Via E-mail

Merrill Lynch

April 12, 2004

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

Re: File No. S7-06-04: Comments Regarding Proposed 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

Dear Mr. Katz:

Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") appreciates the opportunity to comment on the new rules and rule amendments that the Securities and Exchange Commission (the "SEC" or "Commission") has proposed with respect to rule 15c2-2, rule 15c2-3, and rule 10b-10 under the Securities Exchange Act of 1934 ("Exchange Act") and amendments to Form N-1A under the Securities Act of 1933 ("Securities Act") and the Investment Company Act of 1940 ("Investment Company Act").[1] The Commission proposes, among other things, substantial changes to the transaction confirmation requirements and the creation of new "point of sale" disclosure requirements in connection with the sale of certain mutual fund shares (the "Proposal").

As discussed in more detail below, while we share the Commission's desire to provide greater transparency in connection with the purchase and sale of mutual fund shares, we believe that specific modifications to the Proposal will more effectively achieve the intended result of providing mutual fund investors with meaningful and actionable information. We believe that the modifications we recommend will be a more effective and a less costly way, in terms of both investors' time and costs, to achieve the desired objectives, which we submit herein.

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1 *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*, Release Nos. 33-8358, 34-49148, IC-26341 (January 29, 2004) ("Proposing Release").

I. SUMMARY OF COMMENTS

A summary of our comments regarding the Proposal is as follows:

- We believe that standardized conflicts of interest and/or relevant distribution-related expense disclosures, prior to the point of sale, would be more informative for prospective investors than select personalized expense disclosure as called for in the Commission's point of sale proposal. Such advance, standardized disclosures would allow investors to track and compare distributors on an apples-to-apples basis.

- We believe that the standardized disclosures we propose, unlike the Commission's point of sale proposal: (1) would be more meaningful to an investor; (2) could be implemented within a relatively brief period of time; and (3) would be significantly more cost effective, with respect to investors' time and costs.

- We believe that the most effective moment and manner to present to investors such standardized distributor-related expense disclosure and information about potential conflicts of interest is in a pamphlet written in plain English, delivered to an investor prior to the point of sale. Such delivery would be made upon account opening or shortly thereafter, and it could be available on the firm's public website. It could also be delivered to customers on an annual basis. We believe that such a pamphlet would provide investors the time to digest this information; and not have to read and absorb the complex information proposed by the Commission, in addition to their investment criteria at the point of sale. It would also provide investors the option of determining – prior to the point of sale – their comfort with the details of the disclosure regarding the financial intermediary and/or direct distributor.

- Furthermore, the Proposal's exclusive focus on the disclosure of transaction costs would be disruptive of the important financial advisor[2]-customer relationship that must exist at the point of sale. The proposed point of sale disclosure would tend to distract investors from more important investment considerations, such as asset allocation, portfolio diversification, investment objectives and investment risks, investment time horizon, overall costs, and historical performance.

- The point of sale proposal's termination right would be further harmful to the financial advisor-customer relationship. To mitigate a brokerage firm's exposure to cancelled trades, the firm would likely need to produce a plethora of disclosure documents. This could lead some intermediaries and direct fund distributors and their customers to seek alternative suitable investment options rather than mutual funds, even though mutual funds may otherwise be a more appropriate option.

- We believe that the Commission's confirmation proposal is too complicated and the required data's relationship to any specific transaction far too remote to be of use to

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[2] We have used the term "financial advisor" throughout this letter to mean all individuals directly involved with public customers in the sale of mutual funds shares and other "covered securities", including registered representatives and those in similar positions even if currently exempt from registration.

investors. As with the point of sale proposal, we believe that investors would be better served if standardized distributor-related disclosures and conflicts of interest information were made available to investors in a written pamphlet on or about the time of account opening and/or annually thereafter, as well as made available on the firm's website. This information would be expansive and complimentary to the fund determined expenses as outlined in a fund's prospectus.

- Also, the Proposal's quantified conflicts of interest information and the allocation of a percentage of such amounts as a cost of a specific transaction is potentially confusing. Much of such amounts has no relationship to the specific mutual fund transaction and is not "in connection with" the transaction. The Proposal's method of calculating these amounts and the required comparisons are based on generalized assumptions. Further, the proposed reporting of such data could be misconstrued by investors as incremental costs to the investor.

- In addition, the proposed confirmation information could be in conflict with the prospectus' presentation of the same information, generating additional confusion and undermining investor confidence.

- Many of the proposed metrics for certain portfolio transactions relating to mutual funds – such as fixed income transactions - will be extremely difficult to obtain and calculate.

- The costs to implement and maintain the Proposal would far exceed the Commission's estimates and any benefits that might be realized by investors. Because such costs would ultimately be borne by investors, the Proposal could lead investors to seek alternative investment products. Both investors' time and dollars should be considered.

- We believe that a number of types of mutual fund transactions and a number of types of investors, such as institutional investors, do not involve the concerns that the Proposal sought to address and should be exempted from the Proposal. In addition, certain types of investment products, such as Section 529 College Savings plans and variable insurance products, are so different in structure from mutual funds that they should be excluded from the Proposal and, if warranted, addressed in a separate proposal tailored to their particular structures.

- We believe that the point of sale proposal's requirement that clearing firms have a "reasonable belief" that the introducing firms have delivered the mandated point of sale disclosures to customers would impose an unreasonable and unprecedented burden on clearing firms, requiring substantial programming modifications and creating additional costs.

- We believe that, if this Proposal is adopted, it is imperative that the Commission apply the Proposal equally to all financial service organizations that transact mutual fund business with public customers, regardless of their legal structure.

