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To: rule-comments@sec.gov
Subject: File No. S7-06-04

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:

I appreciate the opportunity to comment on the above-referenced rule proposal (the "Proposal"), although I would be remiss in not mentioning my objection to the short comment period provided for such unprecedented Commission action. I am an individual that runs a small business and it is difficult to find the time over such a short period (60 days) to effectively review a 113 page Proposal.

As a threshold matter, it is important to state that I support enhanced disclosure for mutual fund investors. However, I believe that the Proposal, even by the Commission's own unrealistically low estimates, is far too expensive. The Proposal imposes a multi-billion dollar cost which will be borne primarily by small retail investors. The net result of the Proposal will be to make mutual funds less available and less attractive for small, beginning and unsophisticated investors—precisely the investors for whom mutual funds are often the most appropriate class of investment.¹ Moreover, the great costs that the Proposal would impose will provide little assistance to investors—the proposed disclosures will distract investors from the more important information in the fund prospectus. Although my comments mainly address the costs associated with this Proposal, I want to briefly indicate there are other issues with the Proposal. Namely, (i) that the Proposal discounts the prospectus as the primary disclosure tool in the offering of a security, (ii) that the Proposal results in redundant disclosure in that the majority of the costs associated with purchasing a mutual fund are already detailed in the prospectus and there are other SEC proposals to mandate the inclusion of all remaining cost elements in the prospectus, (iii) that the Proposal underscores the Commission's lack of attention to a key attribute of the structure of the industry it regulates, i.e., that the majority of broker-dealers that distribute mutual fund shares are introducing broker-dealers that clear their trades through a clearing firm and/or directly with the mutual fund company, and (iv) that the proposal's right of rescission is fundamentally flawed. I want to stress that my disagreement with the Proposal is not over the need for improved disclosure—it is over how best and most cost-effectively to make that information available for investors.

¹ For ease of use, this comment letter generally will refer to "mutual funds," although I recognize that the Proposed Rules also cover UITs and 529 plan securities, and do not cover some closed-end or exchange-traded funds often referred to as mutual funds.

Please note that before going into detail on the cost of this Proposal, I wish to note my endorsement of the comments by both the Financial Services Institute and the Securities Industry Association.

The Commission's Proposal Is Simply Too Costly. The SEC's own estimate is that Rules 15c2-2 and 15c2-3 would cost the industry at least \$1.3 billion to implement.² The SEC estimates that 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 rule would replace. And the SEC estimates that Rule 15c2-3 would impose an annual recurring cost of almost \$1 billion.³ 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.⁴ 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.

I believe that the SEC has substantially underestimated the cost of this rule proposal. 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.⁵ But these figures are substantially too low. The proposed rule would require firms like mine to design a completely new system 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. It would

² 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. I would estimate an implementation cost of at least \$100,000 per broker-dealer, for a total implementation cost of over \$500 million.

³ Id., see also Proposing Release, Costs and Benefits of the Proposed Rule and Rule Amendments.

⁴ 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 I believe is not a credible estimate for a substantial change that will, at a minimum, required substantial legal review by inside counsel, fund counsel and outside directors' counsel to ensure that it is correctly implemented.

⁵ Id. at Initial Regulatory Flexibility Act Analysis.

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. 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, I estimate that the implementation cost of this rule (even considering the number of very small brokerage firms) will be more on the order of \$500,000 per firm, and the annual costs of maintaining and updating these systems and procedures will also be on the order of \$500,000 per firm.⁶ 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.⁷ Once again, I 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. I believe that implementation costs of \$500,000 per firm and ongoing costs of \$750,000 per firm are much more likely to be realistic than the cost estimates in the release.⁸

Even under the SEC's own cost estimates, new rules 15c2-2 and 15c2-3 alone would have an annual cost nearly four times the SEC's entire annual budget. According to the SEC's own FOCUS reports, the entire US brokerage industry's total annual revenue from mutual funds was \$16 billion in 2002, and assuming the brokerage industry's average profit margin of 7.5% (again, the figure is derived from the SEC's own FOCUS reports),⁹ 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 greater than the entire industry's 2002 annual profits from mutual

⁶ My estimate would result in an implementation cost of almost \$2.7 billion for Rule 15c2-3, and an annual ongoing expense of approximately \$3 billion. As discussed below, my estimate that the point-of-sale disclosure will take an average of three minutes to discuss with customers, rather than the Commission's non-credible estimate of one minute, leads to the same \$3 billion annual cost estimate.

⁷ Id.

⁸ My estimate would result in an implementation cost of almost \$2.7 billion for Rule 15c2-2, and an annual ongoing expense of over \$4 billion.

⁹ The SEC's FOCUS reports do not have a separate "mutual funds expenses" line to compare to the "mutual funds revenue" line. My calculation of the overall brokerage industry profit margin is a comparison of overall revenues and overall expenses reported in the FOCUS reports. I am 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 my conclusions.

funds. And the annual recurring costs these rules would impose are substantially larger than the entire industry's annual profits from mutual funds.¹⁰

Under the SEC's own cost estimates, these rules 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.

Analyzing the cost of the Proposal on a per-household basis is appropriate. While the cost may fall in the first instance on broker-dealers, like the firm I am registered with, of course they will have to pass 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 are investing a small amount every month in a few mutual funds. The SEC can expect that these rules will cause broker-dealers to increase transaction fees for mutual funds (especially for small investors), as well as increased minimum balance sizes and increased periodic account service fees. The SEC should have requested comments from the public on the basis of its own cost estimates: would US mutual-fund owning households be willing to pay \$55 per year (and \$80 in year one) for the type of disclosure mandated by the proposed rules. I suspect very few investors would answer yes.

To the extent that these cost estimates are too low, the total cost of the rules would be even more astronomical than the SEC itself estimates. My estimate (set forth above) would be that the annual ongoing expense of these rules equates to nearly \$125 per US household that owns mutual funds. The year-one cost (including both implementation costs and one full year of ongoing expense) equates to well over \$200 per household. Again, I challenge the SEC to ask investors, especially small investors, whether they would voluntarily choose to pay this much for the SEC's proposed disclosure. If the rule is adopted, of course investors will not have the choice—they will be required to subsidize the cost of the rule.

The SEC does not even attempt to quantify the expected benefit of the proposed rules. The Proposing Release states that the benefits “while qualitatively important, are necessarily difficult to quantify.”¹¹ I believe that before the SEC imposes what is, even by

¹⁰ I am aware of estimates that the mutual fund industry charges \$13 billion annually in 12b-1 fees and \$6.7 billion in sales loads. I 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 earned by brokerage firms; for example, some contingent deferred sales loads are returned to the mutual fund complexes themselves.

¹¹ Proposing Release at Costs and Benefits of the Proposed Rule and Rule Amendments.

its own calculation, a multi-billion dollar tax on American investors, it should be able to provide a better justification than that.

As stated at the outset of this letter, I share the Commission's overall goal of improving investors' ability to make informed decisions when choosing to invest in mutual funds. However, I believe that there are other more effective, more comparable, more efficient and faster means to achieve this important goal. Additionally, I believe the rules suggested in the Proposing Release will have unintended negative consequences that will far outweigh their limited value.

Sincerely,

Sarah L. Smithey
Registered Representative
1st Global Capital Corp.