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April 12, 2004

Via Electronic Mail to Rule-Comments@sec.gov

Jonathan G. Katz, Secretary
U.S. Securities and Exchange Commission
450 Fifth St. N.W.
Washington, D.C. 20549-0609

Re: Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, File No. S7-06-04

Dear Mr. Katz:

The Securities Industry Association ("SIA")[1] appreciates the opportunity to comment on the above-referenced rule proposal (the "Proposal") that would require broker-dealers and municipal securities dealers to make additional disclosures in connection with transactions in securities issued by mutual funds, interests issued by unit investment trusts or "UITs" (including insurance company separate accounts that offer variable annuity contracts and variable life insurance policies) and securities issued by education savings "529" plans.[2] Under the Proposal, new rule 15c2-2 would mandate extensive new confirmation disclosures to clients for mutual fund transactions. New rule 15c2-3 would impose mandatory "point of sale" disclosure requirements for mutual fund transactions before they could be completed.[3] Amendments to Form N1-A would expand mutual fund prospectus disclosures concerning funds' distribution arrangements with broker-dealers. Amendments to rule 10b-10 would delete requirements

[1] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs 780,000 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift and pension plans. In 2003, the industry generated $209 billion in domestic revenue and $278 billion in global revenues. (More information about SIA is available on its home page: www.sia.com).

[2] For ease of use, this comment letter generally will refer to "mutual funds," although we recognize that the Proposed Rules also cover UITs and 529 plan securities, and do not cover some closed-end or exchange-traded funds.

[3] Proposed rules 15c2-2 and 15c2-3 are referred to herein as the "Proposed Rules".

formerly applying to mutual funds, but add new requirements for transactions in callable preferred stock and callable debt.[4]

Executive Summary

This letter makes four key points.

First, SIA strongly supports enhanced disclosure of mutual fund economics as well as all other material aspects of mutual fund investing, such as investment objectives, performance and risk.

Second, SIA agrees with the SEC on the basic types of information that need to be disclosed.

Third, SIA is concerned that in its current form, the SEC's proposal will have significant adverse unintended consequences, for both the securities industry and the investors that it serves. We describe on pages 7-9 below an alternative to the SEC's proposed approach that we believe would be more useful to investors and more cost-effective. SIA agrees with recent statements by the Commission in a related context, that disclosure that is standardized is easier to use, especially for comparison shopping, and more cost-effective than disclosure that is personalized on a transaction-by-transaction basis. Moreover, investors are better served by providing a flexible range of mediums for making the disclosures (such as websites, telephonic disclosure or hard copy) rather than requiring point-of-sale disclosure.

Fourth, SIA recommends that its disclosure alternative, together with the SEC's proposed approach (and perhaps other approaches that other commenters might suggest) be tested with investor focus groups to determine which approach is the most useful and cost-effective. SIA stands ready to participate with the SEC and others in designing and implementing such market research.

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As a threshold matter, it is important to state that SIA strongly supports enhanced disclosure for mutual fund investors. SIA has been looking forward to guidance from the SEC on how to improve mutual fund trade confirmations ever since the Commission committed to issue a release on the subject in its amicus brief in the *Press* case.[5]

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[4] *See* Proposed Rule: Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, Securities Act Rel. No. 8358 (Jan. 29, 2004) (the "Proposing Release").

[5] *See Press v. Quick & Reilly, Inc.*, 218 F.3d 121 (2d Cir. 2000), discussed in Proposing Release at nn.35-39 and accompanying text. In its amicus brief, the SEC urged the court not to issue a ruling that would have the effect of imposing new mutual fund transaction disclosure requirements in a private damages action. The court's decision in the case adopted the position advocated by the SEC.

As noted in the Proposing Release, SIA submitted a letter dated Oct. 31, 2003 to Paul Roye, Director of the SEC Division of Investment Management recommending that when applicable, a mutual fund transaction confirmation should contain an indication that associated persons might have received additional compensation in connection with the purchase.[6] The letter also suggested that when a broker-dealer has received a cash payment "as a condition for inclusion of the investment company on a preferred or select sales list, or similar grouping, in connection with any other sales program, or as a reimbursement or advancement of expenses," then the confirmation should contain a statement indicating that it may have received a cash payment relating to the transaction. SIA suggested that brokerage firms have the choice of providing the precise details of these arrangements on a website or through a toll-free telephone number, rather than requiring that the extensive and inherently complex disclosures be included on the confirmation statement itself. We continue to believe that this tiered approach to mutual fund transaction expense and conflict disclosure is the most effective way to convey meaningful information to *all* investors.

In his testimony to the U.S. Senate Committee on Governmental Affairs on January 27, 2004, SIA President Marc Lackritz stated that SIA also supported broader disclosure of revenue sharing, including expense reimbursements from mutual funds and their affiliates to broker-dealers. SIA also supported enhanced disclosure of soft dollars and directed brokerage.[7]

SIA believes that much of the information addressed in the proposal may be useful to investors. Regrettably, the Proposal in its current form has two overarching problems. First, the Proposal in several respects would provide information to investors in a potentially misleading manner, and could distract investors from the more important basic information disclosed in the fund prospectus. Second, the Proposal would impose a multi-billion dollar cost on the industry that, ultimately, will be borne primarily by retail investors. Taken together, these problems, if not remedied, threaten to make mutual funds less available and less attractive for small and beginning investors – precisely the investors for whom mutual funds are often the most appropriate class of investment.

Fortunately, we believe the Commission's important objective of conveying useful information regarding costs and conflicts can be achieved by other means. SIA presents below an alternative approach to disclosure that we believe will achieve the SEC's objective without incurring the disadvantages of the Proposal. We believe our approach would be more investor friendly, because investors would be better able to process the information, make appropriate cost comparisons among different mutual funds and brokerage firms, and then proceed with a suitable investment plan. We believe that the better, more cost-effective way to provide the information is to take advantage of technology, using websites and toll-free telephone numbers.

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[6] *See* Proposing Release at n.52.

[7] Available at http://www.sia.com/testimony/html/mlackritz1-27-04.html. SIA anticipates making further comments on issues related to the distribution of mutual funds connection with the SEC's recent release on Rule 12b-1 fees, Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Rel. No. 26,356 (Feb. 24, 2004).

We understand that the SEC plans to convene focus groups to test their proposed point of sale and confirmation disclosures. While we applaud the Commission's sensitivity to investor needs, we hope the Commission will not limit its test to a simple "yea or nay" vote on its proposed disclosure templates. We believe that in order for this approach to be meaningful, the focus groups should be asked how much they would be willing to pay in increased fees for the proposed disclosures, so that their responses can be assessed against the multi-billion dollar cost that the SEC acknowledges the disclosures will incur. In addition, we believe that the Commission should offer investors a range of other disclosure alternatives developed by the staff with input from investors, other regulators, mutual funds and brokerage firms, so that investors can compare the SEC's approach with other possible approaches. Systematic experimentation and feedback from investor focus groups with a number of disclosure formats would be more likely to yield the best approaches, which the SEC could then refine through the normal public notice and comment process. We invite the Commission to use our proposed disclosure alternative as one such format. Whether or not the SEC opts to include our proposed alternative in its focus groups, we are willing to commission our own focus group to test our proposal against the SEC's approach, and to share the results of that test in a supplemental comment letter.[8]

What concerns us, too, is the need to have a holistic approach to the information brokerage firms and mutual funds are required to provide to investors. We believe it is important that there be consistency across the various disclosures investors receive about mutual funds. The Commission, by approaching different methods of disclosure separately in its regulatory proposals, may not be taking advantage of opportunities to coordinate and condense information so as to minimize investor confusion. SIA encourages the Commission to look at the entire disclosure process and consider all the tools used - including point of sale information, the prospectus, the confirmation, and the account statement - as part of a single, integrated framework, rather than as piecemeal components.

I. Background

A. Proposed Rule 15c2-3 -- Point of Sale Disclosure

Proposed rule 15c2-3 would require broker-dealers to disclose, at the point of sale, and prior to effecting a transactions, by reference to value of the customer's proposed investment, or if the value is not reasonably estimable at the time of investment, by reference to a model investment of $10,000:

- The amount of any sales load that the customer would incur at the time of purchase;

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[8] Prof. William Lutz, an expert on Plain English often consulted by the SEC, recently testified in Congress criticizing the Proposed Rules. He advocated a similar process of consultation with investors and experts on the effective presentation of information. Statement of Prof. William D. Lutz to the Senate Committee on Banking, Housing and Urban Affairs, March 23, 2004 (available at http://banking.senate.gov/_files/lutz.pdf).

- An estimate of the amount of any asset-based sales charge and asset-based service fees that, in the year following the purchase, would be incurred by customer in connection with the shares or units purchased if the net asset value does not change;[9]

- An estimate of the maximum amount of any deferred sales load associated with the shares or units purchased if those shares or units are sold within one year (other than deferred sales loads of no more than one percent that expire no later than one year after purchase, when no other sales load would be incurred on that transaction), along with a statement about how many years a deferred sales load may be in effect;

- The amount of any dealer concession that the brokerage firm would earn at the time of sale in connection with the transaction;

- Whether the brokerage firm or any affiliate receives revenue sharing from the fund complex;

- Whether the brokerage firm or any affiliate receives portfolio brokerage commissions from the fund complex; and

- If applicable, whether the brokerage firm engages in specified differential compensation practices related to the class of security to be purchased, or in connection with the sale of a proprietary security.

As defined in paragraph (f)(1) of rule 15c2-3, "point of sale" would include disclosure in telephone calls or in-person meetings with clients, or in electronic order entry systems, before a mutual fund order could be accepted. Failure to give the point of sale disclosure, in addition to being a regulatory violation, would give clients the right to terminate the order at any time until they receive the disclosure.

B. Proposed Rule 15c2-2 – Confirmation Disclosure

The proposed confirmation disclosures required by rule 15c2-2 would include information currently disclosed to mutual fund investors under rule 10b-10, which rule would be amended to exclude from its application mutual fund transactions. In addition, entirely new, highly detailed, transaction-specific disclosure requirements would apply to purchase transactions involving mutual funds, as described below:

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[9] The Proposing Release does not indicate whether or how disclosures should be made of the newly proposed mandatory redemption fees (nor for that matter existing short-term redemption fees). See Investment Company Act Rel. No. 26375A (Mar. 5, 2004). Required disclosure of asset-based sales charges and service fees without similar disclosure of mandatory redemption fees strikes us as inappropriate. On the other hand, if the SEC requires both types of disclosure, the disclosures will be even more complicated, confusing to investors, and costly. As discussed below, it is not technically possible to make point-of-sale disclosure of the precise amount of a redemption fee because the calculation rests on knowledge of the fund's net asset value, which is established later in the day.

- Disclosure would be required of the amount of any sales load that the client has incurred or will incur at the time of purchase, expressed in dollars and as a percentage of the net amount invested, together with: (1) if the customer will incur a sales load at the time of sale, information about the availability of breakpoints, including specified information relating to the sales load; or (2) if the customer will not incur a sales load at the time of sale, information about the availability of breakpoints with regard to a different class of security, including a statement of the sales load that the customer would have incurred at the time of sale if the transaction had been in that different class of security.

