FINANCIAL SERVICES INSTITUTE
VOICE OF INDEPENDENT BROKER-DEALERS AND INDEPENDENT FINANCIAL ADVISORS
www.financialservices.org

VIA ELECTRONIC MAIL

August 7, 2009

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, N.W.
Washington, D.C. 20006-1506

RE: FINRA Regulatory Notice 09-34: Investment Company Securities

Dear Ms. Asquith:

On June 17, 2009, the Financial Industry Regulatory Authority, Inc. (FINRA) published Regulatory Notice 09-34 seeking comment on its proposal to incorporate and replace NASD Rule 2830[1] regarding the distribution and sale of investment company securities with new FINRA Rule 2341 (Proposed Rule).[2] The Proposed Rule would revise the existing NASD rule in four areas. Specifically, the Proposed Rule:

- Requires firms to make new disclosures to investors regarding the receipt of cash compensation;
- Makes a minor change to the recordkeeping requirements for non-cash compensation;
- Eliminates a condition regarding discounted sales of investment company securities to dealers; and
- Codifies past FINRA staff interpretations regarding the purchases and sales of exchange-traded funds (ETFs).[3]

The Financial Services Institute[4] (FSI) recognizes that combining the rulebooks of the predecessor regulatory authorities represents a significant challenge. As we have in the past, FSI commends FINRA for recognizing in the rulebook consolidation process an opportunity to develop a new organizational framework for the rules, consider new approaches to regulatory concerns, and delete obsolete rules. With so many changes in the structure and substance of the rulebook being considered, we believe industry input is more important than ever. We, therefore, praise FINRA for seeking industry comment on the Rule Proposals prior to submitting them to the SEC.

With that in mind, FSI is concerned about the potential unintended consequences of the Proposed Rule. Most importantly, we are concerned that the Proposed Rule seeks to regulate investment companies indirectly by imposing new requirements on the broker-dealers that distribute their products. This effort to regulate the activity of investment companies through the "back door"

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[1] See NASD Rule 2830 at http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=4368&element_id=3691&highlight=2830#r4368 .
[2] See FINRA Regulatory Notice 09-34 at http://www.finra.org/Industry/Regulation/Notices/2009/P119013.
[3] See page 3 of Regulatory Notice 09-34.
[4] The Financial Services Institute, Voice of Independent Broker-Dealers and Independent Financial Advisors, was formed on January 1, 2004. Our members are broker-dealers, often dually registered as federal investment advisers, and their independent contractor registered representatives. FSI has 115 Broker-Dealer member firms that have more than 152,000 affiliated registered representatives serving more than 14 million American households. FSI also has more than 10,000 Financial Advisor members.

will unfairly subject broker-dealer firms to regulatory and liability risks that they have very little ability to mitigate. In addition, we believe several of the Proposed Rule's key concepts have not been clearly defined. We urge FINRA to alleviate the ambiguity of the Proposed Rule by crafting clear definitions for these critical terms. We also recommend additional changes to the Proposed Rule that will improve investor access to information and reduce the cost of compliance. Finally, we ask FINRA to allow broker-dealers a significant implementation period so they will have adequate time to update client disclosures, account documentation, and product distribution contracts. Each of these concerns is discussed in detail below.

Background on FSI Members

The independent broker-dealer (IBD) community has been an important and active part of the lives of American investors for more than 30 years. The IBD business model focuses on comprehensive financial planning services and unbiased investment advice. IBD firms also share a number of other similar business characteristics. They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of packaged products, such as mutual funds and variable insurance products; take a comprehensive approach to their clients' financial goals and objectives; and provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their registered representatives. Due to their unique business model, IBDs and their affiliated financial advisors are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.

In the U.S., approximately 98,000 independent financial advisors – or approximately 42.3% percent of all practicing registered representatives – operate in the IBD channel.[5] These financial advisors are self-employed independent contractors, rather than employees of the IBD firms. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans with financial education, planning, implementation, and investment monitoring. Clients of independent financial advisors are typically "main street America" – it is, in fact, almost part of the "charter" of the independent channel. The core market of advisors affiliated with IBDs is clients who have tens and hundreds of thousands as opposed to millions of dollars to invest. Independent financial advisors are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities and client base. Most of their new clients come through referrals from existing clients or other centers of influence.[6] Independent financial advisors get to know their clients personally and provide them investment advice in face-to-face meetings. Due to their close ties to the communities in which they operate their small businesses, we believe these financial advisors have a strong incentive to make the achievement of their clients' investment objectives their primary goal.

