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Comment Letter on Amendments to Rules Covering Communications with the Public, February 2002

February 13, 2002

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: NASDR Conduct Rules Relating to Communications with the Public
(File No. SR-NASD-00-12)

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on the proposed revisions to the conduct rules of NASD Regulation, Inc. (NASDR) relating to communications with the public.[2] The proposed revisions, which are intended to modernize and clarify the rules governing member communications with the public, would, in large part, simplify the content standards applicable to member communications. The revisions would also, for the first time, distinguish communications directed to institutional investors from those directed to retail customers and provide different regulatory treatment for both classes of communications.

The Institute commends NASDR for undertaking this initiative and we generally support the proposed revisions. We particularly welcome the distinction that would be recognized in the rules between communications directed to institutional investors and those directed to retail investors. Importantly, the revised rules will ease the regulatory burdens on members without in any way diminishing NASDR's protection of investors.

The Institute is pleased that many of the recommendations we made to NASDR on its original proposal are reflected in this proposal.[3] We recommend that NASDR reconsider our comments that have not yet been incorporated, which are discussed in more detail below. In addition, we recommend that other revisions be made to the proposed rules to provide greater clarity, ensure that the language of specific provisions in the rules is consistent with their intent, and avoid the imposition of unduly burdensome requirements that do not result in any increased protections.

I. Summary of Comments

Our comments are divided into two groups—specific comments, which are directed toward individual provisions in proposed amendments to Rule 2210 and IM-2210-3, and in proposed Rule 2211,[4] and general comments, which apply to the proposed rule changes overall.

Our specific comments include the following recommendations:

- The proposed definition of "independently prepared reprint" in Rule 2210(a)(6) should be revised to: (1) clarify the "affiliate" test applicable to an article reprint that discusses an investment company portfolio security; and (2) clarify the rule's application to excerpts.
- The requirement in proposed Rule 2210(c)(3)(A) that members file backup ranking and comparison material should be eliminated. Instead, such backup material should be filed only when requested by NASDR staff either because it is not readily available or because the member has used ranking or comparison material inappropriately.
- Proposed Rule 2210(c)(4)(B), which authorizes NASDR to impose pre-use filing requirements on members subject to certain conditions, should be revised to reinstate provisions from the current version of this rule that: (1) require NASDR to make certain findings prior to imposing such pre-use filing requirements; and (2) limit the duration of the pre-use filing requirement to a period

not to exceed one year.

- Proposed Rule 2210(c)(7) should be amended to exclude generic fund advertisements and shareholder reports from the rule's filing requirements.
- The treatment of hypothetical illustrations of mathematical principles under Rule 2210(d)(1)(D) should be clarified.
- The definition of "institutional investor" proposed in Rule 2211(a)(3) should be revised to: (1) include qualified retirement plans beyond those covered by Section 401 of the Internal Revenue Code; (2) lower the proposed $50 million asset threshold; and (3) clarify the definition relating to persons acting solely on behalf of an institutional investor.
- The definition of "existing retail customer" proposed in Rule 2211(a)(4) should be revised to clarify the scope of the rule with respect to affiliates and persons with an actual or beneficial interest in an account.

Our general comments include the following recommendations:

- NASDR should use the adoption of these revisions as an opportunity to emphasize to its staff the need for consistent interpretation of and comment on materials prepared under the rules.
- The Commission should set a date certain by which NASDR must accommodate electronic filing of advertisements and sales literature.

Each of these comments is discussed in more detail below.

II. Specific Comments on Rule 2210: Communications With the Public

A. Article Reprints (Rule 2210(a)(6))

1. Affiliation Prohibition

Proposed section (a)(6) of Rule 2210 would include a new category of communications with the public— "independently prepared reprint"—that would be exempt from the rule's filing requirements as well as most of its contents standards. As proposed, an article would not fall within the definition of "independently prepared reprint" if, for example, the publisher is affiliated with an underwriter or issuer of a security mentioned in the reprint. The Institute generally supports the proposed treatment of these communications. However, while we concur with the proposed requirement that the publisher not be affiliated with the member using the reprint, we are concerned with the extension of this "affiliate" test to any underwriter or issuer of a security mentioned in the article.

