

Comment Letter on NASDR Proposal Regarding Unregistered Persons' Communications with the Public, October 1997

October 31, 1997

Ms. Joan Conley
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, N.W.
Washington, D.C. 20006-1500

Re: NASD Regulation Request for Comment 97-58

Dear Ms. Conley:

The Investment Company Institute¹ is writing in response to NASD Regulation Request for Comment 97-58 ("RFC 97-58"). RFC 97-58 seeks comments on proposed Interpretive Material 1031 ("IM 1031"), regarding "cold calling activity."² As discussed below, the Institute is concerned that as drafted, proposed IM 1031 could be read to prohibit certain legitimate activities involving unregistered persons. To avoid this result, we recommend that NASDR withdraw proposed IM 1031. Alternatively, if NASDR is determined to go forward with this initiative, it should substantially revise proposed IM 1031 to address the issues described below and repropose it for comment.

The scope of proposed IM 1031 is at best, unclear, and at worst, inappropriately broad. For example, the title of proposed IM 1031 is "Registration of Cold-Callers, Telemarketers and Related Persons." Yet, nowhere in proposed IM 1031 or the NASD's rules is there a definition of "cold-caller" or "telemarketer."³ Nor is it clear to whom "related persons" refers. Moreover, none of these terms is used within the text of proposed IM 1031.

In addition, RFC 97-58 states that IM 1031 "is directed primarily to 'cold calling' activity."⁴ It appears, however, potentially to extend far beyond such activity. For example, even though common usage of the terms "cold calling," "cold-callers" and "telemarketers" would seem to suggest that proposed IM 1031 addresses persons engaging in outbound communications by telephone, nothing within its text indicates that this is the case. Instead, the wording of proposed IM 1031 refers simply to persons who communicate with members of the public, without limiting those communications to telephone calls (much less outbound telephone calls).

Moreover, although RFC 97-58 describes "'cold calling' activity" as "solicitation of persons who are not existing customers,"⁵ proposed IM 1031 itself both seems to extend beyond "solicitation" activities and contains provisions governing communications with persons who are existing customers.⁶

The structure of proposed IM 1031 exacerbates the confusion as to its scope. Specifically, proposed IM 1031(a)(1) and (a)(2) proscribe certain activities involving communications by unregistered persons on behalf of an NASD member with members of the public. Proposed IM 1031(b)(1) then sets forth certain limited circumstances under which unregistered persons are permitted to communicate with existing customers⁷ of an NASD member for the purpose of soliciting the purchase of securities or related services, "notwithstanding the provisions of paragraph (a)" (emphasis added). This wording suggests that the activities described in subparagraph (b)(1) otherwise would be prohibited under paragraph (a). It also suggests that the activities listed in subparagraph (b)(1) are the only types of communications in which unregistered persons may engage on behalf of an NASD member. Both of these implications are problematic.

First, communications with existing customers by definition do not involve "cold calling" and thus cannot logically be characterized as an exception from a prohibition on cold calling. Similarly, the limited functions that would be permitted under subparagraph (b)(1) (i.e., extending invitations to firm-sponsored events and inquiring whether a person wishes to discuss investments with a registered person or receive investment literature) do not constitute cold calling.⁸ These limited functions clearly would not encompass the

abusive practices that are cited in RFC 97-58 as forming the basis for proposed IM 1031, i.e., "high pressure and aggressive sales pitches, often delivered by unregistered persons using specially designed scripts."⁹ Thus, the "exceptions" set forth in subparagraph (b)(1) do not follow from the prohibitions set forth in paragraph (a).

Second, and more importantly, if subparagraph (b)(1) is intended to describe the only permissible communications by unregistered persons on behalf of a member, it is much too narrow.¹⁰ In the mutual fund context, it is common and longstanding practice for unregistered persons to engage in a variety of non-selling activities. Such activities include, for example, performing market research, conducting focus groups, providing investment education,¹¹ taking names and addresses of persons who call to request information (e.g., in response to an advertisement),¹² making follow-up calls to clarify requests for information about a fund, receiving and transmitting unsolicited exchange or redemption orders from existing shareholders and responding to inquiries about shareholder account services.

None of these activities involve the type of outbound marketing efforts with which NASDR is concerned, nor have they led to abusive practices. Yet, they may involve communications with the general public and/or existing customers and possibly could be deemed to be "for the purpose of soliciting the purchase of securities or related services."¹³ Thus, proposed IM 1031, as drafted, could be read to prohibit such activities unless they are conducted by a registered person. This obviously unintended result would significantly disrupt the fund industry and does not seem consistent with the purpose of IM 1031.

Another problem with proposed IM 1031 arises under subparagraph (a)(2). Subparagraph (a)(2) provides that no NASD member "shall engage or use any person to communicate on behalf of the member with members of the public to solicit the purchase of securities or related services or to identify prospective customers unless such person is registered as a broker or dealer under the Securities Exchange Act of 1934, or is registered as a representative."¹⁴ This provision is inappropriately broad. For example, it appears to be inconsistent with Securities and Exchange Commission staff no-action positions that permit, for example, so-called "networking" arrangements between a broker-dealer and a financial institution that is not required to register as a broker-dealer (e.g., a bank), the payment of "finders' fees" to unregistered persons in certain circumstances, payments by broker-dealers to on-line service providers and affinity arrangements between a broker-dealer and another entity.¹⁵ Similarly, it is potentially inconsistent with the federal banking regulators' Interagency Statement on Retail Sales of Nondeposit Investment Products, which allows the payment of referral fees under certain conditions. Although we do not believe that NASDR meant for proposed IM 1031 to prohibit such arrangements (and we would oppose their prohibition), the wording of proposed IM 1031(a)(2) could be construed to do so.