- With respect to deferred sales loads, disclosure would be required of the maximum potential deferred sales load (other than a deferred sales load of no more than one percent that expires no later than one year from purchase, when no other sales load would be incurred) on a year-by-year basis for so long as the deferred sales load may be in effect, expressed in dollars and as a percentage of net asset value at the time of sale or purchase.

- Proposed rule 15c2-2 would also require disclosure of any asset-based sales charges and service fees paid in connection with the customer's purchase of mutual fund shares, including any 12b-1 fees or service fees incurred by issuers, directly or indirectly, expressed as a percentage of net asset value. In addition, the rule would require disclosure of an estimate of the total annual dollar amount of asset-based sales charges and service fees that would be associated with the shares purchased, assuming a stable net asset value and level of fees paid out under the fund's distribution plan.

- Dealer concessions earned by the brokerage firm in connection with the transaction would be required to be disclosed, expressed in dollars and as a percentage of the net amount invested.

- Disclosure of information would be required relating to two types of arrangements: (1) revenue sharing payments received by the broker-dealer from persons within the fund complex; and (2) commissions earned by the broker-dealer associated with portfolio securities transactions on behalf of the issuer or other mutual funds within the complex. Information on these arrangements would be required to be disclosed on the basis of the firm's sales on behalf of the fund complex, as a percentage of the total net asset value represented by the broker-dealer's total sales of mutual funds within the complex over the four most recent calendar quarters, updated each calendar quarter. In addition, the broker-dealer would be required to disclose the total dollar amount of revenue sharing or portfolio brokerage commissions that the firm may expect to receive in connection with the transaction, calculated by multiplying that percentage by the net amount of the transaction. Firms would have 30 days to update this information each quarter.

- Rule 15c2-2 would also require disclosure of whether the broker-dealer pays differential compensation to its representatives related to purchases of mutual fund shares that: (1) carry a deferred sales load (other than a deferred sales load of no more than one percent that expires no later than one year from purchase, when no other sales load would be incurred); or (2) offered by proprietary mutual funds.

The required additional disclosures for purchase transactions (front-end sales loads, deferred sales loads, annual asset-based sales charges and service fees, dealer concession or other sales fees, revenue sharing and portfolio brokerage commissions) would need to be accompanied by "median information and comparative ranges" (the median, 5th and 95th percentile range) for each type of expense, based on the same category of security covered by the rule. According to the Proposing Release, the SEC will publish the median and comparison ranges from time to time, and all disclosures provided more than 90 days following the publication would need to conform to the revised ranges.

II. Alternatives Are Available That Would Provide Better Information to Investors at Dramatically Lower Cost

For the reasons discussed below, we believe the Proposal could confuse ordinary investors and undermine the role of the prospectus as the principal disclosure document intended to inform mutual fund investors. The sheer volume and complexity of the information required to be disclosed at point of sale and upon confirmation will be a challenge for investors to read, understand and take into consideration, much less to place into context with the other information contained in the prospectus.

If adopted in its current form, the Proposal will be remarkably expensive both to implement and on an ongoing basis. These costs, most of which will ultimately be borne by investors, far outstrip the potential benefits of the SEC's proposed disclosures. However, SIA strongly agrees with the Commission that the *status quo* is unacceptable. We suggest that in place of the proposed point-of-sale disclosure, brokerage firms should be required to maintain website disclosure concerning their relationships with mutual funds or mutual fund families available for purchase through that brokerage firm. This website disclosure might cover much of the same basic information described in the Proposal: sales load charges, asset-based service fees, sales fees and breakpoints (information which should be available from the mutual funds). The website should also disclose if the brokerage firm has revenue sharing or portfolio brokerage commission relationships with the mutual fund complex,[10] and a general summary of the brokerage firm's compensation practices for registered representatives, including whether the firm engages in either specified type of differential compensation. In addition, the website should contain information about whether the mutual fund family has a soft-dollar or directed brokerage relationship with the brokerage firm (subjects not addressed in the Proposal).

For the relatively small number of investors who do not have access to a computer, we suggest that brokerage firms make the information available either by a toll-free telephone

[10] For the reasons discussed below, we do not believe that quantifying revenue sharing or portfolio brokerage in terms of a percentage of an investor's purchase is appropriate – in most cases such a calculation would be misleading because it suggests a relationship between the purchase and those practices which may not exist. Also as discussed below, we do not believe the Commission should designate mutual funds as "similar" or to calculate industry median or range disclosures for comparison. While such comparisons may be useful to some investors, they are best left to private sector organizations such as Morningstar, Lipper or Standard & Poors.

number or by mail in response to a client's request. And brokerage firms should be required to remind investors periodically about the existence of this information, at account opening, at least annually thereafter, and in each mutual fund confirmation.[11] As discussed below, we concur with the NASD's Breakpoint Task Force that the percentage amount of a front-end sales load for a particular mutual fund transaction (but not the precise dollar amount) should appear on the mutual fund confirmation itself.

The quantified portions of the website or toll-free telephone information should be presented both in terms of a standardized investment of $1,000 and with an assumed return of five percent per year. This type of disclosure is consistent with the Commission's recently adopted requirement for prospectus disclosure of fund expenses, and will facilitate investors' comparison of the brokerage firm's relationships with different fund companies.[12] The information also could be accompanied by a calculator that will allow customers to model each type of fee for the precise amounts the investor is considering investing.[13] We believe this proposal would provide investors with better information at the point of sale than would be provided by the Commission's proposed point-of-sale disclosure, with substantially greater utility to investors, but at a greatly reduced cost. Each mutual fund confirmation, as noted above, would contain the URL address for the website disclosure for detailed information about each of these other types of fee or potential conflicts of interest, for investors who desire it. These changes to mutual fund trade confirmations: (1) would be substantially less expensive than the Proposed Rules, and (2) would provide better information for investors in a format that is easier to understand and compare than the Proposed Rules.

As the Commission recently determined with respect to mutual fund expense disclosure, standardized expense disclosure is superior to personalized expense disclosure. As the Commission stated, "personalized expense disclosure . . . would not assist investors in making comparisons among funds because it would be based on different investment amounts and different rates of return." [14] Comparable disclosures are more investor-friendly, because they allow investors to see most easily which potential investments have the lowest costs and fewest conflicts of interest. Ensuring comparability of the disclosures will provide the greatest pressure against excessive costs and unnecessary conflicts.

And as the Commission itself recognized, standardized expense disclosure "avoids certain costs and logistical complexity that individualized disclosure . . . might entail". The

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[11] We suggest that standardized language appear on each mutual confirmation, stating generically that information about loads, sales charges and other economic relationships between the brokerage firm and the mutual fund family are available at the relevant website and toll-free telephone number.

[12] *See* Investment Company Act Rel. No. 26,372 (Feb. 27, 2004).

[13] The SEC itself has just such a mutual fund cost calculator on its own website, at http://www.sec.gov/investor/tools/mfcc/mfcc-int.htm (visited Apr. 7, 2004). The calculator will satisfy the SEC's desire for investors to be able to see cost amounts specific to their own investment.

[14] Investment Company Act Rel. No. 26,372 (Feb. 27, 2004).

Commission noted that individualized mutual fund expense disclosure might cost $200 million to implement and $65 million annually, in contrast to an estimate of $16 million in annual cost for prospectus disclosure. The Commission found that this level of costs for individualized expense disclosure was not justified.[15] As discussed below, the costs of the proposed point-of-sale and confirmation disclosures suggested in the Proposing Release are, even under the Commission's estimate, orders of magnitude larger than those deemed unjustifiable in the expense disclosure context. The SEC should require brokerage firms to disclose mutual fund expenses in a way that is consistent with, and comparable to, the expense disclosures required of mutual funds.[16]

The Commission has endorsed website disclosure (together with periodic paper reminders about where to find the website disclosure) in a number of recent contexts, particularly where, as here, the information is data-intensive and there is benefit to allowing investors to compare similar disclosures from different firms. Most recently, the SEC required that mutual funds make a quarterly website disclosure of their portfolios.[17] In the past year, the SEC has required website disclosure of mutual funds' proxy voting records,[18] and month-end performance information.[19] Similarly, in the brokerage firm context, the Commission required that its order execution quality disclosures be made on a website rather than being mailed to each client.[20] The recent research analyst reforms allow brokerage firms to make website disclosure about potential conflicts of interest, price charts, and the performance of the firm's research recommendations.[21] The Commission has also required issuers to make information available by website.[22] We applaud the Commission's endorsement of timely and effective technology-based disclosure solutions and strongly encourage the SEC to follow these precedents here.

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[15] *Id.*

[16] It certainly would appear arbitrary and inconsistent to impose personalized disclosure requirements on brokerage firms when the Commission has just rejected personalized disclosure as too expensive and contrary to the interest of comparability in the closely related context of mutual fund expenses.

[17] *See* Investment Company Act Rel. No. 26,372 (Feb. 27, 2004).

[18] *See* Securities Act Rel. No. 8188 (Jan. 31, 2003).

[19] *See* Securities Act Rel. No. 8294 (Sept. 29, 2003).

[20] *See* Exchange Act Rel. No. 43590 (Nov. 17, 2000).

[21] NASD Rule 2711 and NYSE Rules 351 and 472; *see also* NASD Notice to Members 04-18 (March 2004) (joint NASD-NYSE memorandum on interpretation of research analyst rules).

[22] *See* Securities Act Rel. No. 8128 (Sept. 4, 2002) (periodic reports); Securities Act Rel. No. 8230 (May 7, 2003) (beneficial ownership reporting).

III. The Proposed Disclosures May Distract Investors from Important Information in the Mutual Fund Prospectus

Disclosure focused only on a subset of overall mutual fund expenses and possible conflicts of interest has a significant potential to mislead investors. Investors may naturally assume that if the SEC demands some information to be provided to investors twice in short succession – once at point of sale and then again in a confirmation – then this information must be what the SEC views as the most important information to read and understand. We hope that this issue is part of what the SEC is exploring with the investor focus groups that it has commissioned to test its proposal. But notably missing from the Proposal's mutual fund transaction disclosure is the information that is of greatest importance to investors in the decision-making process, namely: the fund's investment objectives, the risks of investing in that fund, the operating expense ratio ("OER") of the fund, and the performance of the fund in relation to a broad-based securities market index over specified time periods.

Historically, the Commission has sought to focus investors' attention on the mutual fund prospectus as the document containing critical information about the fund for consideration in a client's investment decision. Indeed, the Commission currently has out for comment some half dozen proposals to expand and improve upon the mutual fund prospectus.[23] However, if investors get an extensive point-of-sale disclosure first, and then get a second brokerage firm disclosure (largely repeating the point-of-sale disclosure) accompanied by the prospectus, many investors are likely to view the prospectus as the least important of the disclosures they receive. The transaction disclosures will have the result of distracting investors from information in the prospectus that is critical to their investment decision.[24]

Even among different measures of cost to investors, the Proposing Release highlights the wrong data. One of the strongest correlations predicting a mutual fund's performance is the size of its overall OER – more expensive funds are more likely to under-perform the market.[25] No

[23] These initiatives include expanded mutual fund prospectus disclosure concerning corporate governance, codes of ethics, breakpoints, market timing and fair value pricing policies, disclosure of portfolio holdings, portfolio manager compensation, distribution practices and approval of investment advisory agreements. Indeed, this proposal itself contemplates further prospectus disclosure concerning sales loads and revenue sharing.