For example, assume that an article in Time magazine discusses a mutual fund and various stocks, including America OnLine (AOL), that the fund holds. If a mutual fund that has no affiliation with Time magazine or AOL (though it may hold shares of AOL) wants to send the article to its investors, under the proposed definition in Rule 2210(a)(6), the fund could not treat the article as an independently prepared reprint, solely because of the affiliation between Time Warner (the publisher of Time magazine) and AOL[5]—neither of which is affiliated with the fund. And yet, there would seem to be no public policy purpose served by treating the article in this example, when used by the mutual fund, as something other than an independently prepared article reprint. For purposes of a member's use of article reprints where the member is the principal underwriter of an investment company, it would seem the appropriate test of affiliation is whether the publisher is an affiliate of the investment company. We believe this more limited test would be consistent with the intent of the definition and, therefore, we recommend that the definition of "independently prepared reprint" be revised or interpreted accordingly.

2. Excerpts

We also recommend a technical change to the definition of "independently prepared reprint" to clarify the rule's application to excerpts. In particular, we recommend that "or excerpt" be added following each reference in the subparagraphs of proposed Rule 2210(a)(6)(A) to "reprint." We believe this clarification is necessary because, while the introductory language to the definition refers to "any reprint or excerpt," the various conditions of the definition that follow this introduction reference only reprints. This revision would clarify that, where an excerpt of an article will be used, the conditions of the definition must be met by that excerpt, not by the entire article. So, for example, a mutual fund could treat as an "independently prepared reprint," an article that has been excerpted by the member to delete information on its competitors so long as the information on the fund using the article has not been materially altered. In making this recommendation, we note that any such alteration would be subject to the provisions of proposed IM-2210-1, including provisions requiring a member to ensure that any statement made not be misleading in the context in which it is made.

B. Filing Requirements/Exclusions (Rule 2210(c))

1. Backup Filing Requirement (Rule 2210(c)(3)(A))

As in NASDR's 1999 proposal, the proposed amendments would continue to require members to file a copy of the ranking or

comparison used in sales materials that contain such ranking or comparison. The Institute's 1999 comment letter recommended that this requirement be eliminated in those instances where the items are readily available to NASDR staff, or where different pieces of sales material rely on the same backup material. Notwithstanding our recommendation and those of other commenters, NASDR has chosen not to eliminate this filing requirement because, according to the Release, (1) it is not unusual for NASDR to comment on sales material that presents a ranking or comparison in a manner inconsistent with the backup ranking information; and (2) sales material often contains rankings or comparisons that are not readily available.

The Institute submits that neither of these explanations, separately or together, supports requiring all backup material to be filed with NASDR. With respect to (1), where the backup material is readily available to the staff, the staff would be able to obtain it and address any inconsistency between the ranking information and its presentation in sales material. With respect to (2), the fact that some rankings or comparisons are not readily available should not result in a requirement that all rankings and comparisons be filed. Similarly, the fact that some members may inappropriately use rankings should not result in a requirement that allmembers file their back-up material. Accordingly, the Institute recommends that NASDR revisit its position on this issue and require the filing of backup materials only when requested by NASDR staff either because such material is not readily available or because a particular member has used ranking or comparison material inappropriately. Such a requirement would provide NASDR the information it needs to complete its review, without subjecting all members to a burdensome filing requirement that may serve a useful purpose only in a limited number of cases.

2. Imposing Pre-Filing Requirements on Members (Rule 2210(c)(4)(B))

Rule 2210(c)(5)(A) currently authorizes NASDR to require a member to file its advertising prior to use upon a finding by NASDR that (1) the member has departed from the standards of Rule 2210 and (2) "there is a reasonable likelihood that the member will again depart from the standards of [Rule 2210]." The rule further provides that the period during which NASDR may require pre-filing "shall not exceed one year."