II. BACKGROUND

A. Merrill Lynch

Merrill Lynch is registered as a broker-dealer under Section 15 of the Securities Exchange Act of 1934, as amended (the "1934 Act"), and as an investment adviser under Section 203 of the Investment Advisers Act of 1940, as amended (the "Advisers Act"). In addition to offering Merrill Lynch proprietary funds, Merrill Lynch supports approximately 140 fund companies and currently offers approximately 11,700 individual mutual fund share classes on behalf of its customers. Merrill Lynch has approximately 11.1 million customer positions in retail brokerage accounts that are invested in mutual funds and serves approximately 5.4 million additional retirement plan participants who have mutual fund investments. In 2002, Merrill Lynch executed over 130 million fund transactions (excluding money market transactions) for these customers. Currently, Merrill Lynch supports the transactions of over $300 billion in mutual fund assets. Merrill Lynch is also a major distributor of variable insurance products. In 2003, Merrill Lynch's sales of such products were approximately $5.1 billion, with assets aggregating to approximately $35 billion.

Merrill Lynch is a wholly owned subsidiary of Merrill Lynch & Co., Inc. ("ML&Co."), one of the world's largest financial services firms. Its affiliates include Financial Data Services, Inc. ("FDS"), a registered transfer agent that serves as the transfer agent for Merrill Lynch's proprietary mutual funds, and Merrill Lynch Investment Managers ("MLIM"), the investment management unit of ML&Co.

B. Proposed Rule 15c2-3

Proposed rule 15c2-3 (the "point of sale proposal") would require broker-dealers to provide point of sale disclosures to investors prior to effecting transactions in mutual fund shares. The disclosure would provide investors with targeted material information about distribution-related costs and remuneration that could lead to conflicts of interest for their broker-dealers. In particular, broker-dealers would be required to provide: (a) the amount of any sales load that the customer would incur at the time of purchase; (b) 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 the fund over the next year if net asset value does not change; (c) an estimate of the maximum amount of any deferred sales load if the fund shares are sold within one year; and (d) the amount of any dealer concession that the broker-dealer would earn at the time of sale in connection with the transaction. With respect to potential conflicts of interest, the broker-dealer also would be required to disclose: (a) whether the broker-dealer, or any affiliate, receives "revenue sharing" from the fund complex; (b) whether the broker-dealer receives portfolio brokerage commissions from the fund complex; and (c) whether the broker-dealer engages in differential compensation practices in connection with the purchase and sale of fund shares.

C. Proposed Rule 15c2-2

Proposed rule 15c2-2 (the "confirmation proposal") would require broker-dealers to disclose detailed information about the costs and conflicts of interest connected with transactions in mutual fund shares.[3] Broker-dealers would provide this information to customers in the form of written confirmations. In particular, they would be required to disclose: (a) information about loads and other distribution-related costs that directly impact the returns earned by investors in those securities; (b) information about compensation of broker-dealers for selling those securities and information about "revenue sharing" arrangements and portfolio brokerage arrangements that create potential conflicts of interest; and (c) information about whether their associated persons receive incremental compensation for selling proprietary fund shares or certain fund share classes.

III. DISCUSSION

A. Point of Sale Proposal

We share the Commission's goal of promoting more informed decision-making by investors in mutual fund shares. We support the Commission's stated goal of providing more information that would enable investors to better understand the costs and potential conflicts of interest associated with investments in mutual fund shares prior to entering into transactions. Our experience suggests that mutual fund shareholders who invest through an intermediary such as Merrill Lynch, or are self-directed and go directly to the fund's distributor, seek to understand a whole range of concerns, including fees and expenses. They wish to be able to define and weigh a number of issues when making an investment decision. However, the Proposal mandates a level of detail and complexity at the point of sale that may frustrate the investment decision making process for the investor, the fund, and the intermediary. Therefore, we believe that the delivery of a plain English disclosure document ***prior*** to the point of sale – *i.e.*, upon account opening or shortly thereafter – would be a more effective disclosure alternative to the Commission's point of sale proposal regarding distributor conflicts of interest and fees, which would act as a compliment to the fund's prospectus disclosure of total fees and expenses. Further, we believe that such disclosure information should be available on the firm's public website and might be distributed annually to a firm's customers.

1. Alternative to Point of Sale Proposal

We believe that standardized disclosure of share class costs, asset-based service fees, sales fees, and breakpoint information that is currently set forth in a fund's prospectus is more helpful for prospective investors if communicated via the fund's prospectus. As the Commission has concluded with respect to mutual fund expense disclosure, standardized expense disclosure is more informative for prospective investors than personalized expense disclosure and would allow investors to track and compare funds on an apples-to-apples basis.[4] According to the Commission, "personalized expense disclosure … would not assist investors in making comparisons among funds because it would be based on different investment amounts and

[3] In order to avoid redundancy with proposed rule 15c2-2, the Proposal would modify rule 10b-10 to exclude certain transactions in mutual funds from the rule's scope.

[4] *Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies*, Release Nos. 33-8393, 34-49333, IC-26372 (February 27, 2004) ("Shareholder Reports Release").

different rates of return."[5] And as the Commission also noted, standardized expense disclosure "avoids certain costs and logistical complexity that individualized disclosure . . . might entail."[6]

We also believe it would be appropriate for all financial intermediaries and direct distributor firms to disclose prior to the point of sale whether they have established commercial arrangements to provide various services to mutual fund complexes that they offer the public. Additionally, it would be appropriate for firms to summarize their compensation practices for financial advisors, including any differential compensation.

We believe that the foregoing information is most effectively presented upon account opening or shortly thereafter, and possibly annually to investors along with their account statement, rather than at the point of sale. As was noted in a recent U.S. General Accounting Office ("GAO") Report that described the results of its survey of mutual fund investor preferences, shareholders believe that the account statement is probably the most important communication that they receive from a mutual fund.[7]

Moreover, a disclosure document delivered at the point of sale would necessarily be terse given the brief time available to an investor to read and absorb it. For example, the point of sale hypothetical disclosure document provided in the Proposal contains two pages in fine print of distribution expense data, explanations, and definitions, which would be largely unabsorbable to the average investor immediately prior to placing an order. We believe that comparable, standardized information should be available to investors prior to the point of sale in a way that is designed to allow investors adequate time to absorb and compare the information. The importance of information design was recently highlighted by the testimony of Professor William Lutz before the Senate Banking Committee.[8] Professor Lutz, an expert on information design, testified that investors are now inundated with too much information without consideration of designing the information in a way to maximize the investor's understanding. We believe that the Proposal endeavors to deliver complex information to an investor immediately prior to the investor's placing an order, which could cloud and obscure the investor's understanding of the transaction at hand.