[24] The Commission's other recent mutual fund disclosure initiatives all depend on the primacy of the prospectus as the main disclosure document for mutual fund transactions; they will all be undermined if the Commission requires extensive and highly detailed cost and conflict information to be included in both a point of sale disclosure document and a transaction confirmation.

[25] As the SEC's own website states, "A fund with high costs must perform better than a low-cost fund to generate the same returns for you." Mutual Fund Investing: Look at More than a Fund's Past Performance (available at http://www.sec.gov/investor/pubs/mfperform.htm). Academic research has long noted the correlation between high expenses and diminished performance. *See, e.g.*, S. P. Ferris and D. M. Chance, "The Effect of 12b-1 Plans on Mutual Fund Expense Ratios: A Note," *The Journal of Finance*, Vol. 42, No. 4, September 1987, pp. 1077–1082; R. W. McCleod and D. K. Malhotra, "A

such correlation has ever been demonstrated with any of the data mandated for disclosure in the Proposal. Yet, as discussed above, the SEC has concluded that the OER is best disclosed on a standardized basis in the fund prospectus. The Proposal would highlight, at point-of-sale and in the confirmation, expenses that are less relevant to an investor's decision among different mutual funds. As a result, the Proposal would detract from the Commission's just-adopted mutual fund expense disclosure rule.

As discussed below, in many situations (for example rebalancing assets among several different funds, or modeling different levels of investment in different funds), the proposed point-of-sale rules would generate so much paperwork that they would resemble a real estate closing. The comparison to a real estate closing is not made idly. The FTC recently conducted an empirical study on the effect of mortgage broker compensation disclosures on consumers.[26] The FTC concluded that broker compensation disclosure "is likely to confuse consumers [and] cause a significant proportion to choose loans that are more expensive than the available alternatives".[27] The Proposal could have the same result: by focusing investors on broker compensation rather than issues such as overall cost, the Proposal may cause a significant number of investors to choose funds with higher OERs than they would otherwise choose.

IV. The Proposal Is Simply Too Costly.

A. The Enormous Costs of the Proposal Are Understated.

The SEC's own estimate is that Rules 15c2-2 and 15c2-3 would cost the industry at least $1.3 billion to implement.[28] The SEC estimates that the confirmation requirements of Rule 15c2-2 would cost the industry approximately $2 billion in annual recurring costs after initial implementation. The SEC estimates that this cost is $160 million more than the current Rule 10b-10 confirmations that Rule 15c2-2 would replace. The SEC estimates that Rule 15c2-3

Re-Examination of The Effect of 12b-1 Plans on Mutual Fund Expense Ratios," *The Journal of Financial Research*, Vol. 17, No. 2, Summer 1994, pp. 231–240.

[26] *See* FTC, Bureau of Economics Staff Report, "The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment" (February 2004) (available at http://www.ftc.gov/os/2004/01/030123mortgagefullrpt.pdf).

[27] *Id.*, Executive Summary at 1. Home purchases are one of the few decisions that are comparable to securities investments in their importance to ordinary consumers.

[28] *See* Proposing Release, Initial Regulatory Flexibility Act Analysis Section D (sum of $850 million implementation cost estimate for Rule 15c2-2 and $450 million implementation cost estimate for Rule 15c2-3). The IRFA does not contain any implementation cost estimate for the changes to Rule 10b-10, although the Regulatory Flexibility Act requires the SEC to include such an estimate, and in fact the changes required by this proposed amendment are far from trivial. We would estimate an implementation cost of at least $100,000 per broker-dealer, for a total implementation cost of over $500 million. Attached as an Appendix to this letter are summaries of the SEC's cost estimates for the various rules, and SIA's cost estimates.

would impose an annual recurring cost of almost $1 billion.[29] All of the Rule 15c2-3 costs would be new costs for the industry. Including the costs of the remaining portion of Rule 10b-10, the SEC estimates that combined recurring costs for these rules (not including the initial implementation costs) will be nearly $7.5 billion per year.[30] By the SEC's own estimate, the year-one costs of these rules, including both the implementation cost and the first year of annual recurring costs, would be nearly $9 billion.

We believe that these estimates, as significant as they are, are far too low. The SEC estimates that Rule 15c2-3, the point-of-sale proposal, would cost less than $85,000 for the average broker-dealer to implement, and would impose annual compliance costs of $180,000 per firm.[31] But these figures are substantially too low. As discussed below, the proposed rule would require firms to design completely new systems to create an entirely new written disclosure document and ensure that the disclosure document is available for distribution to clients at every location in which the firm meets with clients. It would require another system to ensure that the information in the disclosure document is available at every location where the firm accepts telephone calls from clients.[32] It would require every firm that accepts mutual fund orders over electronic channels to reprogram all of those order-entry systems to give this disclosure before any order could be accepted.[33] Moreover, every firm would be required to establish and monitor supervisory and compliance procedures to ensure that the disclosures are made in customer interaction (including live meetings and telephone calls) before a mutual fund order is accepted.

In sum, based on our conversations with member firms, we estimate that the implementation cost of rule 15c2-3 would be more on the order of $500,000 per firm, and the annual costs of maintaining and updating these systems and procedures would also be on the

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[29] *Id.*, *see also* Proposing Release, Costs and Benefits of the Proposed Rule and Rule Amendments.

[30] *Id.* at Costs and Benefits of the Proposed Rule and Rule Amendments (sum of $935 million in internal costs and $1.05 billion in external costs for Rule 15c2-2, $935 million in internal costs and $40 million in external costs for Rule 15c2-3, and $2.12 billion in internal costs and $2.26 billion in external costs for Rule 10b-10 as amended). The Commission estimates that the entire mutual fund industry can comply with the Form N1-A amendments for a combined cost of less than $100,000, which we believe is not a credible estimate for a change that will, at a minimum, require review by inside counsel, fund counsel and outside directors' counsel to ensure that it is correctly implemented.

[31] *Id.* at Initial Regulatory Flexibility Act Analysis.

[32] For the many firms that accept mutual fund orders through automated telephone calls as well as through calls with live registered representatives, the rule proposal would require extensive changes to two different sets of systems.

[33] Many firms maintain multiple electronic order-entry systems, for example for Internet users, for dial-up modem users, for wireless device users, for institutional customers, and for active traders – all of which would have to modified to comply with the rule.

order of $500,000 per firm.[34] The SEC estimates that the confirm disclosure changes in proposed Rule 15c2-2 would impose an average one-time implementation cost of $157,000 per broker-dealer, and have an annual recurring cost of $368,000 per firm.[35] Once again, we believe the cost of creating an entirely new confirmation statement, with multiple complex new data feeds and complex new calculations personalized for every transaction, and the continuing cost of producing those confirmation within the very compressed time in which confirmations must be sent, are likely to be far higher than the SEC estimates. Based on our conversations with member firms, we believe that implementation costs of $500,000 per firm and ongoing costs of $750,000 per firm are likely to be more realistic than the cost estimates in the release.[36]

According to the SEC's own FOCUS reports, the entire U.S. brokerage industry's total annual revenue from mutual funds was $16 billion in 2002. Assuming the brokerage industry's average profit margin of 7.5% (again, the figure is derived from the SEC's own FOCUS reports),[37] the entire US brokerage industry earned $1.2 billion in annual profits on mutual funds. In other words, the initial implementation cost of these Proposed Rules (under the SEC's own underestimates) is far greater than the entire industry's 2002 annual profits from mutual funds. And the annual recurring costs these rules would impose are substantially larger than the entire brokerage industry's annual profits from mutual funds.[38]

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[34] Our estimate would result in an implementation cost of $2.7 billion for Rule 15c2-3, and an annual ongoing expense of approximately $3 billion. As discussed below, our estimate that the point-of-sale disclosure will take an average of at least three minutes to discuss with customers, rather than the SEC's estimate of one minute, leads to a similar increase in the annual cost estimate.

[35] Proposing Release at Initial Regulatory Flexibility Act Analysis.

[36] Our estimate would result in an implementation cost of $2.7 billion for Rule 15c2-2, and an annual ongoing expense of over $4 billion. Some of our member firms have estimated that their implementation costs for the Proposed Rules would be several million dollars each – even greater than our estimates above.

[37] The SEC's FOCUS reports do not have a separate "mutual funds expenses" line to compare to the "mutual funds revenue" line. Our calculation of the overall brokerage industry profit margin is a comparison of overall revenues and overall expenses reported in the FOCUS reports. We are not aware of any evidence suggesting that the brokerage industry's profit margin is different on mutual funds than it is on other types of investments (although clearly mutual fund advisers have higher profit margins). Assuming a 10% profit margin on mutual fund business instead of a 7.5% profit margin would not materially change any of our conclusions. We note that the profit margin is likely to be lower for many small firms, and thus the impact of the Proposed Rules would be correspondingly greater.

[38] SIA is aware of estimates that the mutual fund industry charges $13 billion annually in 12b-1 fees and $6.7 billion in sales loads. We believe these estimates are consistent with the SEC's FOCUS report numbers – a substantial portion of 12b-1 fees go to general advertising expenses for mutual funds, or to revenue sharing with retirement plans, banks or entities other than brokerage firms. Similarly, not all sales loads are retained by brokerage firms; for example, some contingent deferred sales loads ultimately are returned to the mutual fund families themselves.

B. Harm to Investors

Under the SEC's own cost estimates, Rules 15c2-2 and 15c2-3 will cost more than $55 per year for each of the 54 million US households that invest in mutual funds – or more than 5% of the annual savings of a typical middle-class household that is able to invest one thousand dollars per year in a mutual fund. The year-one costs, including both implementation and the first full year of ongoing costs, equate to almost $80 per US household that owns mutual funds – or 8% of the savings of a middle-class household which is able to invest one thousand dollars per year in a mutual fund.[39]

Analyzing the cost of the Proposal on a per-household basis is appropriate. As discussed below, while the cost may fall in the first instance on brokerage firms, they will have to pass most of that cost on to their customers. The cost will fall disproportionately on smaller investors, who already are the least profitable customers for most broker-dealers. Since the cost of these rules will be incurred primarily on a per-transaction basis, it will fall most heavily on small investors who save a limited amount out of every paycheck or every month in mutual funds.

Our estimate (set forth above) would be that the annual ongoing expense of Rules 15c2-2 and 15c2-3 equates to nearly $125 per U.S. household that owns mutual funds. Our estimate of the year-one cost (including both implementation costs and one full year of ongoing expense) equates to well over $200 per household. We urge the SEC to ask investors, especially small investors, whether they would voluntarily choose to pay this much for the SEC's proposed disclosure - especially in light of SIA's less expensive alternative. If the rule is adopted, of course, investors will not have a choice – they will be required to subsidize the cost of the rules.