Proposed paragraph (c)(4)(B) would eliminate, without explanation, the second prong of NASDR's required determination, as well as the one-year limit provided in the current rule.[6] Due to a lack of explanation for these proposed changes in the Release, we are uncertain as to why NASDR has proposed them. We note that the elimination of the second prong conceivably could allow NASDR, upon a mere showing that a single advertisement from a member has departed from the standards of Rule 2210, to require a member to pre-file material, which it would not be able to do under the current rule. Considering the burdens that pre-filing would impose, we believe NASDR should be required to show more than a single violation. Accordingly, we oppose this proposed revision and recommend that the rule be revised either to: (1) restore the second prong of the current test; or (2) require NASDR to demonstrate a pattern of repeated violations of the standards prior to exercising its authority under Rule 2210(c)(4)(B).

The Institute also opposes elimination of the one-year limit in the current rule. This seems both inappropriate and unduly punitive. We believe a period not to exceed one year, as provided in the current rule, is an appropriate period and we recommend it be reinserted in the rule.

3. Generic Fund Advertisements (Rule 2210(c)(7))

In NTM 99-79, NASDR invited comment on whether generic fund advertisements should be exempt from Rule 2210's filing requirements. The Institute recommended such an exemption because, in our view, such advertisements do not involve significant investor protection issues. Our letter noted that generic advertisements are most often used to educate investors about investing concepts, such as dollar cost averaging, and are not permitted to be used to promote a particular fund. Moreover, the contents of generic advertisements are strictly limited under Rule 135a under the Securities Act of 1933 and subject to spot-checks and review by both NASDR and the SEC during examinations. The proposed rule, however, does not provide such an exemption.

NASDR's basis for retaining the filing requirement for generic fund advertisements is that "members sometimes misunderstand the content requirements of Rule 135a, and sometimes misclassify advertising that falls under other rules as generic advertisements." As a result, the Release notes that NASDR is "concerned that an exclusion for generic advertisements could lead some members not to file investment company sales material that should be filed due to their misunderstanding of Rule 135a."

The Institute believes that it is inappropriate to subject all NASDmembers to a filing requirement merely because some members may misunderstand the filing requirements. We believe a more appropriate way to address the potential misunderstanding of some NASD members would be through the spot-check procedures set forth in the rule, inspections by NASDR and the SEC, NASDR regulatory and compliance alerts, and the educational seminars regularly offered by NASDR. We therefore recommend that NASDR amend proposed Rule 2210(c)(7) to exclude generic fund advertisements from the filing requirements.

4. Shareholder Reports (Rule 2210(c)(7))

In 1999, NASDR solicited comment on whether mutual fund shareholder reports should be exempt from the filing requirements under

NASDR's advertising rules. The Institute's 1999 comment letter recommended that they be exempt for two reasons. First, the practice of supplementing the management's discussion of fund performance with marketing material that goes far beyond the SEC's regulatory requirements for shareholder reports, with which NASDR expressed concern, did not appear to be as widespread as NTM 99-79implied. Second, our letter noted that shareholder reports continue to be subject to the scrutiny of the SEC staff during regular and special audits, to specific content requirements under the securities laws, and to NASDR spot-checks and review during NASDR examinations. Our letter, therefore, recommended that NASDR reconsider its position and exempt mutual fund shareholder reports from the filing requirements. NASDR's current proposal does not include the exemption recommended by the Institute.

We continue to believe that shareholder reports should be exempted from the filing requirements, and recommend that NASDR amend proposed Rule 2210(c)(7) to so provide. If NASDR declines to follow this recommendation, however, at the very least it should modify the position expressed in the Release that members "must file the management's discussion of fund performance ("MDFP") portion of a report (as well as any supplemental sales materials attached to or distributed with the report) with [NASDR]." This statement seems to presume that the MDFP always is sales literature. We disagree. We submit that if the MDFP contains only the information that is required by Item 5 of Form N-1A, it is not sales literature and therefore should not be required to be filed with NASDR.[7]

C. Content Standards: Predictions and Projections (Rule 2210(d)(1)(D))

The Institute's concern with proposed Rule 2210(d)(1)(D) relates to NASDR's proposal to reinsert in this provision a sentence relating to the permitted use of hypothetical illustrations of mathematical principles. This sentence, which appears in the current rule, was deleted by NASDR in its 1999 proposed revisions to the rule, and we recommended at that time that it be reinserted. While we are pleased to see the reinsertion of a provision along these lines, we note that the language of the provision in the current proposal differs from that in the current rule.[8] We are concerned that this change in language might be read by members as a change in the substance of this provision, notwithstanding the Release's explanation to the contrary.[9] Similarly, we are concerned that the revised language will raise interpretive issues for members, because its meaning is not clear. To avoid these results, the Institute recommends that the adopting release reaffirm, consistent with the proposing Release, that hypothetical illustrations that are currently permitted under Rule 2210 will continue to be permitted under this revised provision.

