

Comment Letter on Proposed NASD Rules Governing Broker/Dealer Conduct at Financial Institutions, May 1997

May 9, 1997

Mr. Jonathan G. Katz
Secretary, Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Notice of Filing of Amendment No. 4 to Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Proposed Rule Governing Broker/Dealers Operating on the Premises of Financial Institutions (File No. SR-NASD-95-63) (the "Proposing Release")

Dear Mr. Katz:

The Investment Company Institute¹ appreciates the opportunity to comment on proposed amendments to NASD Regulation, Inc.'s Rules of Fair Practice concerning the regulation of broker-dealer activities of NASD members on the premises of financial institutions.² The Institute commends the comment process in this instance as it has resulted in a proposed rule change that removes unnecessary burdens while preserving those elements that will enhance investor protection.

The Proposing Release reflects amendments made to NASDR's bank broker-dealer rule proposal released in March 1996³. At that time, the Institute submitted a comment letter addressing the proposed amendments, and we are pleased that NASDR's Proposing Release reflects many of the recommendations made in that letter.⁴ We note, for example, that removed from the Proposed Release is the provision that prohibits a financial institution from paying its unregistered employees a referral fee conditioned on a resulting transaction, and the provision that prohibits a NASD member from paying unregistered bank employees a referral fee. Also removed is the provision relating to the use and release of customer confidential financial information.⁵ Each of these provisions would have imposed additional unnecessary burdens on participants in the bank channel without furthering the proposal's objective of minimizing potential investor confusion.

The Institute also appreciates that the Proposing Release addresses other issues discussed in our earlier comment letter. We note particularly that the Proposing Release clarifies that the proposed rules: (1) would be applied, with respect to physical setting requirements, in a manner consistent with the standards imposed by the Interagency Statement⁶; (2) would apply only to broker-dealer services provided on bank premises where retail deposits are taken; (3) would not prohibit members from conducting a brokerage business in one-person branches, in walkup windows, kiosks, or desks in public places such as supermarkets, as long as adequate safeguards are adopted, including adequate disclosure and signage; (4) would not require the Interagency Statement disclosures on confirmation statements and account statements with respect to bank-sold funds; and (5) would permit reference in member sales materials to relationships between members and banks without limiting these references to "material" relationships, and permit the description of relationships between members or products (such as mutual funds) and banks.

In light of the foregoing revisions and clarifications, the Institute is generally supportive of the proposed rule change. We do, however, believe that there remain certain unresolved issues that should be addressed before the Commission approves the proposal. These issues involve clarification that the proposed rules, if adopted, (1) would not apply to mutual fund distributors and underwriters; (2) would not apply to broker-dealer services provided by telephone or computer; and (3) would permit members to provide the requisite disclosures and customer acknowledgment on an account application.

Meaning of "Broker-Dealer Services"

In our earlier comment letter we recommended clarification of the meaning of the phrase "broker-dealer services." We noted that, apparently, the phrase would include mutual fund distributors and underwriters.⁷ We expressed concern that application of the

proposed rules to these service providers would be unnecessary and inappropriate because sales material and customer communications produced by fund underwriters and distributors relate principally to mutual funds and do not generally refer to insured bank products. Moreover, to the extent any concerns about investor confusion remain, these can be addressed through application of the NASD's mutual fund advertising rules.

The Proposing Release does not address this issue. Accordingly, we reiterate our recommendation that the Commission clarify that the rules with respect to broker-dealer services would apply only to the activities of NASD members that are engaged in direct retail brokerage activities on bank premises.

Meaning of "On the Premises"

In our earlier comment letter we expressed concern that the proposed rule would apply to broker-dealer services provided by telecommunications, even where there would be little, if any, risk of customer confusion.⁸ The Proposing Release indicates that the NASDR intends to "issue a Notice to Members in a question and answer format after the rule is approved, clarifying this and other interpretive issues regarding how the rule will be applied."⁹ This would not adequately address this matter. First, it would remain unclear how such scenarios would be treated before the Q&A is issued. Second, the Proposing Release indicates that the Q&A will "clarify" that the rule would apply if the broker-dealer "has a physical presence on the [bank] premises." As noted above, however, in certain cases the mere fact that the broker-dealer is physically present at the bank does not give rise to the potential customer confusion which the rule is meant to address (e.g., where a broker answers a telephone call while at the bank). Therefore, we reiterate our recommendation that the Commission clarify that the proposed rules would not apply in the scenarios discussed above, and do so prior to the adoption of the rule.

