



Financial Industry Regulatory Authority

Joseph P. Savage
Vice President
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March 6, 2012

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: File No. SR-FINRA-2011-035 – Rebuttal

Dear Ms. Murphy:

On July 14, 2011, FINRA filed with the Securities and Exchange Commission (“SEC” or “Commission”) SR-FINRA-2011-035, a proposed rule change to adopt NASD Rules 2210 and 2211 and NASD Interpretive Materials 2210-1 and 2210-3 through 2210-8 as FINRA Rules 2210 and 2212 through 2216, and to delete paragraphs (a)(1), (i), (j) and (l) of Incorporated NYSE Rule 472, Incorporated NYSE Rule Supplementary Material 472.10(1), (3), (4) and (5) and 472.90, and Incorporated NYSE Rule Interpretations 472/01 and 472/03 through 472/11. The Commission published the proposed rule change for comment in the Federal Register on August 3, 2011.¹ The Commission received nine comment letters in response to the proposed rule change.

On October 31, 2011, FINRA filed Partial Amendment No. 1 to the proposed rule change and a letter responding to comments.² On November 7, 2011, the Commission published in the Federal Register a notice and order to solicit comments on Partial Amendment No. 1 from interested persons and to institute proceedings pursuant to Section 19(b)(2)(B) of the Securities Exchange Act of 1934 (“Exchange Act”) to determine whether to approve or disapprove the proposed rule change, as modified by Partial Amendment No. 1.³ The Commission received seven comment letters in response to this notice.

¹ See Securities Exchange Act Release No. 64984 (July 28, 2011), 76 FR 46870 (August 3, 2011) (Notice of Filing of SR-FINRA-2011-035).

² See letter from Joseph P. Savage, FINRA, to Elizabeth Murphy, Secretary, SEC, dated October 31, 2011; see also Partial Amendment No. 1 to SR-FINRA-2011-035, available on www.finra.org.

³ See Securities Exchange Act Release No. 65663 (November 1, 2011), 76 FR 68800 (November 7, 2011) (Notice of Filing of Partial Amendment No. 1 and Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change, etc.). The comment period closed on December 7, 2011.

On December 22, 2011, FINRA filed Partial Amendment No. 2 to the proposed rule change and a rebuttal letter that responded to comments.⁴ On December 29, 2011, the Commission published in the Federal Register a notice of filing of Amendment No. 2 to the proposed rule change, as modified by Amendment No. 1, and solicited comments on the proposed rule change, including whether the filing as amended by Amendments 1 and 2 is consistent with the Exchange Act.⁵ The Commission received two comment letters in response to this notice.⁶ This letter responds to those comments.

Previous Response to Comments

FINRA steadfastly believes that the proposed rule change, as amended, satisfies the statutory standard for Commission approval. The proposed rule change is primarily intended to simplify FINRA's advertising rules by reducing the number of communications categories, codifying long-standing interpretations of the rules, and clarifying certain provisions. The industry supports most of these amendments, which should simplify application of the rules by compliance professionals and other broker-dealer personnel. At the same time, the proposed rule change would continue to ensure that FINRA's rules protect investors from false and misleading communications.

FINRA has been exceedingly responsive to industry and Commission staff comments. The industry and other members of the public have had four formal opportunities – one provided by FINRA and three by the Commission – to comment on iterations of the proposal. Throughout this comment process FINRA has diligently and in good faith responded to commenters' concerns. Indeed, many of the comments concerned provisions of existing NASD Rules 2210 and 2211 that FINRA had not originally proposed to amend. All of the issues addressed in this letter concern such existing provisions.

⁴ See letter from Joseph P. Savage, FINRA, to Elizabeth Murphy, Secretary, SEC, dated December 22, 2011; see also Partial Amendment No. 2 to SR-FINRA-2011-035, available on www.finra.org.

⁵ See Securities Exchange Act Release No. 66049 (December 23, 2011), 76 FR 82014 (December 29, 2011) (Notice of Filing of Amendment No. 2 to Proposed Rule Change, etc.). The comment period closed on January 18, 2012.

⁶ See letter from Dorothy M. Donohue, Senior Associate Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, dated January 18, 2012 ("ICI"); and letter from Stephanie R. Nicolas, WilmerHale, on behalf of Citigroup Global Markets Inc., Credit Suisse Securities (USA) LLC, Goldman, Sachs & Co., JP Morgan Securities Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated, Morgan Stanley & Co. LLC, and UBS Securities LLC, dated January 19, 2012 ("Wilmer").