III. Comments on Proposed Rule 2211: Institutional Investor Communications[10]

A. Definition of "Institutional Investor" (Rule 2211(a)(3))

As originally proposed in 1999, the term "institutional investor" would have been limited to those persons and entities described in NASDR Rule 3110(c)(4), association members, and associated persons of such members.[11] In response to comments received on its proposal, the proposed definition in Rule 2211(a)(3) has been expanded, in part, to include specified qualified retirement plans and persons acting solely on behalf of an institutional investor. The Institute supports expansion of the definition in these ways but requests three additional revisions or clarifications to it, as discussed below.

1. Qualified Plans

As proposed in Rule 2211(a)(3)(C), the only qualified plans that would be deemed institutional investors for purposes of the rule are those that meet the definition of a "qualified plan" in Section 3(a)(12)(C) of the Securities Exchange Act of 1934 and that have at least 100 beneficiaries.[12] Pursuant to Section 3(a)(12)(C) of the Exchange Act, to be a "qualified plan," a plan must either: (1) meet the requirements for qualification under Section 401 of the Internal Revenue Code of 1954 ("IRC"); (2) be an annuity plan that meets the requirements for the deduction of the employer's contribution under Section 404(a)(2) of the IRC; or (3) be a government plan as described in Section 414(d) of the IRC. We believe that limiting the definition of "institutional investor" in this manner is too narrow in that it will preclude a member from treating other employer-sponsored retirement plans, such as a Section 403(b) plan or a Section 457 plan, as an "institutional investor" for purposes of Rule 2211.[13] The public policy reasons that support treating qualified plans under Section 401 of the IRC as institutional investors would seem to apply to other employer-sponsored retirement plans as well. We therefore recommend that the provisions of proposed Rule 2211(a)(3)(C) be expanded to include other employer-sponsored retirement plans beyond those covered by Section 3(a)(12)(C) provided that the plan has at least 100 "participants."

2. $50 Million Threshold

As proposed, the term "institutional investor" would also include, in part, a natural person, corporation, partnership, trust or other entity with assets of at least $50 million (see Rule 3110(c)(4)(C)). As we recommended previously, the definition of "institutional investor" should be broadened to include any entity or individual meeting a designated asset threshold substantially lower than the proposed $50 million level set forth in Rule 3110(c)(4) (e.g.,$5 million or $10 million).[14] Reducing the threshold would permit members to treat a larger universe of financially sophisticated entities as institutional investors under the communication rules

without raising investor protection concerns.[15]

3. Person Acting Solely on Behalf of an Institutional Investor

As originally proposed, the definition of "institutional investor" did not include a person acting solely on behalf of an institutional investor. The current proposal includes such a person in the definition.[16] According to the Release, this inclusion resulted from several commenters urging NASDR to include in the definition "pension consultants and others acting on behalf of institutional investors." As explained by NASDR, "rather than establishing a new category based upon a person's occupation, [NASDR] has determined to include any person acting on behalf of an institutional investor."[17] The Institute strongly supports this revision. We recommend, however, that a technical change be made to the language to clarify that this new category would include, for example, supervised persons of a state or federally registered investment adviser or other individuals acting on behalf of a person that qualifies as an "institutional investor."[18]

B. Definition of "Existing Retail Customer" (Rule 2211(a)(4))

The Institute supports the amendments made to the proposed definition of "existing retail customer" clarifying that a person who has opened an account with an investment company or transfer agent for such an investment company would be deemed an existing retail customer. Consistent with these revisions, the Institute recommends two additional modifications—one that would address communications by affiliates of member firms that serve as principal underwriter to an investment company, and one that would clarify that retirement plan participants are included in the definition.

