Rule 15c2-3
Supporting Statement

A. Justification

1. Necessity For Information Collection

Proposed rule 15c2-3 under the Securities Exchange Act of 1934 ("Exchange Act") would require brokers, dealers and municipal securities dealers to provide customers with specified information at the point of sale – prior to the time they purchase mutual fund shares, UIT interests[1] and college savings plan interests. Investors, therefore, would have this information before they finalize their investment decision to purchase a covered security, regardless of whether the transaction is solicited or unsolicited. The proposed rule would not apply to transactions in which an investor sells a covered security, because those transactions do not raise the same special cost and conflict concerns.

Mutual fund investors may, directly or indirectly, incur distribution-related costs that can reduce their investment returns. The type and amount of those costs often vary among funds and among share classes issued by the same fund. Some mutual funds issue share classes that impose sales fees, or loads, on investors when they purchase the fund shares ("front-end" sales loads). Mutual funds may also sell share classes with sales loads that investors must pay when they redeem fund shares ("deferred" or "back-end" sales loads). The amount of the deferred sales load, generally calculated as the lesser of a percentage of the value of the initial investment or the account's value upon redemption, typically declines each year that the investor holds the shares, and eventually disappears entirely. Some mutual funds also use their assets to pay distribution-related expenses, including compensation of broker-dealers in connection with distributing fund shares, under plans adopted pursuant to rule 12b-1 under the Investment Company Act ("12b-1 fees"). Sales loads and asset-based sales charges and service fees reduce the returns that investors earn on their mutual fund investments. Not all mutual funds are sold subject to front-end or deferred sales loads or impose asset-based sales charges and service fees.

Broker-dealers that sell mutual fund shares to customers may participate in distribution arrangements that create conflicts of interest for the broker-dealers as well as their personnel. Those arrangements can give broker-dealers a heightened financial incentive to sell particular funds or share classes, and therefore may lead a broker-dealer to provide some groups of funds with heightened visibility and access to the broker-dealer's sales force, or otherwise influence the way that broker-dealers and their associated persons market those funds or share classes to customers. Those arrangements therefore pose special confirmation disclosure issues. Moreover, some of those arrangements may violate NASD rules, and the failure to disclose relevant information about those arrangements – regardless of whether disclosure specifically is required by the confirmation rules – also may violate the antifraud provisions of the federal securities laws.

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1 "Unit investment trust" means an investment company which (A) is organized under a trust indenture, contract of custodianship or agency, or similar instrument, (B) does not have a board of directors, and (C) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities; but does not include a voting trust.

As part of those distribution arrangements, broker-dealers that sell mutual fund shares generally earn sales fees from the fund's principal underwriter at the time of sale. Alternatively, the principal underwriter may pay the selling broker-dealer sales fees attributable to a particular sales transaction over time, for as long as the customer holds the shares purchased. The amount of those sales fees is not uniform, however, and a broker-dealer may receive a higher fee for selling a particular dollar amount of shares issued by one fund rather than shares issued by another fund, or for selling one share class rather than other share classes issued by the same fund and available to the customer.

Broker-dealers also may be paid in other ways for distributing fund shares, such as through revenue sharing payments from a fund's investment adviser. In some cases, a broker-dealer may receive payments from a fund or a fund's affiliates that are characterized as service fees, recordkeeping and transfer fees, seminar sponsorships or other types of payments that ostensibly compensate the broker-dealer for costs that it incurs as part of its mutual fund distribution activities. Broker-dealers may also be compensated for distribution through receiving commissions for portfolio transactions executed on behalf of the fund or affiliated funds, even though the broker-dealer may not necessarily execute those transactions.

These types of distribution-related arrangements may give broker-dealers heightened incentives to market the shares of particular mutual funds, or particular classes of fund shares. Those incentives may be reflected in a broker-dealer's use of "preferred lists" that explicitly favor the distribution of certain funds, or they may be reflected in other ways, including incentives or instructions that the broker-dealer provides to its managers or its salespersons. Such incentives create conflicts between broker-dealers' financial interests and their agency duties to customers.