Among the changes that FINRA has proposed in response to industry comments are the following:

- Eliminating the existing requirement that internal training material is subject to NASD Rule 2211;
- Explicitly excluding retail communications that are posted on online interactive electronic forums from the filing requirement;
- Expanding a Supervisory Analyst's authority to approve retail communications (as described below);
- Eliminating the current filing requirement for advertisements concerning government securities;
- Providing a new exception from the filing and principal pre-use approval requirements for those retail communications that do not make a financial or investment recommendation or otherwise promote a product or service of the member;
- Permitting firms to combine multiple retirement plans offered by the same employer for purposes of determining whether there are 100 participants, thereby making it easier for such an employer to qualify as an institution for purposes of the rule;
- Permitting retail communications concerning collateralized mortgage obligations (CMOs) to be filed within 10 days of first use, rather than 10 days prior to use as required by the existing rule; and
- Authorizing FINRA to grant exemptions from both the filing and principal pre-use approval requirements for good cause shown.

These changes to the existing rules, which would go into effect upon approval of the proposed rule change, would address concerns raised by the industry in the comment process while maintaining rigorous investor protections.

Shareholder Reports

FINRA currently requires members to file the Management's Discussion of Fund Performance ("MDFP") and sales material portion of a mutual fund annual or semi-annual report if a member intends to use the report to market the fund to prospective investors. In its comment letters, the ICI stated that FINRA should exempt the sales material and MDFP in shareholder reports from filing with FINRA on the ground that

they are already filed with the Commission and are subject to certain control and certification requirements under federal law and Commission rules.⁷ The ICI also argued that Section 408(c) of the Sarbanes-Oxley Act requires the Commission staff to review issuers' disclosures, including the sales material and MDFP portions, at least once every three years.⁸

The existing filing requirement under NASD Rule 2210 is limited to those shareholder reports that are being provided to prospective investors. It does not apply to shareholder reports provided only to existing shareholders. This limitation is designed to ensure that the filing requirement can achieve its purpose, which is to ensure that shareholder reports that the fund uses to market its shares to retail and other investors are reviewed in the same manner as other fund marketing material. Shareholder reports that are used only for informational purposes by existing shareholders of a mutual fund need not be filed. The filing requirement is further tailored to require the filing only of the sales material and MDFP portions, which are narrative in form. FINRA does not require firms to file financial statements that appear in shareholder reports.

A mutual fund's sales material and MDFP typically provide content beyond that which the Commission requires for a shareholder report. The shareholder report may contain an interview with the portfolio manager, or an appealing performance chart, such as a chart depicting how much the investor would have earned had he invested in the fund many years earlier. Many shareholder reports present the fund's historical performance with a comparison to an index. The reports typically describe the prospects for the fund, opportunities in which the fund is investing, and the possible effects of market conditions on the fund's performance. All of this discussion is designed to appeal to prospective investors of the mutual fund as well as existing shareholders.

FINRA's current review program has found problems with a significant number of fund shareholder reports. For example, among those that were filed with FINRA in 2011, approximately 7.5 percent required substantive comments to make the shareholder report fair, balanced and not misleading.⁹ For example, FINRA recently commented on a

⁷ See ICI Letter dated January 18, 2012 at 3-4; ICI Letter dated December 7, 2011 at 2-5.

⁸ See ICI Letter dated December 7, 2011 at 5.

⁹ The FINRA Advertising Regulation Department staff codes mutual fund shareholder reports as "performance reports," which includes not only fund shareholder reports, but also other periodic performance reports, such as quarterly fund reports and other types of periodic fund performance updates. The 7.5 percent figure reflects comments made on all communications coded as performance reports, although most performance reports are sales material and MDFPs included within mutual fund shareholder reports.

shareholder report that illustrated a fund's past performance by providing performance concerning other accounts of the investment adviser, without disclosing the differences between those accounts and the advertised fund. Another recently filed report provided an "overall credit rating" of "A-versus AA3" for a fund, without disclosing material information necessary to balance this rating, such as the fact that it was not provided by a nationally recognized statistical rating organization. A recently filed shareholder report provided non-standardized performance without providing the standardized one, five and ten year performance required by Securities Act Rule 482.

Shareholder reports are filed with the Commission, but might be reviewed by Commission staff only on a three-year cycle. In contrast, FINRA reviews all shareholder report sales material and MDFPs that are filed with the FINRA Advertising Regulation Department. The Department's comprehensive review program discourages funds from including content that is misleading or potentially harmful to investors.