First, we recommend adding a reference to "affiliates" to this definition. This addition would enable a financial services firm that includes more than one NASD member to send a "blanket" or general communication to all of its customers without having to send multiple versions of the communication, each reflecting individual member names. Second, we recommend that the definition be revised to include a reference to "actual or beneficial interest in the plan." This change, which would ensure that retirement plan participants are included within the definition, is necessary because retirement plan accounts are held in the name of the plan itself, and not in the names of the individual participants in the plan. We believe that each of these recommended revisions is consistent with the changes NASDR has already proposed to this definition and are more technical, clarifying amendments than substantive changes to the current proposal.[19]

IV. General Comments

A. Uniformity of Analysts' Interpretation

Members of the Institute continue to report to us that, oftentimes, comments they receive from NASDR analysts on communications with the public that are filed with NASDR appear to reflect the subjective views of the analyst reviewing the material rather than any objective criteria established by NASDR. Not surprisingly, this often results in a lack of consistency in the comments provided by different NASDR analysts. While the Institute understands that NASDR continues to strive to ensure that its analysts' comments are consistent, we believe the current revisions provide NASDR an opportunity, as it trains its staff on these new requirements, to emphasize the need for consistent interpretation and comment. We encourage NASDR as it implements these new rules and interpretative material to take advantage of this opportunity.

B. Electronic Filing of Communications with the Public

The Institute has long advocated that NASDR should take whatever steps are necessary to permit the electronic filing of sales material.[20] The Institute's 1999 comment letter encouraged NASDR to "move quickly" to permit such filing for sales material that is delivered electronically, as well as for other sales material, including print materials. In the intervening two years, the need to accommodate electronic filings has become crucial. It is not merely a matter of making the filing process more convenient and expedient. Today, our members are more reliant than ever on the as a means to communicate with their shareholders and prospective investors.

Because of the vast information that can be communicated via the, and the economic sense of utilizing this resource, it is slowly becoming the vehicle of choice for our members and investors generally. And yet, today, any information posted on a website that falls within Rule 2210 must be downloaded, page-by-page and screen-by-screen, and filed with NASDR in hardcopy. In today's world, this archaic process makes little sense.Accordingly, it is not surprising that our members report to us their increasing frustration with NASDR's continued inability to accommodate electronic filings. Moreover, we understand from our members that some information that appears on their websites is incapable of being downloaded, printed and filed.[21] To ensure that NASDR's filing and review requirements do not become an impediment to our members' ability to communicate effectively, quickly, and efficiently with their investors and potential investors, we strongly encourage the Commission to set a date certain by which NASDR must offer members the option of submitting their advertising and sales literature to NASDR electronically.[22]

* * *

The Institute appreciates the opportunity to provide these comments on NASDR's proposed revisions to its rules relating to communications with the public. If you have any questions concerning our comments, please do not hesitate to contact the undersigned at (202) 326-5824, Tamara Reed at (202) 326-5825, or Frances Stadler at (202) 326-5822.

Sincerely,

Amy B.R. Lancellotta
Senior Counsel

cc: Paul F. Roye, Director
Division of Investment Management
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ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry.Its membership includes9,040 open-end investment companies ("mutual funds"), 484 closed-end investment companies and 6 sponsors of unit investment trusts.Its mutual fund members have assets of about $6.906trillion, accounting for approximately 95% of total industry assets, and over 88.6 million individual shareholders.

[2] See Release No. 34-45181, 66 Fed. Reg. 67586 (December 13, 2001) (the "Release").

[3] See Letter from Craig S. Tyle, General Counsel, ICI, to Ms. Joan Conley, Office of the Corporate Secretary, NASDR, dated October 29, 1999 (the "Institute's 1999 comment letter") commenting on NASD Notice to Members 99-79 ("NTM 99-79").

[4] Our specific comments follow the order in which the provisions appear in the proposal.

[5] While in our example the affiliation is obvious because most persons know of the relationship between Time Warner (the publisher) and the issuer (AOL), we submit that in many instances a member may have no way of knowing about an affiliation between a publisher and non-investment company issuers or underwriters of securities.