FSI is the advocacy organization for IBDs and independent financial advisors. Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisors play in helping Americans plan for and achieve their financial goals. FSI's mission is to ensure our members operate in a regulatory environment that is fair and balanced. FSI's advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. FSI also provides our members with an appropriate forum to share best practices in

[5] Cerulli Associates Quantitative Update: Advisor Metrics 2007, Exhibit 2.04. Please note that this figure represents a subset of independent contractor financial advisors. In fact, more than 138,000 financial advisors are affiliated with FSI member firms. Cerulli Associates categorizes the majority of these additional advisors as part of the bank or insurance channel.

[6] These "centers of influence" may include lawyers, accountants, human resources managers, or other trusted advisors.

an effort to improve their compliance, operations, and marketing efforts.

Comments on the Proposed Rule

As mentioned above, FSI has significant concerns with the Proposed Rule. We discuss these comments in detail below:

- **Proposed Rule Unwisely Seeks to Regulate Investment Companies Indirectly Through Broker-Dealers** – Under existing NASD Rule 2830(l)(4), broker-dealer firms are prohibited from accepting cash compensation from an investment company unless the payment is disclosed in the prospectus. Broker-dealer firms are able to comply with this requirement by simply comparing their cash compensation arrangement with the prospectus' disclosure to insure the arrangement is accurately described. The Proposed Rule would amend this requirement by requiring the prospectus to disclose "sales charges and service fees" paid by the investment company. If the arrangements between the investment company and each of the distributing broker-dealers are consistent, a general description of the arrangements is satisfactory. However, if the investment company has unique payment arrangements with its distributing firms, the Proposed Rule would require the prospectus to disclose the specific details of each broker-dealer's arrangement.

  We believe this new requirement represents an unwise attempt to indirectly regulate investment companies by placing responsibility for the quality of their prospectus disclosures on broker-dealer firms. The distributing broker-dealer cannot evaluate the accuracy of the sales charge and service fee disclosure in the prospectus because it is not privy to the arrangements that exist between the investment company and other broker-dealers, nor do broker-dealers have an opportunity to review or modify a fund's prospectus prior to its filing with the SEC. As a result, the broker-dealer must blindly rely upon the accuracy of the investment company's disclosure and knowledge of its own compensation practices. We believe this unfairly subjects broker-dealer firms to regulatory enforcement and liability exposure with no effective means by which to mitigate or avoid this risk. As a result, we urge FINRA to retain the requirement of NASD Rule 2830(l)(4) that broker-dealer firms insure their compensation arrangement with the investment company is accurately described in the prospectus.

- **Proposed Rule Needs Greater Clarity for the Benefit of Broker-Dealers and Investors** – The Proposed Rule introduces new terms and requirements, eliminates longstanding and well-understood terms, and makes other changes to existing requirements that need additional clarity. A lack of clarity deprives broker-dealer firms of the ability to develop policies and procedures with confidence that they are properly designed to achieve compliance with the Proposed Rule. As a result, we encourage FINRA to provide greater clarity in each of the following areas:

  - "Cash Payments" Should Be Defined or Clarified – Section 2341(l) (4)(B)(ii) of the Proposed Rule would require a broker-dealer firm that receives "cash payments" to disclose "the nature of such cash payments." FINRA's intent is unclear in this requirement. If FINRA is referring to "cash compensation," which is a defined term, then FINRA should use that term in this portion of the Proposed Rule. Alternatively, if "cash payments" refers to something other than cash compensation, FINRA should define "cash payment" clearly within the Proposed Rule.
  - Expanding Definition of Revenue Sharing – In footnote 8 to Regulatory Notice 09-34, FINRA states that revenue-sharing payments can take many forms,

including "the form of other cash payments…" This suggests to us that it is FINRA's desire to expand the definition of revenue sharing payments. However, if this is FINRA's intention, then FINRA has an obligation to provide broker-dealer firms with a clear definition of the term. Additionally, an offeror helping to pay the cost of a firm's annual sales meeting has historically been treated as a form of non-cash compensation. This footnote, however, appears to depart from these current standards leaving broker-dealers to guess whether it is FINRA's specific intent to reclassify such payments. If FINRA wants to expand the definition of revenue-sharing payments, it should include a definition that does so in the text of the Proposed Rule. Such a definition should provide an exhaustive list of the forms such payments can take to alleviate any confusion on behalf of broker-dealer firms.