As an alternative, we propose that the Commission require that all intermediaries and direct fund distributors deliver a disclosure document to their retail clients at account opening or shortly thereafter ("Client Pamphlet"). The Client Pamphlet should be available on the entity's public website and it might also be delivered annually to customers. The Client Pamphlet would contain information, described in plain English, regarding how the intermediary and direct fund distributor conducts its mutual fund distribution business, including its policies on fees and expenses. Potential conflicts of interest topics would be included so that a prospective investor

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5 *Id.*

6 *Id.*

7 *Greater Transparency Needed in Disclosures to Investors*, U.S. General Accounting Office, GAO-03-763 (June 2003).

8 Testimony of William Lutz, Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Fund Operations and Governance before U.S. Senate Committee on Banking, Housing and Urban Affairs (Mar. 23, 2004).

can assess their significance. The Client Pamphlet would be delivered to customers in connection with account opening and made available on the intermediaries or direct distributor's website. The Commission should require that all intermediaries and direct fund distributors provide periodic reminders to investors regarding the availability of the Client Pamphlet in quarterly account statements and/or in each mutual fund transaction confirmation. Further, the annual distribution of the Client Pamphlet, together with its availability on the firm's public website, would reinforce the disclosure and be beneficial for investor education.

Specifically, the Client Pamphlet would contain an overview of the benefits and trade-offs of various sales load charges, asset-based service fees, and sales fees and breakpoint information. The Client Pamphlet would remind investors that the intermediaries and direct fund distributors firm's financial advisors are available to assist in determining whether the investor is eligible for any breakpoint discounts, including any rights of accumulation, and would direct the investor to the fund's prospectus and statement of additional information, to obtain fund-specific information on breakpoint discounts. The Client Pamphlet would also outline the financial intermediary's or direct distributor's policies relating to the mutual funds offered and include the following information:

- Differential compensation arrangements or policies for financial advisors and their management with regard to the sale of mutual fund shares, specifically addressing share classes, and proprietary vs. non-proprietary differentials, if any;
- Marketing service and support arrangements, in which an intermediary provides marketing support to, and receives payments from, an affiliate of a fund;
- The commercial arrangements of any differential marketing and/or sales support payments;
- Criteria on which funds are placed on a preferred or "recommended funds" list, if any;
- Sub-accounting and/or networking services provided to funds for a fee; and
- Overview of portfolio transactions and other business relationships with the offered fund groups.

This type of disclosure would facilitate investors' comparison of the intermediary's and direct fund distributor's relationship with different mutual funds, as well as provide the investor with information to be better able to compare various financial intermediaries and direct fund distributors.

We note that the Commission has taken the position in a very similar context that disclosure regarding revenue streams to broker-dealers that may raise conflicts of interest with its customers should be made at the time of account opening. In particular, the SEC adopted Rule 11Ac1-3 under the Exchange Act addressing conflicts of interest that arise in connection with a broker-dealer's receipt of payments for order flow.[9] In a striking similarity to the current environment regarding mutual fund fee disclosure, the Commission noted that:

> The practice of paying for order flow has generated much debate and controversy regarding the potential benefits and harm to public investors and whether receipt and retention of payment for order flow compromises a broker-dealer's duties to its customer. Congress has shown continuing interest in the resolution of that controversy.

The approach adopted by the Commission in addressing these concerns included: (1) disclosure at the time of account opening of a broker-dealer's policies regarding the receipt of payment for order flow, including whether payment for order flow is received and a detailed description of the nature of the compensation received;[10] (2) annual disclosure of these policies after account opening;[11] and (3) confirmation disclosure that payment for order flow is received by the broker or dealer and that the source and nature of the payment for order flow received in connection with the particular transaction will be furnished upon written request of the customer.[12]

The approach we recommend is consistent with the approach that the Commission took in that very similar context. The Client Pamphlet would include substantial information – far in excess of that required in the payment for order flow context – regarding compensation and other arrangements that raise the concerns expressed by the Commission in making the Proposal. As with Rule 11Ac1- 3, the Client Pamphlet would be provided at account opening or shortly thereafter and would be available on the firm's public website. The Client Pamphlet also could be distributed annually to customers.

The approach we recommend also is consistent with that under consideration by the National Association of Securities Dealers ("NASD"). In September 2003, the NASD proposed amendments to Rule 2830 ("NASD Proposal"), which would require disclosure of "revenue sharing" and differential cash compensation arrangements relating to the sale of investment company securities.[13] The NASD Proposal would require that a member disclose these compensation arrangements in writing when a customer first opens an account or purchases fund shares and on a periodic basis thereafter.

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9 *Payment for Order Flow*, Release No. 34-34902 (October 27, 1994).

10 *See* Rule 11Ac1-3(a).

11 *Id.*

12 *See* Rule 10b-10(a)(2)(i)(C).

13 *Compensation for the Sale of Investment Company Securities*, NASD Notice to Members 03-54 (Sept. 2003).

2. Point of Sale Proposal May Cause Unintended Results

a. Point of Sale Proposal would be Disruptive to the Financial Advisor-Customer Relationship

We believe that the key factors for investors to consider when purchasing shares in a mutual fund include the customer's portfolio diversification goals, investment objectives, and risk tolerance, as well as the fund's investment strategy and objective, its potential risk characteristics, the operating expense ratio of the fund, the fund's historical performance, and the impact of the fund relative to an investor's current asset allocation and investment time frame.

An investor's decision to purchase shares in a particular fund calls for factoring in all of the above. This is not a decision that lends itself to becoming one-dimensional: buy the lowest cost fund and all will be well. It is our view that a low cost fund that does not match an investor's investment strategy and objectives, risk profile, asset allocation, and investment time frame is an inappropriate investment that cannot be overcome by lower fees.

However, the Proposal's exclusive emphasis on point of sale costs would tend to drive just such a one-dimensional investment process. By requiring the financial intermediary or direct fund distributor at the point of sale to so dramatically focus the investor's attention almost exclusively on the intermediary's or direct fund distributor's compensation, rather than on other extremely important investment considerations, the Proposal could result in leading investors to choose less suitable fund investments than they would have chosen had their financial intermediary or direct fund distributor been free to focus their attention on other important investment considerations.