The Proposing Release states that the benefits of the rules "while qualitatively important, are necessarily difficult to quantify." We believe that before the SEC imposes what is, even by its own calculation, a multi-billion dollar cost on American investors, it should be able to demonstrate more tangible benefits.

C. Anti-Competitive Effects and Harm to Capital Formation

The Commission recognizes that if adopted, the Proposed Rules may lead to a reduction in overall investment in mutual funds, may cause investors to pursue other types of investments, and may result in a restructuring of the relationships between mutual funds and brokerage firms.[40] The Proposing Release opines that the rules would be "an efficient and cost-effective means ... to deliver information to consumers," would enhance capital formation because it would increase investor confidence, and would give investors enhanced access to information that would thereby enhance competition.[41] To the contrary, SIA believes that the Proposing

[39] And these estimates do not include the cost of the SEC's other recent mutual fund proposals, some of which (such as the 4:00 PM hard close, and the tracking of mandatory redemption fees) will impose significant additional costs that the securities industry also will have to recoup from investors.

[40] Proposing Release at Costs and Benefits of the Proposed Rule and Rule Amendments.

[41] *Id.* at Consideration of Burden on Promotion of Efficiency, Competition, and Capital Formation.

Release underestimates the effect the rules will have on the securities industry, the negative competitive impacts that would result from the rules, and the costs the rules would impose, especially in comparison to what we believe would be the very limited benefits to investors. We do not believe the Proposed Rules are consistent with the findings the SEC must make under Section 3(f) of the Securities Exchange Act of 1934 (the "Exchange Act").

Many of the primary negative effects of the proposed rules stem from their high cost. Brokerage firms will have to recover those costs, and ultimately most of these costs will be borne by investors. Those costs may be borne in different ways: brokerage firms may feel compelled to increase transaction fees for mutual fund trades, increase annual account fees for accounts holding mutual funds, or increase account minimum balance requirements to close smaller, less profitable accounts. Or brokerage firms may require increased 12b-1 fees or other types of revenue sharing from mutual fund complexes as a condition of offering those funds. One way or another, brokerage firms will have to recoup their increased costs – especially since, as discussed above, the ongoing costs of the rules would exceed the brokerage industry's entire annual profit from sales of mutual funds.

The inevitable result of the higher cost of compliance would be to reduce the return for ordinary retail customers who invest in mutual funds. Even small differences in costs, over time, can substantially reduce the returns of a long-term investor. As the Commission recently stated, "[a] 1% annual fee, for example, will reduce an ending account balance by 18% on an investment held for 20 years."[42] As noted above, for a household that invests $1000 per year in mutual funds, by the Commission's own cost estimates, the additional costs imposed by the Proposed Rules could swallow more than 5% of their annual investment.

As costs are shifted to mutual fund investors, the Proposal would create a financial incentive for investors to avoid mutual funds. The result will be to drive small investors away from the types of investments covered by the Proposal and towards alternative investments and investment vehicles, such as common stocks, limited partnerships, ETFs, bank collective trust funds, and insurance separate accounts. These other types of investments are suitable for many investors, particularly investors with greater wealth and investing experience, but may not be the best alternative for many investors of modest means.

Further, the Proposal would substantially increase the cost of adding any new mutual fund (or new mutual fund family) to the platform of any brokerage firm. The Proposal would make it more expensive for brokerage firms to offer mutual fund supermarkets, which as the Commission has recently noted offer investors many benefits, such as increased choice and convenience.[43] In particular, the Proposal would make it more difficult for innovative, new

[42] Final Rule: Shareholder Reports and Quarterly Portfolio Disclosure of Registered Investment Management Companies, Investment Company Act Rel. No. 26,372 (February 27, 2004).

[43] *See* Memorandum to SEC Chairman William H. Donaldson from Division of Investment Management Director Paul F. Roye re: Correspondence from Congressmen Paul E. Kanjorsky and Robert W. Ney (June 11, 2003) at 62 (noting benefits to investors of mutual fund supermarkets).

mutual funds or fund families to obtain effective distribution arrangements. The result would be to increase barriers to entry and lessen competition in the mutual fund industry.[44]

The cost and complexity of implementing these rules will fall disproportionately on smaller brokerage firms with limited resources and capital. As discussed below, small firms will not be able to rely on their clearing firms to implement the rules. All of the burden of the point-of-sale disclosure rule will fall on a small firm, as will the burden of gathering the data necessary for the confirmation rule. Small firms will have the most difficulty in recouping those costs from their clients, and are most likely to see their profits diminish and their ability to create new jobs weaken. Small brokerage firms will therefore have a particular disincentive to do business with mutual funds (or with more than a few mutual fund families). Therefore, the Proposal would also increase barriers to entry and decrease competition in the brokerage industry as well. Ultimately, less competition in the brokerage industry would result in higher prices and reduced services for investors.[45]

In sum, we believe that SIA has proposed a more efficient alternative to the Proposal that will provide better and more comparable disclosure at a lower cost. Earlier this year the SEC concluded that standardized expense disclosure by mutual fund companies is preferable to individualized disclosure, and the Commission should not make an inconsistent finding for mutual fund expense disclosure by brokerage firms. The Proposal would make the mutual fund and brokerage industries less competitive and will increase costs, particularly for small investors. And the Proposal would harm capital formation. For these reasons, SIA believes the SEC should find that the Proposal does not satisfy the standards of Section 3(f) of Exchange Act.

V. No Comparable Precedent For the Expense and Burden of Point of Sale Disclosure

Moreover, there is no SEC precedent for requiring both point-of-sale and confirmation disclosure for every mutual fund transaction.[46] Even the penny stock rules (the closest existing

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[44] As discussed below, the fact that the Proposed Rules apply to brokerage firm sales of mutual funds but not to bank sales of mutual funds will put brokerage firms at a competitive disadvantage as compared to banks. The Proposing Release offers no explanation or justification for the lack of equal treatment across different types of competitors.

[45] The Commission's own cost estimates (which we believe are underestimates, as discussed above) demonstrate that the Proposed Rules are "major rules" under SBREFA. The Commission estimates that the rules will cost over a billion dollars to implement and will impose further billions in annual costs, far more than the $100 million threshold in SBREFA.

[46] The Proposing Release cites two cases for the proposition that the antifraud provisions of the federal securities laws sometimes require disclosure "before a securities transaction." Proposing Release at n.54, citing *Ettinger v. Merrill Lynch Pierce Fenner & Smith, Inc.*, 835 F.2d 1031, 1036 (3d Cir. 1987); *Krome v. Merrill Lynch & Co.*, 637 F. Supp. 910, 916 (S.D.N.Y. 1986). However, neither case stands for the proposition for which they are cited in the Release. Both cases hold that undisclosed excessive mark-ups may violate Rule 10b-5. However, the mark-ups in those cases were never disclosed at all, and nothing in either case even remotely suggests any requirement for point-of-

analogy) apply only to recommended transactions, and then only to firms that specialize in penny stocks. In our view, there is no logical justification for imposing point-of-sale disclosures on one of the lowest risk types of investments (transactions in registered mutual funds). Nor is there any justification that would rationalize imposing point-of-sale disclosure on all mutual fund transactions, but only solicited penny stock transactions by firms specializing in penny stocks. The inevitable message that investors will understand from this proposal will be that mutual funds are more risky than other types of investments and should be avoided. This is not an acceptable result. Even the harshest critics of the mutual fund industry agree that mutual funds in fact have the best disclosure, the strictest governance structure, the best diversification requirements and the most thorough oversight of any investment class.[47]

VI. The Point-of-Sale Proposal is Too Complex and Unmanageable

Under the Proposed Rules, the point-of-sale disclosure would have to be in writing (other than in oral conversations such as telephone calls), including in any face-to-face meeting. If the client changed his or her mind about the amount to be invested, the firm would have to generate a new disclosure before accepting the order. In a client interaction where the registered representative is discussing different options to rebalance a family's portfolio (including the holdings in the parents' brokerage, IRA and 401(k) accounts, as well as their children's 529 accounts), the result could be literally dozens of point of sale disclosure documents – each of which must be reproduced each time the clients change any factor in their assumptions. Such a paperwork-dominated client interaction would look more like a real estate closing than an informed discussion of investment alternatives. As a result, the Proposed Rules would seriously interfere with the provision of quality investment guidance.[48]

For purely oral orders (such as by telephone), the Proposing Release would mandate that firms have compliance policies demonstrating that in all cases the full point of sale disclosure was made before the order was accepted. Clients would be given a "put" – if they alleged that they did not receive every disclosure precisely as mandated, they would be able to rescind the transaction. To mitigate this risk, many brokerage firms will generate and mail a paper point of sale disclosure even for telephone orders where the rule does not mandate a paper disclosure. Clients would be mailed a paper point of sale disclosure, and then would get essentially the same

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sale disclosure as distinguished from confirmation disclosure. At most these cases simply support the proposition that compliance with Rule 10b-10 is not a safe harbor from liability under Rule 10b-5.

[47] *See, e.g.,* Testimony of Mercer Bullard, Fund Democracy, Inc., before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, at 2 (June 18, 2003) ("for the overwhelming majority of Americans, mutual funds offer the best available investment alternative").

[48] As discussed below, we believe the Commission's proposed "definitions" accompanying the point-of-sale disclosure and the confirmation disclosure are unbalanced. In particular, we believe it is unwieldy and unhelpful to require the definitions to be included in a point-of-sale disclosure. Moreover, we believe the definitions will be ignored by investors during in-person interactions.

information a day or two later in the trade confirmation.[49] The Commission's proposal will inundate investors with costly paperwork and oral disclosures they will quickly learn to ignore. As discussed above, the most significant information (that in the mutual fund prospectus) will come last, and investors will give it the least attention.

Further, the oral point of sale disclosures will be time consuming. In a branch office or call center environment, extending the point of sale disclosure requirements to unsolicited transactions will mean that registered representatives will be able to take many fewer calls from investors. On a heavy volume day (e.g. in a rapidly moving market), the result will be that investors will have much more difficulty reaching a registered representative.[50] This is another significant cost that will be borne primarily by investors. The Proposing Release estimates that the point of sale disclosures will take an average of one minute each to deliver.[51] We believe this is a substantial underestimate, especially given the Commission's stated intent that the disclosures should spark a dialogue with investors. If the Commission increases this to a more realistic (and still conservative) estimate of three minutes per transaction, then the annual cost of the point of sale disclosure increases dramatically from the Commission's own estimate of about $1 billion per year.[52]

The point-of-sale disclosures in particular will introduce substantial and unacceptable new risks into brokerage firm trading systems. Before a brokerage firm can accept a mutual fund trade, it would be required to make the point-of-sale disclosures. Therefore, an entirely new system, containing the transaction-specific information contained in these disclosures, would have to be linked to the trading system. Any kind of systems or data problem in the new disclosure system would have the potential to take down the trading system. Even if the systems or data problem could be isolated, a brokerage firm would still be unable to accept mutual fund orders until the problem was fixed, because it would be unable to make the required disclosures first. Particularly in heavy volume, down-market days, when trading systems are under the

[49] The SEC requests comment (but does not formally propose) requiring that the client sign all point-of-sale disclosures before the order can be accepted. Many brokerage firms may adopt such a requirement to protect themselves from the risks created by the rescission provision of the Proposal (which we urge the Commission not to adopt). But we believe firms should have the flexibility not to obtain signed disclosures. A requirement for signed disclosures would essentially prohibit accepting mutual fund orders by telephone – which would be a calamitous result, and would have an extremely harmful effect on clients seeking to switch to money market funds or other conservative investments in a rapidly declining market.