[6] As a general matter, the Institute is troubled by the fact that NASDR has proposed this substantive change to its existing rules without alerting members to the change in the Release or explaining the basis for the change. It is critical to the public comment process that the notice or release relating to proposed revisions identify all substantive changes that are proposed and provide an explanation for each such change.

[7] Item 5 requires a fund to "discuss the factors that materially affected the Fund's performance during the most recently completed fiscal year, including relevant market conditions and the investment strategies and techniques used by the Fund's investment adviser."

[8] Currently, Rule 2210(d)(2)(N) provides in relevant part that "hypothetical illustrations of mathematical principles are not considered projections of performance." The proposal would revise this sentence to read, in relevant part, "A hypothetical illustration of mathematical principles is permitted provided that it does not predict or project the performance of an investment or investment management strategy."

[9] According to the explanation of this change in the Release, "the proposed rule change . . . would permit the use of mutual fund cost calculators and other hypothetical illustrations that are permitted by existing Rule 2210." See Release at p. 67604.

[10] The Institute notes that Rule 2210 governs only communications with the public. Proposed Rule 2211, however, does not expressly clarify that its application, too, is limited to such communications, although that appears to be its intent. To avoid any potential confusion on this point (e.g., subjecting a member's internal material that is not distributed to the public to the provisions of Rule 2211), we recommend that it be clarified in the adopting release.

[11] See NTM 99-79 at p. 587.

[12] We recommend that the definition of “institutional investor” use the term “participants” in place of “beneficiaries.”Pursuant to Section 3 of the Employee Retirement Income Security Act of 1974 (ERISA), the term “participant” means any employee or former employee who is or may become eligible to receive a benefit from an employee benefit plan.As such, “participants” appear to be the group that NASDR intends to count to determine whether the plan qualifies as an institutional investor.

[13] Section 403(b) plans are employer-sponsored, defined contribution plans that are generally available only to employees of public education organizations and tax-exempt entities under IRC Section 501(c)(3).Section 457 plans are deferred compensation plans for states, counties, cities, agencies, and their political subdivisions or agencies, the purpose of which is to provide a tax-favored vehicle for participants to save for retirement.

[14] We note that a $5 million asset threshold has been recognized by the Commission under Regulation D as an appropriate level of sophistication for limited offerings of securities.Regulation D’s definition of “accredited investor” includes entities with a $5 million asset level. See Rule 501(a), Regulation D of the Securities Act of 1933.Given this recognition of their sophistication for purposes of participating in securities offerings, it seems incongruous to impose stricter standards on advertisements and sales literature directed to such persons.

[15] We note that under our recommendation such communications still would be subject to the content and spot-check provisions of the rule.

[16] See proposed Rule 2211(a)(3)(E).

[17] See Release at p. 67601.

[18] Our request for clarification results from the fact that, while Rule 2211(a)(3)(D) would expressly include in the definition of “institutional investor” any member or “registered associated person of . . . a member,” a corresponding change was not made to expressly include in Rule 2211(a)(3)(E) representatives of the persons listed therein.

[19] In particular, the Institute recommends that the definition in Rule 2211(a)(4) be revised in relevant part as follows “. . . or who has an account with any registered investment company for which the member or its affiliate serves as principal underwriter, who has an actual or beneficial interest in the account, and who is not an institutional investor.”

[20] See, e.g.,Institute’s 1999 comment letter at p. 10 and Letter from Craig S. Tyle, General Counsel, ICI, to Ms. Joan Conley, Secretary, NASDR, dated February 12, 1999.

[21] Information in JavaScript falls into this category.

[22] We recognize that full conversion to an electronic filing system is something that will take some time. Therefore, it might be appropriate to gradually implement such a system. For instance, as a first step, the Commission could require NASDR, by a date certain, to make the arrangements necessary to enable members to file electronically print materials, which we understand are currently either created electronically or capable of being easily converted to an electronic format. This step could be quickly accomplished with existing technology. (For example, NASDR could permit such materials to be submitted to it in PDF format via email.)