In addition, proposed IM 1031 seems to overlap with proposed NASD Conduct Rule 2460, which would prohibit NASD members from paying compensation to unregistered persons "in connection with locating, introducing, or referring prospective brokerage account customers to the member."¹⁶ (As noted above, proposed IM 1031 would prohibit an NASD member from "engaging" an unregistered person to identify prospective customers.) NASDR should take care to ensure that, if both of these items proceed towards final adoption, they are consistent with each other.¹⁷

Finally, we note that RFC 97-58 indicates that proposed IM 1031 "would not prohibit a member's administrative personnel, in the normal course of their duties, from contacting customers regarding routine administrative matters such as confirming mailing addresses and acknowledging receipt of communications." If proposed IM 1031 goes forward, NASDR should expand and clarify the scope of this exception for routine administrative matters and incorporate the exception into the text of IM 1031.¹⁸

* * *

Thank you for considering the Institute's comments on proposed IM 1031. If you have any questions or need additional information, please call me at (202) 326-5822.

Sincerely,

Frances M. Stadler
Associate Counsel

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ENDNOTES

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 6,661 open-end investment companies ("mutual funds"), 443 closed-end investment companies, and 10 sponsors of unit investment trusts. Its mutual fund members have assets of about \$4.160 trillion, accounting for approximately 95% of total industry assets, and have over 59 million individual shareholders.

² See NASD Notice to Members 97-58 (September 1997).

³ NASD Conduct Rule 2211 (entitled "Telemarketing") imposes certain restrictions on NASD members' telemarketing activities. Although it does not define the term "telemarketing," the rule specifically applies to outbound telephone calls made by a member or a person associated with a member for the purpose of soliciting the purchase of securities or related services.

⁴ Request for Comment at p. 465.

⁵ *Id.*

⁶ RFC 97-58 states that NASDR "is considering altering its policy and practice with respect to cold calling to require registration of all persons who contact prospective customers concerning the purchase of securities or related services or for the purpose of identifying potential customers." Yet, the language of proposed IM 1031(a)(1) and (a)(2) refers to communications with members of the public and thus is not restricted to prospective customers. In addition, as discussed below, proposed IM 1031(b)(1) specifically deals with communications with existing customers.

⁷ The proposed definition of "existing customer" does not work in the context of directly marketed mutual funds, because the broker-dealer involved (i.e., the principal underwriter) does not "carry" shareholder accounts. We recommend that if subparagraph (b)(1) is retained, the definition be revised to encompass current shareholders of any of a fund complex's funds.

⁸ These functions would not constitute cold calling even if they involved prospective customers, rather than only existing customers. RFC 97-58 offers no compelling rationale for why unregistered persons should be prohibited from performing these limited functions with prospective customers.

⁹ RFC 97-58 at p. 466.

¹⁰ For example, this would imply that there are no circumstances under which unregistered persons may communicate with persons other than existing customers (except perhaps to the extent the communication could not be construed as being "for the purpose of soliciting the purchase of securities or related services" or clearly involved a "routine administrative matter").

¹¹ For example, firms may hold investor education seminars at which mutual fund portfolio managers and/or research analysts (who typically would not be registered) make presentations. Other communications (e.g., telephone calls) between portfolio managers and investors also potentially could be viewed as coming within the scope of proposed IM 1031, which would be inappropriate.

¹² In some cases, these activities may be performed by a third-party mailhouse.

¹³ There is no explanation of what "related services" would cover.

¹⁴ Emphasis added. Proposed IM 1031(a)(1) refers to communications on behalf of a member with members of the public "for the purpose of soliciting the purchase of securities or related services or for the purpose of identifying prospective customers . . ." It is not clear whether any substantive difference is intended between the wording "for the purpose of soliciting . . ." (in subparagraph (a)(1)) and "to solicit" (in subparagraph (a)(2) (or between "for the purpose of identifying" and "to identify"). If not, we recommend that NASDR use consistent phrasing.

¹⁵ See, e.g., Chubb Securities Corporation (pub. avail. November 24, 1993) (networking arrangement); International Business Exchange Corp. (pub. avail. December 12, 1986) (finder's fee arrangement); Charles Schwab & Co., Inc. (pub. avail. November 27, 1996) (payments to on-line service provider).

¹⁶ See NASD Notice to Members 97-11 (March 1997). The Institute's comment letter on proposed Rule 2460 recommended several changes to clarify the scope of that rule. See Letter from Frances M. Stadler, Associate Counsel, Investment Company Institute, to Ms. Joan Conley, Office of the Corporate Secretary, NASD Regulation, Inc., dated April 30, 1997 (NASD Regulation Requests for Comment Nos. 97-11 and 97-12).

¹⁷ It would be helpful if NASDR provided guidance on the relationship between these two proposals.

¹⁸ For example, NASDR should clarify that functions such as calling shareholders regarding proxy voting and taking down names and addresses of investors who call to request fund prospectuses would be considered routine administrative matters for this purpose.

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