[50] We believe the point-of-sale disclosure requirements would render automated telephone systems (in which the investor uses a touch-tone phone or voice-recognition software to enter orders) almost unusable for mutual fund orders. The Commission should not discourage use of these systems, because often they have the greatest capacity to handle increased numbers of customer orders on the heaviest volume days, when customers may have the greatest need to reach their brokerage firm.

[51] *See* Proposing Release at Paperwork Reduction Analysis.

[52] *See* Proposing Release at Costs and Benefits of the Proposed Rule and Rule Amendments.

greatest stress, this could result in investors being unable to access their investments (and being unable to provide liquidity to the markets). The Commission should not take steps that increase the risk that brokerage firm trading systems will be unavailable or that brokerage firms will be unable to accept orders from clients.

In some situations, the point-of-sale disclosures contemplated in the Proposing Release simply would be impossible to provide.[53] Consider the case of a client who wishes to exchange all of his or her investment in one mutual fund for an investment in another mutual fund. Today the investor can conduct a same-day exchange from one fund to another – which is highly beneficial because it prevents the investor from having to be out of the market during the exchange process.[54] However, under the proposed rule, it would be impossible to make the point-of-sale disclosure for the second leg of the exchange (the purchase). Until one receives the NAV of the first fund being sold, one does not know the exact dollar amount of the investor's sales proceeds to be invested in the second fund. Yet without knowing the exact dollar amount of the sales proceeds, one cannot make an accurate quantitative point-of-sale disclosure for the purchase leg of the transaction. In many cases, the brokerage firm will not be able to calculate the exact amount of a front-end load at the point of sale: when an investor is adding to an existing position, the brokerage firm cannot know by exactly how much the investor is exceeding the applicable breakpoint thresholds until the NAV is set at the end of the day for the investor's pre-existing position. Similarly, the Commission could not require point-of-sale disclosure of the exact amount of a mandatory redemption fee[55] or back-end load: until the fund sets its NAV for the day, the brokerage firm does not know the exact amount of the proceeds, and thus cannot calculate and disclose how much a specific percentage of those proceeds would be. In these situations, brokerage firms only would be able to provide customers with estimates, which would defeat the purpose of transaction-specific disclosure - all of which, in our view, argues for a more comparable standardized disclosure instead. For all of the reasons discussed above, SIA believes that the point-of-sale disclosure proposal in its current form is largely unworkable and counterproductive, and the Commission should not adopt it.

If the Commission is determined to impose some sort of point-of-sale disclosure for mutual funds (contrary to our recommendation), SIA suggests that the disclosure should be generic rather than transaction-specific. A generic disclosure could describe the firm's practices with respect to portfolio brokerage, revenue sharing and differential compensation. A generic disclosure could direct investors to the fund's prospectus so they could determine the amounts of

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[53] The Proposing Release does not provide guidance about how the rules could operate in an NSCC Level 0 processing environment, in which the mutual fund is responsible for providing transaction documentation to investors.

[54] The Commission recognized the importance of preserving same-day exchanges in its Mutual Fund Pricing proposal, effectively making an exception to the 4:00 PM "hard close" for same-day exchange orders. *See* Investment Company Act Rel. No. 26,288 (Dec. 11, 2003) at Section II.B.

[55] *See* Investment Company Act Rel. No. 26375A (Mar. 5, 2004).

any front-end or back-end load, and the availability of breakpoints.[56] Such a disclosure could also remind investors to review the important information in the fund prospectus concerning investment objectives, risks, performance and the fund's expenses. In addition, generic disclosure (not containing data about the specific transaction) would significantly reduce the risks to trading systems that a data-specific point-of-sale disclosure would present. Generic disclosure would also eliminate the need to issue multiple disclosures for client interactions involving rebalancing among multiple funds, or whenever the client changed the amount of his or her anticipated investment. While a generic point-of-sale disclosure would sacrifice some of the data now proposed in Rule 15c2-3, it would be far less expensive to produce, and investors could still receive reasonable transaction-specific information as part of their confirmation.

If the Commission does pursue point-of-sale disclosure, SIA urges that unsolicited transactions be excluded, because the potential for conflicts of interest or undue sales pressure is greatly reduced in unsolicited transactions. It was for exactly this reason that the Commission did not impose point of sale disclosure requirements for unsolicited penny stock transactions.[57] Finally, point-of-sale disclosure should not apply to an investor's subsequent purchases of a fund in which he or she already has a position – once again, the potential for conflict of interest or undue sales pressure is diminished since the investor has already received the basic information about the brokerage firm's relationship with the fund complex. While we believe there should be "carve-outs" in each of these circumstances, as a practical matter the costs associated with applying these carve-outs still would be substantial.

While we have significant concerns regarding any point-of-sale disclosure for mutual funds, generic point-of-sale disclosure would be far preferable to requiring transaction-specific disclosure. Similarly, we believe the timing requirements for any point-of-sale disclosure should be more flexible. As noted above, if the Commission insists on transaction-specific data at point of sale, many brokerage firms will decide to send written disclosures rather than take the continuing risk that a client might argue that their oral disclosure either was not made or was inaccurate. We urge the Commission to permit written point-of-sale disclosures that accompany a transaction (rather than occurring before the transaction), subject to a rescission right until the customer receives that disclosure. Otherwise, we believe that some brokerage firms may decline to accept mutual fund orders by telephone at all, an outcome which would have a serious negative effect on investors.

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[56] The recommendations of the NASD's Breakpoint Task Force will result in some generic point-of-sale disclosure about breakpoints for funds with front-end loads.

[57] The exception to point-of-sale for transactions as part of a "covered securities plan" in Rule 15c2-3 should be expanded to include money market transactions – it would make no sense to require point-of-sale disclosure for money market transactions where the Proposal would not even require an immediate confirmation (compare Rule 15c2-2(d)(1)).

VII. Broker-Dealer Compensation from Transactions with Funds Better Addressed Through Web-Based Disclosure

A. Revenue Sharing

The Proposal would require that the brokerage firm disclose at point of sale whether it receives revenue sharing from the fund adviser or its affiliates (but not from the fund itself). The Proposal would require that the brokerage firm disclose in confirmations the amount of revenue sharing it expects to receive in the following year, expressed as a dollar amount, as a percentage of the amount invested, and as a range compared to industry norms. The brokerage firm would be required to update this revenue-sharing calculation quarterly, based on the trailing four quarters of revenues. SIA concurs that investors should have access to information about revenue sharing arrangements. As discussed above, we believe that brokerage firms should make website and toll-free telephone disclosure about their revenue-sharing arrangements with each fund complex which has funds offered at that firm, together with a reminder on confirmations about where investors can find this information.

However, the form of revenue sharing disclosure in the Proposal in many cases would be misleading. The Proposal defines revenue-sharing to include all payments received by a brokerage firm from the fund adviser or other fund affiliate, whether those payments are asset-based or not. The Proposal does not differentiate based on whether the payments merely reimburse brokerage firms for their costs in servicing mutual fund shareholders. The Proposal does not provide any indication whether the fund adviser is paying for some kind of preferential treatment from the brokerage firm - the abuse about which the Commission is most concerned. We believe these are important distinctions, yet the Proposal lumps them all together as “revenue sharing” without differentiation.[58]

For example, consider a brokerage firm (or its affiliates) that received both a 25 basis point shareholder servicing fee from a fund affiliate and also received fixed-fee reimbursement for seminars to educate registered reps and video conferences for the benefit of customers. Such a brokerage firm might end up reporting the equivalent of 30 basis points in revenue sharing. Although the calculation would be based on historical revenue-sharing, the disclosure would indicate (misleadingly) that this is the amount the broker-dealer may expect to receive in the coming year – even if the brokerage firm in fact expected to receive a different amount (for example, because the fund adviser had negotiated a different shareholder servicing fee, or was not planning to offer the seminars or video conferences). The disclosure would indicate that the brokerage firm expects to receive the revenue in connection with the client’s purchase, when in

[58] The Proposing Release requests comment on whether the a term “revenue sharing” is appropriate, given the nature of payments from an investment adviser to a broker-dealer. Payments to broker-dealers may be intended primarily to defray significant costs incurred in educating their registered representatives about particular mutual funds or in servicing clients who purchase those mutual funds, rather than simply sharing a portion of the revenues investment advisers earn under advisory contracts. As such, we believe a phrase such as “expense sharing” or “cost sharing” is preferable to “revenue sharing”. Despite our concerns, in this letter we use the term “revenue sharing”.

fact portions of the revenue (in the examples above, flat fees for the seminar and video conference reimbursements) bear no direct relationship to any particular client's purchases.[59]

Further, different mutual fund families may pay the same shareholder-servicing fee to a brokerage firm in different ways. As the Proposing Release recognizes, some fund families take the position that when a brokerage firm takes over the role of providing sub-accounting services, sending confirmations and statements, and providing other services to the underlying clients, these can be characterized as fund expenses and paid out of fund assets (for example, as sub-transfer agent or shareholder servicing fees). Other funds pay shareholder-servicing fees out of fund assets under the funds' board-approved Rule 12b-1 plans. Still other funds pay some or all of the shareholder-servicing fee out of the fund adviser's reasonable profits. Brokerage firms often do not know what determinations the mutual funds make, or the basis for those determinations. Under the proposed rules, a brokerage firm could receive exactly the same shareholder-servicing fee from three different fund families – but would disclose three different levels of revenue sharing based on how the different fund families characterize and split up responsibility for the shareholding-servicing fees. Such a disclosure would (in our view) be affirmatively misleading – it would suggest that the brokerage firm has incentives to favor one fund family over another when in fact no such incentive may exist. Or the disclosure may suggest that the brokerage firm has the same incentives with respect to two fund complexes when in fact it has different incentives (because of different levels of payments to the brokerage firm coming from fund assets).

The Proposal's definition of revenue sharing may be misleading in yet another way. For many fund families, the level of revenue sharing is different for the institutional class of a particular mutual fund than for the retail class.[60] The Proposal's disclosure, which averages revenue sharing across an entire fund family, may result in disclosure of an amount that is flatly inaccurate for any particular transaction.[61] Similarly, some mutual funds for retirement plan accounts are designed so that the brokerage firm shares revenue with the retirement plan sponsor,

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[59] Our concern is exacerbated by the statements in the Proposing Release indicating that even perfect compliance with the rule does not provide any kind of safe harbor from enforcement action for misleading statements or omissions. See Proposing Release at Section IV.B.1.a.