We believe that at the point of sale, investors should be able to determine the topics that are most relevant to additional detailed disclosure as determined by their individual investment requirements. This is not to suggest that fees and expenses are unimportant. Rather, we believe that investors should be able to determine which topics and the level of depth and detail are most important to the investor.

b. Proposed Termination Right would be Further Harmful to the Customer Relationship and Very Costly to Implement

According to the Proposing Release, an order placed prior to the point of sale disclosure should be treated as an "indication of interest," only after the point of sale information is disclosed and customers have received an opportunity to terminate any prior order following disclosure of the mandated information would that order be valid. Further, intermediaries and direct fund distributors would be required to disclose the customer's termination rights at the time of the point of sale disclosure. We believe that the proposal to provide investors with a termination right with respect to point of sale disclosure would be harmful to the intermediary and direct fund distributor-customer relationship, and exceedingly costly to implement.

In face-to-face interactions with their financial advisors, customers may consider a number of differing mutual fund investment options, which could result in the need for numerous point of sale disclosure documents before an order is ultimately executed. The burden of such paperwork for the investor as well as the intermediary could seriously interfere with the financial advisor's provision of high quality, suitable investment guidance.

In the case of strictly oral discussions between a customer and a financial advisor or direct fund distributor (such as by telephone), the Proposal would require that intermediaries and direct fund distributor firms be able to demonstrate that the required point of sale disclosures were provided before the customer's order was transmitted to the fund. The customer would be able to rescind the order apparently at any time after transmittal to the fund if the customer can successfully allege that he did not receive in his conversation with the financial advisor or direct fund distributor accurate versions of every item of the required point of sale disclosure.[14] Apart from the prohibitive expense of adopting compliance systems to track such oral conversations, which we detail below, intermediaries and direct fund distributor firm's exposure to a "put" at any time by customers placing such oral orders for mutual fund shares would likely cause firms to generate paper point of sale disclosure statements before effecting even oral orders. Thus, like face-to-face interactions, telephone conversations between customers and financial advisors are likely to require the generation of substantial paperwork to the detriment of an effective and high quality working relationship between customers and financial advisors. In fact, we process on the order of 20 million retail mutual fund trades annually, which could result in a massive number of disclosure documents a year, all at an incremental time and dollar cost to investors.

In addition, the right to terminate an order for any breakdown, or alleged breakdown, in point of sale disclosure would likely facilitate market timing and other manipulations by unscrupulous investors, as it will create conditional orders. Under the proposal, an investor will be able to place an order with intermediaries and direct fund distributors and later rescind that order purportedly on the basis of the point of sale disclosures. There would be no way of knowing whether the investor's decision to rescind the order was in fact due to the point of sale disclosure or whether the rescission was due to changing market conditions. Rescissions of large orders, ostensibly because of a failure to provide required disclosures but in reality due to changing market conditions, also could potentially impair the net capital of certain broker-dealers or, at the very least, require firms to continuously monitor the impact of such activity on net capital. It could also open up an avenue for some unscrupulous investors to engage in disguised market timing activities.

c. Point of Sale Proposal Would Discourage Investments in Mutual Fund Shares

The Proposal's point of sale disclosure requirements may have the unintended effect of discouraging investments in mutual fund shares on three fronts. First, the sheer size and complexity of the point of sale disclosure requirements may cause some financial advisors to shy away from recommending investments in mutual fund shares when they would have done so otherwise. We do not mean to say that financial advisors would intentionally steer customers away from suitable investments in mutual fund shares. However, the Commission must be cognizant that unique and incremental disclosure requirements at the point of sale may negatively impact a financial advisor's overall perspective on investments in mutual fund shares.

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14 The termination proposal also apparently would not provide the broker with any good faith defense to a rescission claim.

Second, the inordinate prominence of the fees and expenses disclosures may cause prospective investors themselves to either seek other investment alternatives based on unfortunate and unwarranted perceptions that investments in mutual funds are more costly than investments in other alternatives that do not require similar disclosures. Alternatively, customers may inappropriately focus on low cost funds that do not necessarily match the prospective investor's investment strategy and objectives, risk profile, portfolio diversification needs, asset allocation goals, and investment time frame. Finally, the overall message of the Proposal will be that mutual funds are more risky than other types of investments and thus should be avoided. For many, if not most, retail investors, mutual funds are appropriate investments.

d. Some Data Required in the Point of Sale Proposal would be Currently Virtually Impossible to Ascertain at the Point of Sale

The Proposal calls for stating the amount of the front-end sales load as part of the point of sale disclosure to the customer. To determine the applicable front-end sales charge of a particular transaction, a broker-dealer must run a systems process to accumulate requisite information, including rights of accumulation data, other transactions that may have been occurred that day, and related information. Given the need to accurately and precisely calculate front-end sales charges at the point of sale, coupled with the need to take into consideration a myriad of simultaneous activities, it is highly unlikely that exact amounts could be provided at point of sale. Accordingly, the Proposal permits the use of a hypothetical $10,000 investment. This hypothetical would duplicate prospectus information without providing any additional benefit to the investor at the point of sale.

B. <u>Confirmation Proposal</u>

We agree with the Commission that investors should be provided more information about distribution-related costs that have the potential to reduce their investment returns as well as some of the distribution-related arrangements that may create potential conflicts of interest for broker-dealers and their associated persons.[15] However, we do not believe that the transaction confirmation should be used as a summary prospectus. As with the point of sale proposal, we believe investors would be better served if standardized distributor-related disclosures regarding potential conflicts of interest, which would complement the prospectus disclosures relating to fees and expenses, were made available to investors in plain English Client Pamphlets rather than personalized expense disclosure in each confirmation. We do believe it would be appropriate to include in the mutual fund confirmation the percentage amount of a front-end sales load for a specific fund transaction and the precise dollar amount, as both would be calculable when, after the markets closed, the fund calculates and provides the Net Asset Value ("NAV") and the available client data can applied to the specific rules to determine that the most advantageous breakpoint is applied.

