase, as well as the actual dealer concession earned and estimates of the revenue-sharing payments and portfolio transaction commissions received as a result of the investment.

C. Amendments to Form N-1A

As noted above, while lacking jurisdiction over investment companies, NASD regulates the sales practices of broker/dealers that offer mutual fund shares to investors. Accordingly, the Commission's proposals to amend Form N-1A to improve disclosure of sales loads and revenue-sharing payments is relevant to NASD's mandate. The proposal would require that a mutual fund prospectus disclose revenue-sharing payments. NASD suggests an enhancement to the Commission's proposal that would improve investor awareness of revenue-sharing payments.

As described in the Commission's release, a revenue-sharing payment may encompass several different streams of revenue, all of which give a broker/dealer an incentive to sell more shares of funds within a particular fund complex or to keep its customers within the fund complex. For example, a fund adviser may make payments to a firm based on the firm's recent sales of shares of funds offered by the fund complex. The adviser may make payments to a firm based on the asset-based fees received by the adviser that are attributable to the shares of funds within the complex that are held by customers of the firm.

⁶ NASD notes with approval the recent announcements by certain mutual fund management companies concerning soft dollar practices. *See* March 23 Statement of Robert C. Pozen, Chairman, MFS Investment Management, before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, in which Mr. Pozen stated that the current system of paying for goods and services with soft dollars, taken out of brokerage commissions, is detrimental to mutual fund shareholders. NASD notes in particular MFS's decision to no longer use soft dollars to pay for third-party research and market data, and instead to pay cash for these items out of its own resources. MFS also urged the Commission to reassert prior interpretations of the scope of Section 28(e), which allowed the use of soft dollars to pay for research and brokerage services only if the items were not "readily available for cash." *See also* March 15 letter from Mitchell M. Merin, President and Chief Operating Officer, Investment Management, Morgan Stanley, to SEC Chairman William C. Donaldson, supporting the elimination of third-party soft dollar payments in connection with mutual funds.

The Commission's release seeks comment on whether additional prospectus disclosure requirements regarding revenue-sharing payments would be appropriate. NASD staff recommends that the Commission consider requiring that revenue sharing payments be referenced as a subset of the management fees disclosed in the prospectus fee table.⁷ Doing so would require fund complexes to calculate the total revenue-sharing payments that they make, and to make a reasonable allocation of such payments to each fund within the complex. Requiring a fund to disclose revenue-sharing payments in this manner would educate investors as to the amount of the management fee that may be attributed to distribution activities on the part of the fund's adviser.

* * *

NASD looks forward to working with the Commission in its efforts to improve the information that mutual fund investors receive about costs and the conflicts that may be associated with a recommendation to invest in a particular fund. Questions or comments concerning the issues raised in this submission may be addressed to me at 202/728-8140 or Elisse Walter at 202/728-8230 or Thomas Selman at 202/728-6977.

Sincerely,



Mary L. Schapiro
Vice Chairman, NASD
President, Regulatory Policy and Oversight

cc: The Honorable William H. Donaldson
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
Annette L. Nazareth
Paul F. Roye

Enclosure

bcc: Angela Goelzer
Tom Selman
Elisse Walter

⁷ In doing so, the Commission also may wish to consider whether revenue sharing payments should be subject to the requirements of Rule 12b-1.

John Doe International Fund

Class A (the Fund)

What You Pay

This Table shows the total fees and expenses that you would pay as a Class A shareholder in the **John Doe International Fund**. Certain charges decline over time. Please see the Fund's prospectus for more information.

Shareholder Transaction Fees—Paid Directly By You

Maximum Charges (per \$10,000 investment)	
For Purchases.....	\$XX
For Redemptions.....	XX
For Reinvested Dividends	XX
For Exchanges.....	XX
Dealer Transaction Fees	XX

Annual Fund Expenses—Deducted from Fund Assets:

(per \$10,000 Investment over 12 months)

Management Fees	\$XX
Distribution (Rule 12b-1) Fees	\$XX
Other Fees	\$XX
Total Fund Operating Expenses	\$XX

What We Receive

This Table shows the compensation that we receive when you invest in the **John Doe International Fund** through XYZ Broker.

Out of the Total Fees and Expenses that You Pay, We Receive:

- XX% of all Maximum Charges
- 100% of Dealer Transaction Fees
- \$XX in Revenue Sharing Payments from the Fund's sponsor (per \$10,000 investment over 12 months)
- \$XX in Rule 12b-1 fees from the Fund (per \$10,000 investment over 12 months)

Our compensation varies depending upon which fund you choose.

Please note the following:

- Revenue sharing payments are cash payments from a fund sponsor to us to encourage us to bring their funds to your attention. The Fund's sponsor, John Doe Investments, ranks ___th out of ___ fund sponsors in the total amount of revenue sharing payments received by us [add relevant time period].
- In addition to its operating expenses, the Fund pays portfolio transaction costs when it buys and sells securities, which reduces the Fund's price per share. The Fund's current portfolio turnover rate is __%. A higher turnover rate generally results in higher portfolio transaction costs.
- "Soft dollar" payments occur when the Fund pays us to execute portfolio transactions in exchange for research and other services that may benefit the Fund's adviser or other clients of the Fund's adviser rather than the Fund. As a result, the Fund may pay higher commissions than it otherwise would pay.
- Your registered representative receives higher compensation for the sale of the Fund than for the sale of other international funds.

Information current as of prospectus dated XXX.

See XYZBroker.com for comparable information about other funds we offer.