[60] Mutual fund complexes create institutional and retail share classes with different OERs and different levels of revenue sharing to reflect the legitimately different costs incurred – it costs less to service a small number of institutional accounts with large average balances than to service a large number of retail accounts with low average balances. Mutual fund companies use institutional share classes to pass on these economies of scale to large investors. In many cases, the beneficiaries of these institutional share classes, such as pension plans or 401(k) plans, in turn are small investors.

[61] As an example, assume a brokerage firm receives 15 basis points of revenue sharing on institutional shares, 25 basis points of revenue sharing on retail shares, and sells an equal amount of institutional and retail shares. The Proposing Release would require the brokerage firm to disclose 20 basis points of revenue sharing on all shares – when that amount would be inaccurate for each transaction.

administrator or record-keeper, to defray plan administrative expenses.[62] The Proposal would (apparently) require the brokerage firm to disclose a large amount of revenue sharing, when in fact the brokerage firm would expect to retain a much smaller amount. Again, the Proposal would paint a misleading picture of the brokerage firm's actual incentives, and would mislead investors who were attempting to compare the brokerage firm's incentives with respect to different mutual funds or fund complexes.

If the Commission pursues the goal of quantifying revenue sharing, we urge that some types of costs be exempted from its definition. Brokerage firms typically receive some flat fees from mutual funds or their advisers – establishment fees to defray the cost of setting up linkages between the brokerage and the fund, and networking or maintenance fees to cover the ongoing costs of those linkages. Most importantly, these costs do not create potentials for conflict of interest, because the costs are small and do not vary from fund to fund. Brokerage firms incur these establishment, networking or maintenance costs whether or not any of its customers ever invest in a fund, and thus a brokerage firm has little incentive to add new funds or fund families unless they agree to cover these costs. Moreover, because the costs do not vary based on assets, expressing them as a percentage of a client's investment, or stating that the brokerage firm expects to receive it "in connection with [the client's] purchase" would be misleading.

SIA's proposal – website and toll-free telephone disclosure about each component of a brokerage firm's relationship with a fund complex (asset-based or not, and from fund assets or from fund affiliates) – would provide better and more accurate information than that suggested in the Proposal. A website disclosure could provide more accurate information about revenue sharing than confirmation or point-of-sale disclosure ever could, by focusing on revenues that have a direct relationship to a particular client's investment (*e.g.*, whether a fund complex is paying for inclusion on a brokerage firm's preferred list, or otherwise is paying for preferred access to the brokerage firm's customers).

B. Portfolio Brokerage

The Proposal would require that the broker-dealer disclose at point of sale whether it receives portfolio brokerage from the fund adviser or its affiliates. The Proposal would require that the broker-dealer disclose in confirmations the amount of portfolio brokerage it expects to receive in the following year, expressed as a dollar amount, as a percentage of the amount invested, and as a range compared to industry norms. Once again, SIA concurs that investors should have access to information about portfolio brokerage arrangements between brokerage firms and mutual fund complexes. We support requiring broker-dealers to make website disclosure about whether they receive portfolio brokerage commissions from each complex which offers funds through that brokerage firm, together with a confirmation reminder about where investors can find this information.

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[62] Once again, these are entirely legitimate expense structures: without this revenue sharing to subsidize plan administration expenses, many small and mid-sized businesses would be unable to afford to offer their employees retirement plans at all.

It is not fully clear to us what the definition of portfolio brokerage in the proposal means to include. The proposal seems to include all commissions and riskless principal mark-ups received by the brokerage firm or its affiliates from the fund complex in the past year for transactions on behalf of the complex's mutual funds, with this sum expressed as a percentage of total sales of the complex's mutual funds at that broker-dealer in the past year.[63] The amount would have to be recalculated each quarter based on the rolling prior four quarters. The brokerage firm would make this disclosure whether or not the fund adviser has any explicit or implicit agreement to direct trades to that firm or its affiliates, or whether that brokerage firm provides research or other services to the fund complex.[64]

Thus, for a brokerage firm that does a large amount of trading for a fund complex but sells few of those funds to its customers, the brokerage firm would be required to disclose that it expects to receive portfolio brokerage commissions well in excess of the amount of a client's purchase. Once again, the proposed disclosure would state that it is the amount the brokerage firm "may receive" in the coming year in connection with the client's purchase. In fact the data would be calculated based on commissions received historically, and the brokerage firm might expect to receive a very different amount in the coming year. Moreover, there need be no connection between the commissions and the client's purchase.[65] One cannot help but think that if, in the absence of a rule, a brokerage firm made such a disclosure, it might well be deemed to be misleading.

[63] Although the Proposal is not explicit, we interpret the portfolio brokerage provisions not to require disclosure of revenue received from transactions on behalf of the fund adviser for assets managed outside of covered securities – for example, separately managed accounts, offshore mutual funds, or hedge funds managed by the fund adviser. Nor would the brokerage firm's calculation of sales of the fund complex's securities include sales related to separately managed accounts, offshore funds or hedge fund interests. While these definitions may be appropriate, they certainly limit the comprehensiveness of the disclosures in terms of identifying potential conflicts of interest.

[64] For "proprietary covered securities", the Proposal would exclude from the definition of portfolio brokerage earnings from non-broker-dealer affiliates (such as the payment from the fund to its adviser). See Rule 15c2-2(c)(5)(C). This exception should be expanded to cover portfolio brokerage commissions earned by the broker-dealer and affiliated broker-dealers as well. When buying a proprietary fund, investors should be indifferent as to in which pocket an integrated financial holding company is paid – it does not matter whether that money goes to the broker-dealer or an affiliated adviser. Section 17 of the Investment Company Act and the rules thereunder already prevent mutual funds from channeling excessive portfolio brokerage to their affiliated brokers.

[65] As discussed below, SIA has significant reservations about the SEC's proposed comparison range disclosures. In particular for portfolio brokerage, where there is no necessary relationship between the amount of trading that a brokerage firm does for a fund complex and the amount of mutual funds sold by that brokerage firm, we question the relevance of the comparison range disclosure. The comparison range disclosure is more likely to tell customers about the relative sizes of brokerage firm's institutional trading and retail distribution businesses than it is to tell customers about relevant potential conflicts of interest.

SIA believes that the calculation of these brokerage revenue streams (across different affiliates of a firm and different covered securities for each fund complex) is a large and complex undertaking. While today many brokerage firms with significant institutional trading operations informally track commissions paid by each client, those systems typically are not as precise or accurate as systems that would feed mandatory public disclosures. Brokerage firms today often receive trades in bulk from an adviser, and do not know what portion of the trade is for mutual fund portfolios and what portion is for individual advised accounts not subject to the Proposal. That allocation process occurs between the adviser and its custodian, and the executing broker is not involved. Many institutional fixed income trades are executed on a "net" basis, and tracking portfolio brokerage revenue as the Proposal requires would be difficult at best. Similarly, international affiliates of U.S. brokerage firms who execute trades for mutual funds typically do not have systems for tracking portfolio brokerage on a client-by-client basis as the Proposal requires.[66] Building and maintaining systems to track portfolio brokerage across all affiliates of a brokerage firm would be costly and time-consuming. While we believe the fact of portfolio brokerage is a worthwhile disclosure (in a website disclosure about all the relationships between the brokerage firm and a fund complex), we question whether the effort and cost of quantifying this relationship is worthwhile. Our doubts on this point are underscored by the fact that the SEC has already proposed banning the use of portfolio brokerage to finance distribution – the potential conflict of interest that is (arguably) inherent in portfolio brokerage transactions.[67]

C. Differential Compensation

SIA concurs with the Commission's general goal that investors should have information about differential compensation practices that may affect the incentives of registered representatives. We believe this issue is a good example of why web-based disclosure can provide more complete and better information than point-of-sale or confirmation disclosure. Brokerage firm compensation can be complex, and the Proposal rightly refrains from attempting to force a summary discussion of the issue into every client interaction and onto every trade confirmation. But by reducing the issue of differential compensation into two "yes or no" questions, the Proposal does not serve investors well. The differential compensation disclosure in the Proposal focuses on two practices. For funds (proprietary or not) with deferred sales loads (B shares), the brokerage firm would have to disclose whether the registered representative would be paid more in the following year than for a front-end load fund (A shares) of the same fund. While this calculation is straightforward, the disclosure may still be misleading. A registered representative may be paid more for an A share in the first year (because of the one-time front-end load) but still have an incentive to recommend B or C shares (because of higher

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[66] Institutional trading in international markets typically is done on a principal basis. Therefore, for international funds the disclosure mandated in the Proposal (of revenues only from agency and riskless principal trades) will bear little if any relationship to the actual economic incentives of the brokerage firms.

[67] *See* Investment Company Act Rel. No. 26,356 (Feb. 24, 2004).

trailing 12b-1 fees in subsequent years). The Proposal would indicate that there is no potential conflict of interest that a client should investigate.[68]

The Proposal could cause investors to fail to investigate in situations where they should do so, and could give registered representatives an incentive to recommend a share class that may not in that investor's best interest. Also, the proposed Schedule 15D, which does not indicate that the disclosure is limited to potential conflicts within the first year, may create investor confusion about what that disclosure actually represents.[69]

For proprietary funds, the proposed disclosure is broader – the brokerage firm would disclose if it paid a higher percentage of the gross dealer commission to a registered representative for selling proprietary funds than non-proprietary funds. The brokerage firm would also disclose any "other practice" that caused the registered representative to earn more for selling the proprietary fund. The Proposal gives as examples the imposition or waiver of ticket charges or overhead costs. But the scope of this "other practice" requirement is unclear. If a registered representative receives a rating that affects their bonus, and one of the factors the supervisor may consider is sale of proprietary mutual funds, does that constitute differential compensation? If a branch is evaluated and bonuses are paid based in part on overall profitability, and proprietary funds are more profitable to the firm than non-proprietary funds, does that constitute differential compensation? The release leaves these questions unanswered. The Commission should adopt a bright-line test (or at least a brighter-line test) for what it considers an incentive to sell proprietary funds.

We believe that – rather than forcing all differential compensation disclosure into two yes-or-no questions – web-based disclosure once again is a better alternative than the Proposal. Brokerage firms should give investors a general overview of their compensation incentives for registered representatives. That general overview should include any potential compensation incentives with respect to mutual funds, including as between different classes of a single mutual fund, between proprietary and non-proprietary funds, and among different families of non-proprietary funds, and including incentives that last over several years. We believe this general overview would be more useful to investors than attempting to shoehorn information as complex as broker compensation into yes-or-no disclosure at the point of sale or in a confirmation.

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[68] Indeed, the NASD has been pursuing enforcement cases alleging precisely that brokers recommended B shares when A shares would have been more appropriate. *See* NASD Files Enforcement Actions Involving Unsuitable Sales of Mutual Funds (available at http://www.nasdr.com/news/pr2003/release_03_034.html).