FINRA is sensitive to the costs that the communications rules impose upon the industry, and has agreed to changes to our existing rules and the proposed amendments to accommodate these concerns in a manner consistent with investor protection. However, the costs associated with the shareholder report filing requirement appear to be substantially less than the amount estimated by the industry. In its letter, the ICI estimated that "a significant number of Institute member firms pay more than \$20,000 in fees annually to file shareholder reports with FINRA."¹⁰ This estimation was based upon the assumption that a fund complex that files 100 shareholder reports twice a year at FINRA's minimum filing fee would pay \$20,000 in filing fees, and that 31 ICI member firms have more than 100 funds in their complexes.

This cost estimate appears overstated because many fund complexes combine multiple funds' shareholder reports into a single document, which they file one time with FINRA. Of the 10 fund complexes that filed the highest volume of shareholder reports in 2011, only two issue a separate shareholder report for each fund.¹¹ For example, it is not uncommon for fund groups to combine shareholder reports for multiple target date funds, money market funds or municipal bond funds in a single document.

¹⁰ See ICI Letter dated January 18, 2012 at 4.

¹¹ These 10 largest fund complexes filed approximately 30 percent of all mutual fund performance reports received by FINRA in 2011 (which, as noted above, includes shareholder reports). Of these fund complexes, one creates multiple-fund shareholder report documents for all of its funds, seven create multiple-fund shareholder report documents for at least some of their funds, and only two issue a separate shareholder report document for each fund.

In light of the use of mutual fund shareholder reports to market the fund, and the substantive concerns raised by some shareholder reports, FINRA continues to believe that fund shareholder report sales material and MDFPs that will be used with prospective investors should be subject to the same filing requirements as other mutual fund sales material. Consequently, we do not propose to exempt mutual fund shareholder report sales material and MDFPs from the existing filing requirements.

Templates

Proposed FINRA Rule 2210(c)(7)(B) would exclude from the filing requirements retail communications that are based on templates that were previously filed with FINRA, the changes to which are limited to updates of more recent statistical or other non-narrative information. This filing exclusion would codify our long-standing interpretive position under NASD Rule 2210.¹²

The ICI recommended that FINRA permit a risk-based principal review process for narrative updates of templates. According to the ICI, "FINRA could require firms to develop policies and procedures appropriate for their business structure," citing proposed FINRA Rule 2210(b)(1)(D), which permits members to supervise certain categories of retail communications in the same manner as required for supervising and reviewing correspondence.¹³ The ICI notes that this approach preserves FINRA's ability to monitor these materials, both through review via filing and through spot checks and targeted examinations.

This approach is not workable as proposed. For example, the ICI proposes that narrative updates be reviewed in the same manner as correspondence, yet acknowledges that narrative updates to retail communications that are subject to a filing requirement would still have to be filed. FINRA has proposed that an appropriately qualified principal approve a communication prior to a member filing the communication with FINRA.¹⁴ Accordingly, review of narrative updates to templates in a manner similar to correspondence would not be consistent with this filing requirement. In addition, registered principal approval of narrative updates to templates prior to use helps to ensure that the narrative is fair, balanced and not misleading, in the same manner as prior review by registered principals of other types of mutual fund sales material.¹⁵

¹² See Letter from Thomas M. Selman, NASD, to Forrest R. Foss, T. Rowe Price Associates, Inc. (January 28, 2002), available on www.finra.org.

¹³ See ICI Letter dated January 18, 2012 at 5.

¹⁴ See proposed FINRA Rule 2210(b)(1)(F).

¹⁵ Of course, to the extent that this narrative constitutes a retail communication that is subject to more flexible supervision and review standards, then those standards

Reason to Believe Standard

Under existing NASD Rule 2211 the definition of “institutional investor” provides that “[n]o member may treat a communication as having been distributed to an institutional investor if the member has reason to believe that the communication or any excerpt thereof will be forwarded or made available to a retail investor.” Proposed FINRA Rule 2210 would maintain this standard. The ICI expressed concern about this standard, arguing that that many funds are sold through intermediary broker-dealer firms, and an intermediary firm may use institutional communications prepared by a fund’s underwriter with its associated persons. The ICI stated that it believes that, in these circumstances, it would be the recipient broker-dealer that would be responsible for assuring that its associated persons limit use of the communication to institutional investors. The ICI requested that FINRA clarify this issue in any regulatory notice accompanying the final rules.