Written Acknowledgment Requirement

Section (c)(3)(A) of the Proposing Release requires members to disclose that the securities products "are not insured by the FDIC or other deposit insurance." Section (c)(4)(B) requires similar disclosure with respect to advertisements and promotional and sales material. We believe that the phrase "or other deposit insurance" should be deleted. It is unnecessary and inapplicable in this context, and its inclusion would only serve to confuse rather than help the consumer. Moreover, removing this phrase would make the statement consistent with that presently reflected in the Interagency Statement, which makes reference only to FDIC insurance.

In our earlier comment letter we requested procedural clarification regarding the disclosure and customer acknowledgment requirement. The Proposing Release, although addressing other issues related to this provision, fails to address this one. We recommend that the Commission clarify this point and allow members flexibility in determining the placement of such disclosures and acknowledgments. Such flexibility would enable a member, for example, to provide this information on its application to open an account.

We appreciate the opportunity to comment on these important issues. If you have any questions about these matters, please contact the undersigned (202/326-5923) or Frances Stadler (202/326-5822) or Craig Tyle (202/326-5815).

Sincerely,

Barry E. Simmons
Assistant Counsel

cc: R. Clark Hooper
Senior Vice President, Office of Disclosure and Investor Protection
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Barry P. Barbash
Director, Division of Investment Management
Securities and Exchange Commission

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ENDNOTES

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 6,368 open-end investment companies ("mutual funds"), 447 closed-end investment companies, and 10 sponsors of unit investment trusts. Its mutual fund members have assets of about \$3.611 trillion, accounting for approximately 95% of total industry

assets, and have over 59 million individual shareholders.

² 62 Fed. Reg. 19378 (April 21, 1997). While the Institute appreciates the opportunity to provide comments to the Commission on these important amendments, we are nevertheless troubled by the very short time period (22 days) allotted for soliciting such comment. The Proposing Release, if adopted, will have a widespread effect on participants in the brokerage, financial institution, and investment company industries. Adequately assessing the impact of such changes requires appropriate deliberation and concerted efforts by concerned industry participants. Accordingly, we strongly urge the Commission, in the future, to consider providing a comment period more commensurate with the level of impact such rule proposals would have on the industries affected. This is particularly important if it hopes to receive useful, substantive, and detailed commentary from industry participants concerned with such significant proposals.

³ 61 Fed. Reg. 11913 (March 22, 1996).

⁴ See Letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission, from Paul Schott Stevens, Senior Vice President and General Counsel, Investment Company Institute, dated May 21, 1996.

⁵ Both the referral fee provision and the confidential information provision were reproduced as separate proposals. See NASDR Notice to Members 97-11 (March 1997) (referral fee proposal) and NASDR Notice to Members 97-12 (March 1997) (confidential information proposal). Recently, the Institute submitted a comment letter regarding both proposals. See Letter to Ms. Joan Conley, Office of the Corporate Secretary, NASD Regulation, Inc., from Frances M. Stadler, Associate Counsel, Investment Company Institute, dated April 30, 1997.

⁶ See Interagency Statement on Retail Sales of Nondeposit Investment Products (February 15, 1994), (the "Interagency Statement").

⁷ Paragraph (b)(4) defines "broker-dealer services" as "the investment banking or securities business as defined in Paragraph (1) of Article I of the [NASD's] By-Laws." Paragraph (1) of Article I in turn defines "investment banking or securities business" to include "underwriting or distributing issues of securities." See NASD Manual ¶ 1101 (CCH 1994) (emphasis added).

⁸ We provided two examples where broker-dealer services, with respect to bank-advised funds, could be deemed to occur on bank premises, even though either the broker-dealer or the customer is not physically on the premises. The first example involves the situation where the broker-dealer, who is on the bank's premises, fields incoming calls through the bank's telephone operating center, from customers who are not on the bank's premises. The second involves the 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.

⁹ See Proposing Release at 19380.