[69] Once again, given our view of the potentially misleading nature of the mandated disclosures, we see a substantial tension between the disclosure mandated by the Proposal and the Commission's indication (Proposing Release at Section IV.B.1.a.) that compliance with the rules does not serve as a safe harbor from liability for misleading statements.

VIII. Comparison Range Information Should Be Gathered by the Private Sector

The Proposal suggests that on confirmations, brokerage firms would have to disclose the industry median as well as an industry range (the bottom and top 5%) for sales loads, service fees, revenue sharing and portfolio brokerage. As the Commission concedes, no reliable source currently exists for such industry-wide information. The Proposal suggests that the Commission would gather such information and, on some yet-to-be-determined schedule, would update it. The release concedes that the SEC would have to issue a more focused proposal for notice and comment before it can adopt this requirement, but requests comment on the concept nonetheless.

SIA agrees that it is important for investors to be able to compare costs and expenses for different mutual funds. This is why we believe our alternative – web-based and toll-free telephone disclosure concerning a brokerage firm's relationship with every mutual fund family, which will allow investors to make side-by-side comparisons from fund to fund – is preferable to the Proposal. Moreover, we believe the private sector is better situated than is the Commission to perform this function of comparing financial and other information relating mutual funds, and the relationships between mutual funds and brokerage firms.

There is no single correct method to categorize mutual funds, and thereby establish the proper comparison universe. A single fund specializing in the telecom equipment industry might simultaneously be compared to all equity funds; all domestic equity funds; all actively managed domestic equity funds; all actively managed domestic equity growth funds; all actively managed domestic equity growth small-cap funds; and all actively managed domestic equity growth small-cap telecom funds. Depending on the universe of comparison, the results of the comparisons may be quite different – yet none of these comparison universes is more obviously "correct" than another.

As the Proposing Release concedes, the results of the comparison also would differ if all funds were equally weighted, if they were weighted by sales, or if they were weighted by assets. Again, none of these choices are more obviously "correct" than the others. Respected national independent research organizations such as Morningstar, Lipper and Standard & Poor's offer competing comparison universes for mutual funds, which in some cases are significantly different from one another. The decision about when to create a new category (for example to differentiate Internet funds from general technology funds) can be a difficult one: when are there enough funds in a given area to justify separate comparison? In short, these are precisely the kinds of decisions that benefit from the competition and innovation of the private sector.

Moreover, making difficult categorization judgments and calculating large amounts of data are resource intensive tasks and will necessarily detract from other more critical portions of the SEC's investor-protection mission, such as examinations and enforcement. Given the competing demands on the SEC's limited resources, we believe private sector competitors such as Morningstar, Lipper and S&P (which update their comparisons, at a minimum, on a quarterly basis) would be able to update this information more frequently than could the Commission. Mandating use of SEC computations could create the risk that investors would receive stale and unreliable data. For these reasons as well, SIA urges the Commission to abandon the comparison range approach.[70]

IX. The Proposed Rules May Lead to Unnecessary Regulatory Duplication

The Proposal indicates that the Commission is also considering still another type of brokerage firm disclosure, imposed by the NASD's proposed amendments to Rule 2830, in addition to point-of-sale and confirmation disclosure. The NASD's proposal would require broker-dealers to provide customers twice a year with a rank ordering of gross dollar amounts of revenue sharing (including expense reimbursement) received from every mutual fund family, as well as information about the firm's differential compensation practices.[71] The SEC release states that the NASD proposal might complement the SEC proposal, thus creating three tiers of disclosure – one at point of sale, a second with confirmations, and a third semi-annual disclosure presumably delivered with customer account statements. If both proposals are adopted, the regulatory burden would be excessive and duplicative. The Proposing Release does not provide an estimate what this third level of disclosure would cost. As discussed above, the information contemplated by these two different regulatory initiatives can and should be combined in one place, on brokerage firm websites, to enable investors to make easy and efficient comparisons. Or, in the alternative, the SEC should consider implementing the NASD's proposal (reflecting SIA's comments) instead of requiring point-of-sale disclosure for each mutual fund transaction.

X. The SEC Should Defer to the Breakpoint Disclosure Recommendations of the NASD Breakpoint Task Force

The Proposal suggests that brokerage firms disclose, at point of sale, the exact dollar amount of a front-end sales load, and, in the confirmation, the exact dollar amount, percentage amount, percentage range disclosure, and a separate comparison of any breakpoint discount to that disclosed in the prospectus. This elaborate disclosure is quite different from that recommended by the NASD's Breakpoint Task Force.

The Breakpoint Task Force was created in the wake of revelations in late 2002 about industry-wide problems in correctly calculating and applying mutual fund breakpoints. The Task Force included representatives from SIA, ICI, the brokerage industry and the mutual fund industry, who worked with the NASD staff, SEC staff and other regulators to form their

[70] As discussed above, while SIA supports web-based disclosure of the fact of portfolio brokerage, we do not believe that comparison range disclosure of portfolio brokerage provides probative or useful information for investors. And as discussed below, we believe the comparison range disclosures raise particular concerns in the context of variable annuity and life products.

[71] *See* NASD Notice to Members 03-54 (September 17, 2003). SIA submitted a comment letter to the NASD endorsing the NASD's call for disclosure of revenue sharing and differential compensation, while calling for substantial changes in the details of the NASD proposal and urging better coordination with other mutual fund disclosure initiatives, such as enhanced breakpoint disclosure, and this Proposal. SIA's comment letter is available at http://www.sia.com/2003_comment_letters/pdf/NASD10-17-03.pdf.

recommendations. The recommendation of the Breakpoint Task Force was to include only the percentage amount of a customer's actual breakpoint on mutual fund trade confirmations. Work is now underway to implement this proposal, which should be in place sometime this summer. SIA believes the Commission should implement the carefully considered recommendation of the Task Force rather than the much more elaborate and complex rules in the Proposal.

The Breakpoint Task Force specifically considered and rejected the idea of precise dollar disclosure of the amount of front-end loads. The conclusion of the Task Force was that percentage disclosure was the central relevant fact for investors. Confirmation disclosure of the sales load percentage best enables investors to compare their transaction with the sales load disclosed in the mutual fund prospectus, and to spot any potential inconsistency between what they actually paid and what they expected to pay. Mutual fund prospectus disclosure of sales loads is always expressed in percentage terms. Surrounding this critical fact (percentage disclosure) with a variety of extraneous facts (exact dollar disclosure, percentage range disclosure and so on) will only distract investors from the information they need to identify discrepancies or mistakes. SIA endorses the carefully considered and sensible conclusions of the Task Force and urges the SEC to adopt them.

XI. SEC Should Not Mandate Inclusion of "Definitions" in Proposed Disclosures

The Proposal would mandate that lengthy, unbalanced definitions accompany both point-of-sale disclosures and mutual fund confirmations. The Commission should eliminate this aspect of the Proposal. As the Commission learned from its Plain English initiative, investors will ignore lengthy, repetitive disclosures made in tiny typefaces.[72] In our view, the definitions will serve no investor protection function because they will never be read. We concur with the observation of Plain English expert Prof. William D. Lutz that "the SEC's proposed disclosure forms .... are not designed to communicate the information investors want and need to make informed decisions." As Prof. Lutz testified, the definitions should be "simply eliminated" from the Proposed Rules because "it's been our experience that no one will read these definitions, let alone understand any of them."[73] We urge the Commission to undertake a more general effort to ensure that its various mutual fund disclosure initiatives are integrated and consistent.

XII. The Proposed Specimen Confirmation Is Not Sufficiently Flexible

While the Commission clearly made substantial efforts to design new mutual fund confirmations, the result falls short in numerous respects. The Commission's specimen disclosures (contained in the appendices to the Proposing Release) leave no space for other important information a brokerage firm may want to include – for example, how to contact the brokerage firm if the client believes the confirmation contains errors. Nor does the specimen

[72] The Proposing Release could only fit all of the definitions on a single sheet of paper by reducing them to an 8-point type-face virtually illegible to anyone over age 40.

[73] Statement of Prof. William D. Lutz to the Senate Committee on Banking, Housing and Urban Affairs, March 23, 2004 (available at http://banking.senate.gov/_files/lutz.pdf).

confirmation leave space for the additional disclosures brokerage firms may need to make in order for the confirmations not to be misleading, even though the Proposing Release repeatedly indicates that firms face potential Rule 10b-5 liability even if they make all of the required disclosures accurately.[74]

For most firms, trade confirmations need to include the customer's address, placed so that the address can be seen through a glassine window in the envelope. The risk (and cost) of trying to match up an individualized confirmation with a separately-printed envelope label is too great; if a confirmation goes in the wrong envelope, private customer information could be compromised. The Commission's specimen confirmation is too rigid to permit this configuration without requiring two sheets of paper, which would further increase the cost of the Proposal. SIA urges the Commission to delete the proposed definitions (which will free up space for other disclosures the brokerage firm may wish to include, such as how to reach the firm to correct errors), and to decrease the overall amount of information required to be included on the confirmation. SIA's alternative, moving much of the information to a website or toll-free telephone disclosure, would accomplish this goal.

XIII. The Proposal Suggests Clearing Firm Duties Inconsistent with Existing Law and SRO Rules

The Proposal indicates that while an introducing firm and clearing firm may allocate duties under the rules, the clearing firm would be required to have a reasonable basis for believing that the introducing firm was complying with all its legal requirements under the rules. The release suggests that to obtain this reasonable basis, the clearing firm would have to conduct audits to ensure that the introducing firm was complying with its disclosure requirements. SIA believes this is a significant and unwarranted change in well-settled law about the relationship between clearing and introducing firms. We do not quarrel with precedents that the SEC has established which hold that when a clearing firm is put on notice of "red flags" indicating that an introducing firm is violating the law, the clearing firm must respond reasonably to those "red flags" or risk being held liable on an aiding and abetting theory.[75] However, nothing in those precedents supports an affirmative obligation to audit introducing firms for ongoing compliance with legal requirements. Clearing firms and introducing firms should continue to be permitted to define the scope of their respective responsibilities by contract in their clearing agreements.[76]

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[74] *See* Proposing Release at nn.54-55 and accompanying text.

[75] *See, e.g., Del Mar Financial Services, Inc.*, Exch. Act Rel. No. 48,691(Oct. 24, 2003) (dismissing charges that clearing broker participated in or aided and abetted violations by introducing firm).

[76] While introducing firms could delegate production of confirmations to their clearing firm, the rules would still impose significant compliance obligations on introducing firms. Introducing firms would be required to produce the point-of-sale disclosure document to clients before accepting any mutual fund order. And introducing firms would be responsible for maintaining and updating information about their relationship with all mutual fund complexes with which they do business – introducing firms would have to provide that to the clearing firms for the clearing firms to be able to put that information on the confirms. One of the reasons the proposals are so expensive is the fact that they

The risk of imposing additional, non-waivable compliance obligations on clearing firms is that such obligations will increase the cost of clearing services. If third-party clearing costs rise, it will create an incentive for small and start-up brokerage firms to become self-clearing, and will create incentives for firms to exit the third-party clearing business. The SEC and the investing public have benefited from encouraging small and start-up firms to custody their customers' assets at clearing firms – when an introducing firm has financial or regulatory problems (as will inevitably occur at some small percentage of firms), investors are much better protected if the client assets are held by a well-capitalized clearing firm than if the firm has become self-clearing. The current balance of obligations between clearing and introducing firms has served to allow new entrants (and thus has promoted competition) in the securities industry, while also serving the cause of investor protection. The Commission should not interfere with this important balance.