The confirmation proposal would require that an intermediary or direct fund distributor quantify the amounts it expects to receive in the following year for each so-called "revenue sharing" and portfolio brokerage arrangement, expressed as a dollar amount, as a percentage of the amount invested, and as a range compared to industry norms. As we discuss below, we

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[15] Proposing Release at 6471.

believe that the quantified conflicts of interest information is too complicated and the relationship to any specific transaction is far too remote to be of use to investors. Likewise, the allocation of a pro-rata portion of the remuneration received from "revenue sharing" and "portfolio transaction" commissions to the costs of a specific transaction is inherently misleading.

In sum, the Commission's confirmation proposal is simply too overwhelmingly complex to be of practical use to investors. To borrow a term derived from the experience of the banking industry and its regulators, (see, e.g., remarks of John D. Hawke, Jr., Comptroller of the Currency, before the Independent Community Bankers of America, Orlando, Florida, March 4, 2003)[16] the proposed quantitative pre-transaction and post-transaction disclosures will likely result in "information overload" for investors and will more likely paralyze than ease their reaching any reasoned conclusions about the specific transaction. In this regard, we find it noteworthy that the Commission's proposals would require even greater pre-transaction and post-transaction burdens on investors, broker-dealers, financial advisors, and funds than the Commission imposes under its "penny stock rules."[17]

1. Certain Payments to Broker-Dealers

The Proposing Release defines "revenue sharing" to include all payments received by intermediaries and direct fund distributors from the fund's investment adviser or other fund affiliate, whether those payments are asset-based or not. The intermediaries and direct fund distributors would be required to update this calculation quarterly, based on the previous four quarters of revenues. This requirement may be in conflict with a fund's prospectus disclosure of the services/fees and thus generate more confusion than transparency. As the Commission recognized, some fund families take the position that when a broker-dealer 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 are paid out of fund assets. Other funds pay shareholder-servicing fees out of fund assets under a Rule 12b-1 plan. Still other funds may pay some, or all, of the servicing fee out of the fund adviser's reasonable profits. Thus, under proposed rule 15c2-2, intermediaries and direct fund distributors could receive exactly the same fee from three different fund families and be required to disclose three different amounts on the confirmation. In addition, the fund's prospectus disclosure would be based on each fund's characterization of the fees. Such prospectus and financial intermediary and direct fund distributor disclosures of the same fee would effectively confuse or mislead investors into thinking that these fees are duplicative and/or the intermediary has incentives to favor one fund over another when in fact no such incentive exists.

Therefore, a prior to point of sale document that outlines the various services provided to funds offered by the relevant intermediaries and direct fund distributors and the fees associated

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16 http://www.occ.treas.gov/ftp/release/2003-17a.pdf, in which, in connection with disclosures required in the consumer banking context, the Comptroller noted that the extensive albeit well-intentioned disclosures simply engendered "confusion or cynicism" among the recipient consumers.

17 *See Penny Stock Disclosure Rules*, Release No. 34-30608 (April 20, 1992) (adopting series of rules regulating broker-dealers engaging in penny stock transactions).

with those services, along with a requirement to outline any differential distribution positioning provided, if any, would efficiently generate more transparency to potential conflicts of interest.

2. Portfolio Brokerage Commissions

The confirmation proposal would require disclosure of commissions associated with portfolio transactions, including markups or other remuneration associated with transactions effected on a riskless principal basis, on behalf of the fund, or other funds within the same complex. The sum total of the portfolio brokerage would be expressed as a percentage of total sales of the complex's mutual funds at the broker-dealer in the past year. The Proposal would require the amount to be recalculated each quarter based on the rolling prior four quarters. The intermediaries and direct fund distributors would make this disclosure regardless of whether or not the fund adviser has any explicit or implicit agreement to allocate trades to the intermediaries and direct fund distributors or its affiliates, or whether the intermediaries or direct fund distributors provides research or other services to the fund complex. To properly calculate these data, broker-dealers will require substantial guidance from the Commission as to how to treat markups, markdowns, inventory trades, position taking, and all the different trading permutations a fund may utilize regarding access to markets through a broker-dealer. In fact, to allow for the 'benchmarking' concept in the proposal, these definitions will have to be absolutely precise to provide the comparability the Commission is seeking.

Whatever the intended scope of the definition of portfolio brokerage, we believe that the required disclosure, as proposed, would be misleading. Moreover, absent direct or indirect arrangements, there is simply no nexus between this normal institutional trading activity of an intermediary and an intermediary selling fund shares to its customers that could warrant the commissions and other such trading remuneration to be deemed "in connection with" the purchase of mutual fund shares by an investor. For example, a broker-dealer that does a large amount of trading for a fund complex but sells few of those funds to its customers would still be required to disclose that it expects to receive portfolio brokerage commissions well in excess of the amount of a client's purchase. Again, the proposed disclosure would state that it is the amount the broker-dealer "may receive" in the coming year in connection with the client's purchase. In fact, as the data would be calculated based on historical numbers, the broker-dealer might expect to receive a very different amount in the coming year. Moreover, the Proposal would not condition this disclosure requirement on any connection between the institutional revenues and the customer's purchase specific transaction. For example the particular fund purchased by the customer may be a fund that does little or no brokerage business with the brokerage firm, although other funds in that fund family may do so.

The Proposal also fails to take into consideration the varying capabilities of intermediaries and fund distributors. For example, large diverse financial services organizations, such as Merrill Lynch, have capital markets capabilities that are vital to efficient transaction of mutual fund portfolio securities. We believe that it is in the best interest of the funds to have access to vast capital markets capabilities such as ours and other firms of similar capability, to compete to provide quality execution and other services. However, as a result of the proposed disclosure requirements, many funds may feel pressure to avoid using a larger financial services firm such as Merrill Lynch in order to appear more objective. For example, because of a robust capital markets presence, a firm such as Merrill Lynch would be required to disclose revenues in a substantial number of situations that other broker-dealers such as a smaller regional firm might not. This would likely cause some investors to wrongly conclude that purchasing mutual fund shares is more expensive at Merrill Lynch than at other firms.