The ICI is correct that the “reason to believe” standard does not make the fund underwriter responsible for supervising the associated persons of recipient broker-dealers (unless the person is also associated with the underwriter). Accordingly, FINRA agrees that the recipient broker-dealer is responsible for assuring that its associated persons do not forward institutional communications to retail investors. The fund underwriter should take appropriate steps to ensure that institutional communications are appropriately labeled so that there is no confusion as to their status. In addition, if red flags indicate that a recipient broker-dealer has used or intends to use an institutional communication provided by the underwriter with retail investors, the underwriter must follow up those red flags and, if it determines that this is the case, discontinue distribution of the communication to that recipient broker-dealer until the underwriter reasonably concludes that the broker-dealer has adopted appropriate measures to prevent future redistribution. We intend to clarify this issue in a Regulatory Notice announcing adoption of the rule.

Supervisory Analysts

The proposed rule change would generally carry forward existing review and approval standards for advertisements and sales literature under NASD Rule 2210.¹⁶ Proposed FINRA Rule 2210(b)(1)(A) would require an appropriately qualified registered principal of the member to approve each retail communication before the earlier of its use or filing with FINRA. Proposed FINRA Rule 2210(b)(1)(B) would provide that, with

would apply. See, e.g., proposed FINRA Rule 2210(b)(1)(D) (allowing certain categories of retail communications to be supervised and reviewed in the same manner as is required for correspondence).

¹⁶ See NASD Rules 2210(b)(1)(A) and (B).

respect to research reports on debt and equity securities, the requirements of paragraph (b)(1)(A) may be met by a Supervisory Analyst approved pursuant to NYSE Rule 344.

Wilmer commented that proposed paragraph (b)(1)(B) would have a negative effect on the review and distribution of materials prepared by research department personnel, since it would not permit Supervisory Analysts to review research notes and other materials if they do not meet the definition of “research report.” Instead the proposed rule would require a registered principal to review and approve these materials. Wilmer expressed the view that Supervisory Analysts are more qualified to review and approve research materials prepared by research department personnel than associated persons who have only taken a general securities principal examination.

Wilmer argued that requiring registered principals rather than Supervisory Analysts to review these materials would disrupt well-established practices and processes that firms have developed for publishing content produced by research department personnel that does not fall within the definition of “research report.” Accordingly, Wilmer urged that “a Supervisory Analyst should be permitted to review materials that are not defined as ‘research reports’ because they are excepted from the definition in NASD Rule 2711(a)(9), regardless of whether these materials contain a financial or investment recommendation.”¹⁷

FINRA agrees that Supervisory Analysts should be permitted to review and approve research reports on debt or equity securities, as well as retail communications that are described in NASD Rule 2711(a)(9)(A). FINRA also agrees that Supervisory Analysts should be permitted to approve other research that does not fall within the definition of “research report” under NASD Rule 2711(a)(9), provided that they have technical expertise in the particular product area. This revision is not intended, however, to alter current requirements that certain types of retail communications be approved by a principal with a specific qualification, such as retail communications concerning options, municipal securities or security futures.

Accordingly, FINRA is amending proposed FINRA Rule 2210(b)(1)(B) as follows:

(B) The requirements of paragraph (b)(1)(A) may be met by a Supervisory Analyst approved pursuant to NYSE Rule 344 with respect to: (i) research reports

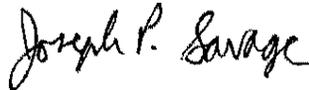
¹⁷ See Wilmer Letter at 2. Proposed FINRA Rule 2210(b)(1)(D) allows a member to supervise certain categories of retail communications in the same manner as required for supervising correspondence. One such category is retail communications that are excepted from the definition of “research report” pursuant to NASD Rule 2711(a)(9)(A), unless the communication makes any financial or investment recommendation.

on debt and equity securities; (ii) retail communications as described in NASD Rule 2711(a)(9)(A); and (iii) other research that does not meet the definition of "research report" under NASD Rule 2711(a)(9), provided that the Supervisory Analyst has technical expertise in the particular product area. A Supervisory Analyst may not approve a retail communication that requires a separate registration unless the Supervisory Analyst also has such other registration.

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If you have any questions, please contact Philip Shaikun, Associate Vice President and Associate General Counsel, at (202) 728-8451, or me at (240) 386-4534.

Very truly yours,



Joseph P. Savage
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Investment Companies Regulation