XIV. Banks And Brokerage Firms Should Be Covered Equally By the Proposals.

For reasons not explained in the Proposing Release, the rules would apply to mutual funds purchased through brokerage firms, but not through banks or other insured depository institutions. Today, banks and other depository institutions are required to comply with rule 10b-10 whenever their customers purchase securities. Failing to apply the Proposal to banks would put brokerage firms at a significant and unjustified competitive disadvantage because of the immense costs that the rules would impose on broker-dealers and their customers, but not on banks.

Even after the SEC adopts the Gramm-Leach-Bliley broker "push out" rules, banks will continue to sell mutual funds to customers in IRA and trust accounts. To the extent that revenue sharing and differential compensation create conflicts of interest that are material to investors, those conflicts are exactly the same for sales by banks and bank employees as for sales by brokerage firms and brokerage registered representatives. Similarly, accurate and reliable information about breakpoints and other sales charges is just as important for an investor who buys a mutual fund in a bank IRA as for an investor who buys the same mutual fund in a brokerage firm IRA. There is no justification for imposing a competitive burden on brokerage firms that will not also be borne by banks selling exactly the same investment products. We urge the Commission to work with the bank regulatory agencies to ensure that the Proposal applies consistently to all financial services firms, not just brokerage firms.[77]

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impose significant burdens on introducing firms and do not contain any exceptions to this disclosure regime for small firms.

[77] The Proposal does not appear to address payments by mutual funds and their affiliates to registered independent investment advisers, which may raise comparable disclosure concerns. Some registered investment advisers have affiliated brokerage firms which receive portfolio brokerage commissions from mutual funds, although the adviser may custody the mutual fund holdings of individual clients at a separate, unaffiliated brokerage firm. The Commission should address how the Proposal would operate in this situation.

XV. Variable Annuities and Variable Life Raise Special Issues Not Adequately Addressed in the Proposing Release.

As issued, the Proposal applies equally to variable annuities and variable life policies as to mutual funds. However, these products are different from mutual funds. For example, SIA believes it would not be feasible to construct comparison ranges for variable annuities and variable life policies. Variable annuities and variable life products have different benefits and different terms. Even where clients are investing in exactly the same asset class, policies with different benefits will have different fees that reflect the cost of those different benefits. A comparison based solely on the underlying asset class could encourage an investor to opt for a policy with an insufficient death benefit, because the policy is less expensive than one with a more appropriate death benefit.

Further, with respect to a variable life insurance policy, the calculation of a sales fees (or other expenses) as a percentage of the investment value of a policy that (especially in its early years) has a substantial death benefit component has the potential to be highly misleading. Such a disclosure will suggest to investors that a substantial portion of their investment is being taken in fees – when in fact the majority of the fees would be more properly characterized as underwriting the death benefit provisions of the policy. Variable life insurance policies are typically sold subject to a 30-day "free look" period, during which the initial premium is invested in the equivalent of money market fund. The client's most important investment decision occurs sometime near the end of that period, and often is made directly with the insurance company, not through the brokerage firm. Once again, the disclosures mandated by Proposal would be time-consuming, burdensome and expensive without providing useful information to the clients. And the focus of the Proposal on portfolio brokerage transactions for "covered securities" is particularly arbitrary in the insurance context, where annuity or life issuers typically will invest separate account assets in nearly identical investment portfolios that are not linked to "covered securities" (and thus not subject to portfolio brokerage disclosure).

XVI. The Proposal Would Require a Minimum of a Two-Year Implementation Period

The Proposing Release requests comment on what implementation period would be appropriate for the proposed rules. If the Commission adopts the rules as originally proposed, we believe the programming and training for these changes would be extensive and time-consuming. After discussing the issue with its member firms, SIA estimates that these changes would take a minimum of 24 months to implement. Given the other extensive, regulation-mandated systems changes going on at the same time, the actual time required for implementation may be significantly longer.

Simply implementing the recommendations of the NASD's Breakpoint Task Force for confirmation disclosure of front-end loads has proven to be a year-long systems project. The Proposal would require additional, even more far-reaching, systems changes. Under the Proposal, brokerage firms would have to create entirely new systems to implement the point-of-sale disclosures, in each of their different channels (in branches, telephone call centers, automated telephone systems, and every electronic order-entry system). As discussed above, these point-of-sale systems would have to be integrated with the firm's trading systems, because the firm cannot accept mutual fund orders unless it has made the disclosures. This set of systems changes would create interdependencies that could endanger the stability of the existing trading systems, especially on high-volume trading days. Brokerage firms would also have to create supervisory and compliance systems to monitor the point-of-sale disclosure process.

In addition, brokerage firms would have to create entirely new tables of information to reflect their relationship with each mutual fund company. They would have to create new systems to track portfolio brokerage commissions and revenue sharing. They would also need to determine how to feed all this information into both the point-of-sale and confirmation systems. As discussed above, introducing firms would have to create these systems themselves, since they would not be able to rely on their clearing firms to make the disclosures. Introducing firms, which tend to be smaller and less technologically sophisticated, would need substantial amounts of time to create these systems. Further, brokerage firms would have to bifurcate what is now a single stream of confirmations, and create an entirely new stream of information for mutual fund confirmations and a different stream for all other securities transactions. Because of the speed with which confirmations must be produced, changes to confirmations are among the most challenging systems changes any brokerage firm must make (other than those to the trading systems, which will also be affected). For each system affected, there would also be a back-up or fallback system that would also have to be changed. Changes to these systems would require extensive testing before they will be able to go live – especially given the other potential simultaneous changes to mutual fund systems involving the same technical staff resources, such as those implementing a 4:00 PM hard close and the tracking of mandatory redemption fees.

If the Commission adopted SIA's alternative of web-based and toll-free telephone disclosure, not only would investors receive better and more comparable information – but they would also be able to get that information more quickly. While the SIA alternative is not without its own technological challenges, we estimate that it could be implemented within one year. The possibility of more rapid implementation is yet another reason why web-based disclosures are preferable to the paper-based approach set forth in the Proposal.

Conclusion

As stated at the outset of this letter, SIA shares the Commission's overall goal of improving investors' ability to make informed decisions when choosing to invest in mutual funds. We urge the Commission to consider our alternative: web-based and toll-free telephone disclosure about brokerage firms' relationships with mutual fund companies, accompanied by reminders on confirmations about where consumers can find this information. We believe this alternative is the most comparable, most effective, most efficient and fastest means to achieve the Commission's important goal. At a minimum, we urge the SEC to consult with investors about the information they would like to receive and the costs they are willing to bear, and with experts on the presentation of information to design disclosures that are more useful than the Proposed Rules.

SIA appreciates the Commission's desire to move quickly to respond to the serious issues that have been uncovered in the mutual fund industry. Indeed, SIA has strongly supported many of the SEC's recent initiatives to address the abuses that have been revealed.[78] Regrettably, this Proposal does not mesh well with the SEC's other recent proposals – as currently written, the Proposal is especially inconsistent with the Commission's own recent rules on mutual fund expense disclosure, as well as with its other initiatives to focus investors on the fund prospectus as the location to find the most important disclosures.

SIA is very concerned that as originally proposed, the Proposal would have unintended consequences, both on the industry and on investors. Among investors, the hardest hit are likely to be those for whom mutual funds are the most appropriate investment vehicle – small and beginning investors. These investors will find increased costs eroding their returns. Some of these investors will be deterred from opening brokerage accounts at all; others will end up choosing unsuitable investment vehicles other than mutual funds. The net result will be to harm these investors' ability to save for homes, their children's education, or for retirement. It is hard to imagine how the President's proposal for $5,000 lifetime savings accounts could be cost-effective using mutual funds, if the Proposed Rules were adopted – the cost of compliance (at least $55 per year per household under the Commission's own estimates, and $125 per household under SIA's estimate) would eat away too much of an investor's annual savings. We believe our more investor-friendly disclosure alternative would successfully address these unintended consequences.

If you have any questions or would like to discuss any of these issues further, please contact the undersigned at 202-216-2000, Michael Udoff, SIA's Vice President and Associate General Counsel at 212-618-0509, or our outside counsel on this matter, W. Hardy Callcott of Bingham McCutchen LLP, at 415-393-2310.

Respectfully submitted,

George R. Kramer
Vice President and Acting General Counsel

cc: Chairman William H. Donaldson
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Commissioner Paul S. Atkins
Commissioner Roel C. Campos

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[78] *See, e.g.*, SIA Comments To The SEC On Proposed Investment Adviser Codes Of Ethics (available at http://www.sia.com/2004_comment_letters/pdf/SEC03-15-04.pdf); SIA Comments To The SEC Regarding Disclosure Of Breakpoint Discounts By Mutual Funds (available at http://www.sia.com/2004_comment_letters/pdf/SEC02-13-04.pdf); Joint Letter To The SEC Regarding Amendments To Rules Governing Pricing Of Mutual Funds (available at http://www.sia.com/2004_comment_letters/pdf/SEC02-06-04b.pdf); Proposed Mutual Funds Disclosures Regarding Market Timing and Selective Disclosure of Portfolio Holdings (available at http://www.sia.com/2004_comment_letters/pdf/MarketTiming.pdf)

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Senior Counsel Tara L. Royal, Division of Investment Management

Director Susan Ferris-Wyderko, Office of Investor Education and Assistance

(all by regular mail)

APPENDIX

SEC Estimate of Costs

	Rule 15c2-2	**Rule 15c2-3**	**Rule 10b-10**	**Form N1-A**
Implementation Cost	$850 million	$450 million	no estimate	no estimate
Annual External Cost	$1.05 billion	$40 million	$2.26 billion	no estimate
Annual Internal Cost	$935 million	$935 million	$2.12 billion	$98,400
Annual Total Cost	$1.985 billion	$975 million	$4.38 billion	$98,400
Year One Total Cost (Implementation plus Annual)	$2.835 billion	$1.425 billion	$4.38 billion	$98,400

Total (All Rules)
Implementation: $1.3 billion
Annual: $7.34 billion
Total Year One Cost: $8.64 billion

SIA Estimate of Costs

	Rule 15c2-2	**Rule 15c2-3**	**Rule 10b-10**	**Form N1-A**
Implementation Cost	$2.7 billion	$2.7 billion	$540 million	$10 million
Annual Cost	$4.05 billion	$3 billion	$4.38 billion	$10 million
Year One Total Cost (Implementation plus Annual)	$6.75 billion	$5.7 billion	$4.92 billion	$20 million

Total (All Rules)
Implementation: $5.95 billion
Annual: $11.44 billion
Total Year One Cost: $17.39 billion