3. Transaction-Specific Cost Disclosure

The allocation of a percentage of the total amount of "revenue sharing" or portfolio brokerage commissions pursuant to paragraph (c)(5)(iii) to a specific transaction in a particular mutual fund is inherently misleading. As discussed above, the aggregate of the various expected streams of revenues from marketing, shareholder servicing, and portfolio brokerage may be wholly or in part totally unrelated to a specific transaction in one particular mutual fund, such as for example a bond fund that itself generates little or no portfolio brokerage. To attribute such a transaction cost to a specific trade in a particular mutual fund in the confirmation of that transaction would suggest to the investor a specific transaction cost that may have little or nothing to do with the mutual fund transaction in question.

Furthermore, such a separate cost item in the confirmation could easily be misconstrued by an investor as a cost of the investor's investment, in addition to the mutual fund's disclosed expense ratio, when in fact the marketing, shareholder servicing, or brokerage costs are either already included in the mutual fund's expense ratio or are costs not borne by the mutual fund being purchased or its investors, but by the fund's advisor or its other affiliates. Such a misconstruction of the investor's total costs of a specific mutual fund transaction, as we discussed above, will cause investor confusion and prompt investors to seek alternatives to mutual fund investments, when mutual funds may, in fact, be the better investment option.

4. Differential Compensation

The Proposal would require disclosure of whether a broker-dealer pays differential compensation to associated persons related to purchases of two specific types of securities: (i) fund shares that carry a deferred sales load (other than a deferred load of no more than one percent that expires no later than one year after purchase, when no other sales load would be incurred), and (ii) shares of proprietary funds that are issued by an affiliate of the broker-dealer. Rather than forcing broker-dealers into responding to yes or no questions, we believe that investors would be better informed by an overview of the intermediary's compensation incentives for its associated persons. That 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 fund families and including incentives that may last over multiple years. Again, we believe this overview should be provided in a plain English Client Pamphlet prior to the point of sale, and not in a confirmation.

5. Comparison Range Information

The Commission proposes to provide a mechanism to give investors additional context for evaluating the significance of certain required disclosures by requiring broker-dealers to provide comparison information. Specifically, broker-dealers would have to disclose the industry median as well as an industry range for sales loads, service fees, "revenue sharing" and portfolio brokerage commissions. While we agree that it is important for investors to be able to compare costs and expenses for different mutual funds, as the Proposal appears to concede, there is no single correct method to categorize mutual funds such that a comparison would be meaningful. To simply compare distribution organizations, funds, and fund families as though there is homogeneity among them would be misleading. Any comparison would require very extensive narrative disclosures to describe and rationalize the methodologies used to determine the appropriate category. The ability of the Commission and the intermediaries to collect, calculate, test, and audit the data envisioned by the Proposal would be a significant challenge. Even if this could be demonstrated to be useful information that would actually benefit investors, like other parts of the Proposal, it could create confusion when large multifaceted firms, such as Merrill Lynch, are compared to firms that do not have the capability to provide portfolio transaction services to mutual funds.

C. <u>The Commission Significantly Underestimates the Substantial Costs of Implementing the Proposal</u>

1. The SEC Understates the Costs of the Proposal, which are Prohibitive

The Commission itself estimates that the cost for the industry to implement its Proposal would be at least $1.3 billion. According to the Commission'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 Commission's own FOCUS reports), the entire U.S. brokerage industry earned $1.2 billion in annual profits on mutual funds. The Commission's own estimate is that the Proposal would cost the industry at least $1.3 billion to implement. In other words, the initial implementation cost of these Proposed Rules (under the SEC's own estimates) is greater than the entire industry's 2002 annual profits from mutual funds, and is greater than the Commission's entire 2005 budget.

a. Merrill Lynch's Estimated Internal Costs for Point of Sale Proposal

Moreover, our estimates of the costs of initial implementation of the Proposal far exceed the estimates of the Commission. The Commission estimates that its point of sale proposal would cost the average intermediary and direct fund distributor firm less than $55,000 to implement and an additional $180,000 in annual compliance costs. This figure is far too low. Because the trade processing systems under the point of sale proposal would have to take into account the possibility of rescinded trades, the system would have to be substantially reconfigured not only to take into account the delivery of mandated point of sale disclosure, but also to attempt deal with the possibility of trade cancellation. For example, orders could be treated as "indications of interest," as suggested in the Commission's Proposal, until receipt of full and complete point of sale disclosure has been verified. Alternatively, effected orders might be held in a suspense account of the brokerage firm until proper verification of the point of sales disclosure is received. We estimate that implementation of a compliant system could cost as much as $100 million and take up to 4 years to implement for Merrill Lynch alone. The Commission would need to provide substantial guidance to all firms regarding the appropriate treatment for book and records purposes, as questions and issues will inevitably arise with the Proposal's "indication of interest" alternative.

We estimate that ongoing compliance costs at Merrill Lynch would be at least $500,000 annually. Additional annual costs associated with the point of sales disclosures would be approximately $2 million for servicing and operational personnel support, $9 million in telephone expenses, and $6 million in supplies and handling. In addition, we estimate that point of sale disclosures will add at least 2-5 minutes per phone call. Considering only those retail client calls that historically have resulted in orders, this would result in roughly an additional 95 million minutes annually for financial advisors and clients, and create a cost of between $40 million and $90 million annually.

b. Merrill Lynch's Estimated Internal Cost for Confirmation Proposal

The Commission estimates that the confirmation disclosure changes mandated by its Proposal would impose an average implementation cost of $157,000 per broker-dealer, and have an annual recurring cost of $368,000 per year. We also believe that this Commission cost estimate is far too low.

The Proposal would require that the confirmation contain extensive data that are currently not uniformly available to systems that generate confirmations. Various systems will have to be modified and information collected and collated to provide the required disclosures. Specific requirements include: commissions data, deferred sales load data, cost data (dollar and percentage of net investment; sales load; breakpoint information; etc.) asset based fee data, sales fee data, "revenue sharing" data, portfolio brokerage data, and differential compensation data.