- Clarification of Interplay Between Proposed Rule and Notice to Members 99-55 – Supplementary Material .01 to the Proposed Rule states that it supersedes all prior guidance regarding the definition of cash compensation. We seek clarification on whether this statement changes in any way the guidance provided by the NASD in Question 15 of Notice to Members 99-55 regarding prospecting trip expenses. The answer to Question 15 directs broker-dealers to comply with the requirements of NASD Rule 2830(l)(4). The Proposed Rule would make significant changes to subsection (l)(4). Are broker-dealers to apply the already-existing guidance to the new provisions or would this proposal render the guidance provided in Question 15 null and void? We urge FINRA to clarify this important point.
- Clarification of Non-Cash Compensation Recordkeeping Requirement – The Proposed Rule would permit firms to estimate the value of non-cash compensation received when a receipt is not available. We seek clarification, however, on FINRA's expectations regarding the acquisition of receipts where receipts are not customarily provided by the investment company. Currently it is often the case that offerors do not provide receipts for non-cash compensation. Rather, broker-dealers often receive some other form of verbal or written estimation of the value of non-cash compensation from the offeror. Under the Proposed Rule, would this practice still be permitted or will FINRA expect greater due diligence in obtaining receipts from investment companies? We ask FINRA to provide specific guidance to broker-dealers on this aspect of the Proposed Rule.

- **Proposed Rule Should Require an Alphabetical Listing of Payments Received** – The Proposed Rule would require firms who receive additional cash compensation from an investment company to disclose a list of offerors making such payments in descending order of payment amounts received. We believe this requirement will confuse, rather than enlighten, investors. Requiring a broker-dealer firm to list the investment companies providing such compensation in descending order of payments received may be useful to FINRA, but this format will not prove user-friendly for the average retail investor who is primarily concerned whether a particular fund family in which they have invested provided the broker-dealer with special compensation. As a result, we believe an alphabetical list will present the required information in a more helpful and intuitive format for investors and in a manner that is consistent with many firms' existing disclosure practices. We urge FINRA to amend the Proposed Rule to require alphabetical listing of this information.

- **Proposed Rule Should be Amended to Reduce Frequency of Sales Charge and Service Fee Disclosure** – Requiring broker-dealers to provide information as to the

nature of cash payments received in a rolling 12-month period is an overly burdensome requirement. Requiring firms to update this information every six months is a requirement whose cost will significantly outweigh its benefits since the terms of a given compensation arrangement are unlikely to change more than once per year. As a result, we believe an annual update is a more reasonable requirement and will not deprive investors of information relevant to their decision making.

- **Proposed Rule Should Allow Delivery of Initial Disclosure Information Via the Internet** – FINRA requested feedback on whether firms should be permitted to deliver initial disclosure information to customers electronically. We believe broker-dealers should be allowed to direct investors to Internet disclosures on their web site unless a customer specifically requests paper-based disclosure. We believe adopting this approach will benefit investors by providing them with disclosures in an easily accessible format and broker-dealers by reducing the cost of compliance.

- **Significant Implementation Period Required to Facilitate Firms' Compliance with the Proposed Rule** – The Proposed Rule will likely have significant cost implications for broker-dealer firms. Building the necessary operational infrastructure in order to accommodate the customer reporting obligations will require significant lead-time. As a result, we urge FINRA to provide broker-dealer firms with twenty-four months in which to prepare for final implementation of the Proposed Rule.

Conclusion

We are committed to constructive engagement in the regulatory process and, therefore, welcome the opportunity to work with you to enhance investor protection.

Thank you for your consideration of our comments. Should you have any questions, please contact me at 770 980-8487.

Respectfully submitted,

Dale E. Brown, CAE
President & CEO