From a processing perspective this data collection presents tremendous challenges. Compiling and monitoring many of the data elements will require organizational components and data repositories not presently in existence, in particular those related to "revenue sharing" and portfolio brokerage commissions. Moreover, the time required to collate, calculate, test, print, and audit the data required under the confirmation proposal would strain the resources of most firms.

We estimate that Merrill Lynch's costs to reprogram its confirmation system to meet the Proposal's data requirements to be $5 million, plus $2 million for a data repository, plus $3 million in billing system design and rewrite, plus $400,000 for data transmissions, and would take up to 2 years. For on-going annual confirmation costs for retail account customers, we estimate at $3 million in administration and operations costs, plus $1 million in systems expenses, plus $750,000 in data center processing costs, plus $400,000 in outside audit and SAS 70 expenses.

2. The Direct and Indirect Costs Ultimately Will Be Borne by Investors

The Commission's estimates on the Proposal's costs to investors fails to consider the totality of the costs that investors will bear. As the Commission itself acknowledged in adopting amendments to rule 10b-10:

> Since the costs of regulation designed to promote investor protection are in the final analysis paid for in large part by the investor, the Commission [must] endeavor[] to adjust regulatory requirements to eliminate those for which

compliance costs appear to be disproportionate to the practical benefits of investor protection thereby obtained.[18]

In this regard, we believe that the Proposal fails.

As discussed above, we believe that this Proposal will cause investors to seek other suitable investments even where an investment in mutual funds might provide them the better investment opportunities given their financial situation and objectives. Not only will this be detrimental to the mutual fund industry, we believe that investors will suffer from lost investment opportunities in mutual fund shares.

We also believe that the indiscriminate disclosure requirements of the Proposal will cause mutual funds, in an effort to appear more objective, to withdraw from relationships with large financial organizations that possess the vast capital markets capabilities to provide for efficient transactions of fund portfolio securities and other services. Mutual funds will trade efficient executions for appearances of objectivity. Ultimately, the increased cost in fund operations will be borne by investors.

The Commission should also consider the costs investors will bear as a result of increased market timing and other similar manipulative activity. As discussed above, we believe that the proposed termination right will provide unscrupulous investors with increased opportunities to engage in market timing. As recognized during the recent mutual fund scandals, market-timing activity in a fund bears directly on the returns of fund shareholders. These are additional costs that will be borne by investors.

Excluding the considerations just discussed, Commission estimates that the Proposal will cost more than \$55 per year for each of the 54 million U.S. 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 U.S. 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.[19]

While the costs associated with the Proposal may fall first on intermediaries and direct fund distributors, those costs will ultimately be passed on to their customers. Since the costs of these rules will be incurred primarily on a per-transaction basis, they will fall most heavily on small investors who are investing a small amount every month in a few mutual funds.

The Proposing Release admits that the benefits "while qualitatively important, are necessarily difficult to quantify." Although we have no doubt that the intent of the Commission's Proposal was for the protection of investors, we do not believe that investors are willing to bear the significant costs associated with the Proposal for benefits that the Commission

18 Release No. 34-12806 (Sept. 16, 1976).

19 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.

cannot quantify. The Commission should consider the GAO Report in this regard.[20] From a survey of over 500 investors regarding disclosure of fund fees and expenses in dollars, only 14 percent of these investors were very or somewhat likely to be willing to pay for the information.[21] We believe that the Commission must have more definitive data on the extent to which investors want and would benefit from the Commission's Proposal before requiring mutual funds, broker-dealers, and other intermediaries to undertake the costly revisions to their systems necessary to implement the requirements of the Proposal.

D. <u>Exemptions and Inclusions</u>

1. Exemptions

The point of sale proposal would exempt several types of transactions from the scope of rule 15c2-3, including, among others, transactions in a covered securities plan, reinvestment of dividends earned, and transactions in which the broker-dealer exercises investment discretion. As stated in the Proposing Release, the Commission believes that these types of transactions do not link the customer's investment decision to the customer's communication with the broker-dealer in a way that establishes a compelling need for point of sale disclosure. In addition to the exceptions already provided in the point of sale proposal, we recommend that the Commission provide five additional exceptions.

a. Subsequent Transactions of the Same Security

The point of sale proposal excepts transactions that are part of a covered securities plan since there would be no link between the customer's investment decision and the customer's communication with the financial advisor and thus no compelling need for point of sales disclosures. For the same reasons, we recommend that the Commission expand the exception to any subsequent transaction in the same covered security that is made through the same broker-dealer, provided that point of sale disclosures were given to the investor or within his or her household at the time of the initial transaction.

b. Investors that are Non-Natural Persons

In response to the Commission's request for comments regarding institutional transactions, we recommend that the Commission except from the point of sale proposal orders in covered securities from investors that are non-natural persons. Such investors would include, among others, trust accounts and institutional investors. The Proposal was clearly designed to address the retail investor's lack of understanding with regard to transactions in covered securities. We believe that trust accounts and institutional investors already are capable of understanding the concerns raised in the Proposal and should not be subject to the proposed disclosure requirements in the absence of a demonstrable compelling need.

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20 GAO Report, supra note 7.

21 *Id.*

c. Section 529 College Savings Plans

As proposed, the point of sale disclosure requirements and the confirmation requirements would be required for purchases in any municipal fund security ("Section 529 plan securities"). However, although the underlying investments of Section 529 plans include mutual funds, we believe that investment in Section 529 plan securities are unique from direct investments in mutual fund shares. For example, with regard to "portfolio brokerage commissions," it would be difficult to meaningfully translate this information as it relates to an investment in a Section 529 plan. In addition, the information required to be disclosed on proposed Schedule 15C relative to comparison ranges is not likely to be accurate enough to be useful to a Section 529 plan investor. As the Commission is aware, Section 529 plans exist in a variety of structures and it would be difficult to describe or determine what the "industry norm" should be for such a comparison. Investments in Section 529 plans also require suitability determinations that are different from investments in mutual funds. Moreover, the calculation of the distribution related costs of Section 529 plan securities and mutual funds are different and require different considerations. Accordingly, we believe that consideration of the appropriate disclosures for investments in Section 529 plans should be considered and, if warranted, addressed in a separate proposal.

2. Inclusions

As proposed, the point of sale and confirmation disclosure requirements would apply to broker-dealers and direct fund distributors, but not transfer agents and other non-broker-dealer intermediaries, including banks and other depository institutions that also engage in transactions in mutual fund shares with their customers. The inequity is highlighted even more by the fact that banks and other depository institutions are already required to comply with rule 10b-10 whenever their customers purchase securities. The conflicts of interest concerns raised in the Proposal by "revenue sharing" and differential compensation arrangements of brokerage firms also apply to banks and bank employees. There is no doubt that an inequitable application of disclosure requirements will only place broker-dealers and direct fund distributors firms at a competitive disadvantage to those other entities, including banks and other depository institutions. We see no justification for imposing such a competitive burden on broker-dealers and direct fund distributors firms. We believe that it is imperative that the Commission apply the Proposal equally to all financial service organizations that transact mutual fund business with public customers, regardless of their legal structure.

E. Variable Annuity and Variable Life (collectively "variable insurance products")

As described in our summary, we believe variable insurance products are such specialized products that they should be excluded from the Proposal and, if warranted, addressed in a separate proposal more tailored to their unique structures.

When a customer purchases a variable annuity or a variable life insurance product, the customer purchases an interest in a sub-account of a separate account of the issuing insurance company. This interest is commonly referred to as a unit. The separate account in turn purchases shares in underlying mutual funds that correspond to the units in the sub-account selected by the "contract owner". The purchase by the insurance company separate account of fund shares is done at NAV. Contract owners have wide latitude to reallocate their contract value among available sub-accounts. Such reallocations are processed using dedicated omnibus accounts and involve daily aggregation and netting formats. Accordingly, when reallocations occur, the contract owner's investment in or redemption from a sub-account typically does not result in a direct purchase or redemption transaction in underlying fund shares. Rather, the above-mentioned netting rules apply. Therefore it is important that any rules recognize this important industry practice and require confirmation only of the transaction at the sub-account level, not any transactions in underlying funds.

Variable insurance products are offered with distinct types of sales loads. Variable life products are usually offered with an up-front sales load. Variable annuity products are often offered with three available sales load structures – a contingent deferred sales load, which declines usually over a 7-year period, a contingent deferred sales load, which declines usually over a 3-year period, or a no-load design. (A small minority of variable annuities is offered with a front-end load, but they represent a small fraction of the marketplace.) However, such products typically offer a wide variety and combination of features and benefits that are independent of their sales load structure and any sales compensation arrangement. Thus, a particular variable annuity product could be sold with all 3 load structures available. On the other hand, a particular variable annuity product might be sold with only one or two of these load structures available. Any final rules, to succeed in their intended goal, should reflect the realities of this special marketplace.

The proposed confirmation rule requires disclosure of any asset-based charges or service fees paid in connection with the purchase of a covered security. The definition of asset-based sales charges is too broad and as a result could be construed to include mortality and expense risk charges that underlie the structure of variable insurance products. Because these uniquely insurance charges have little, if any, relationship to sales charges, inclusion of such charges in the calculation of asset-based charges would be misleading. Moreover, the source of sales compensation for variable insurance products is not directly tied to charges imposed under variable insurance products. Rather than focusing on such product charges, both confirmation and point of sale rules should simply focus on the compensation paid to selling firms. In addition, rather than merely requiring an indication of whether so-called "differential compensation" exists in connection with a particular purchase, permitting an explanation of the nature of the differential compensation would provide more relevant information on potential conflicts of interest to purchasers. Any final confirmation and point of sale rules should permit this type of explanation.

The insurance company rather than the selling firm control the processing of variable insurance product transactions, and, accordingly, the insurer prepares and issues the confirmations on behalf of selling firms. The proposed confirmation rule's requirement for disclosure of a myriad of information related to compensation, "revenue sharing" arrangements, and the like would require significant systems enhancements on the part of both insurers and selling firms in order to systematically provide the required information on the confirmation. Adoption of any final rule needs, at a minimum, to take these operational challenges into account and allow adequate systems development lead-time.

F. Clearing Firms

The point of sale proposal excepts a clearing firm from having to disclose information under the rule if the clearing firm did not communicate with the customer about the transaction other than to accept the customer's order, provided that the clearing firm reasonably believed that another broker-dealer has delivered the required point of sale disclosures to the customer. The exception provides that a clearing firm has a "reasonable belief" if it has entered into an agreement providing for the other broker-dealer to make the required point of sale disclosures, "supplemented with appropriate auditing practices." As the Proposing Release explains, "appropriate auditing practices" would require the clearing firm to audit introducing brokerage firms for ongoing compliance of the point of sale proposal. We believe this to be an unreasonable and unprecedented burden on clearing firms. The obvious conclusion of the exception is that if a clearing firm does not audit the other broker-dealer for compliance with the point of sale proposal, the clearing firm must itself provide point of sale disclosure to the customer from whom the clearing broker only accepted a transaction order. This is at odds with the Commission's own statement in the Proposing Release that a compelling need for point of sale disclosure exists only where there is a link between the customer's investment decision and the customer's communication with the broker-dealer. There is no such link for a clearing firm.

Moreover, the requirement to audit compliance of other broker-dealers will significantly increase the costs of clearing services. Increased clearing costs will ultimately be borne by investors.

IV. CONCLUSION

As stated above, we share the Commission's desire to provide greater transparency in connection with the purchase and sale of mutual fund shares. However, we believe there are more effective and more efficient way to achieve this than contemplated by the Commission. . We also believe that the costs of the Proposal will far outweigh the benefits. We believe that investor interests will be better served by a disclosure document, such as a plain English Client Pamphlet, provided well in advance of the point of sale - at account opening or shortly thereafter – that provides a description of how the brokerage firm conducts its mutual fund business, potential conflicts of interests, and its policies on fees and expenses. We urge the Commission to consider this and other alternatives that are more effective and less burdensome.

Thank you for the opportunity to comment on these proposed significant rule changes.

Very truly yours,

William A. Bridy First Vice President	William J. Rittling First Vice President