In addition to conflicts of interest at the firm level, associated persons of broker-dealers face conflicts arising from financial incentives that promote the sale of some shares or share classes – or "differential compensation." Associated persons may receive higher commissions when they sell shares of a particular fund than they would if they sold the same dollar amount of the shares of another fund. They may also receive higher commissions when they sell a particular class of shares within a fund than they would if they sold the same dollar amount of another share class within that same fund. Other forms of differential compensation may include a broker-dealer waiving certain fees or reimbursement of certain expenses ordinarily borne by an associated person, when the associated person sells the shares of particular mutual funds. Broker-dealers may also sponsor sales contests that provide cash compensation to representatives and managers for meeting certain sales goals. Associated persons, moreover, may receive additional fees in the years after a sale, such as fees that some funds pay to broker-dealers for providing shareholder services. Each of those types of arrangements may motivate broker-dealer personnel to promote the sale of some funds over others. The funds that are favored by those arrangements may include proprietary funds that are affiliated with the broker-dealer, or funds whose advisers pay revenue sharing to the broker-dealer. Differential compensation may give the associated person an incentive to improperly limit the range of mutual fund choices presented to customers, or may affect the associated person's recommendations.

UITs, which include certain insurance company separate accounts that issue variable insurance products (i.e., variable annuity contracts and variable life insurance policies), are subject to similar distribution-related costs and conflicts.

Compensation practices for municipal fund securities used for education savings, or "529" plans, raise many of the same issues. Those securities may be sold subject to loads that can reduce the returns they produce. At times, brokers, dealers and municipal securities dealers that distribute municipal fund securities also may participate in distribution-related arrangements that create conflicts of interest for them, including revenue sharing payments and the use of portfolio commissions to reward distribution. In some cases, a broker, dealer or municipal securities dealer chooses to distribute only the municipal fund securities issued by a particular state, and does not provide its customers with the opportunity to invest in 529 plans issued by other states, even though those other plans may have lower loads or lower expense ratios, or may provide state income tax benefits that are absent from the plans being offered.

The associated persons of brokers, dealers and municipal securities dealers selling 529 plans may also receive incentives, such as differential compensation, that create conflicts of interest for them. Moreover, in contrast to NASD rules applicable to the distribution of mutual fund shares, associated persons of brokers, dealers and municipal securities dealers are not generally precluded from receiving non-cash compensation for selling municipal fund securities.

Proposed rule 15c2-3 is designed to be consistent with the existing obligations of brokers, dealers and municipal securities dealers under the antifraud provisions of the securities laws, which at times require a broker, dealer or municipal securities dealer to disclose information about particular costs and conflicts prior to effecting a transaction in a covered security. It is also intended to supplement the prudent business ethic of firms that assure their customers will be apprised of key facts prior to sales, to avoid surprises and broken trades. Point of sale disclosure should also complement confirmation disclosure, which provides a retrospective record of the complete terms of a transaction for customers to assess in determining whether the transaction occurred as described and whether they received any applicable breakpoint discounts.

2. Purpose of, and Consequences of Not Requiring, the Information Collection

Proposed rule 15c2-3 under the Exchange Act would require brokers, dealers and municipal securities dealers to provide point of sale disclosure to investors prior to effecting transactions in mutual fund shares, UIT interests and college savings plan interests. The disclosure would provide investors with targeted material information about distribution-related costs and remuneration that lead to conflicts of interest for their brokers, dealers or municipal securities dealers. The collection of information under proposed rule 15c2-3 would require some of the disclosure that is also required under rule 15c2-2. However, in contrast to the confirmation disclosure required under proposed rule 15c2-2, which a customer will not receive in writing until after a transaction has been effected, the point of sale disclosure that would be required under rule 15c2-3 would specifically require that investors be provided with

information that they can use at the time they determine whether to enter into a transaction to purchase one of the covered securities.

In addition, the Commission, the self-regulatory organizations, and other securities regulatory authorities would be able to use records of point of sale disclosure delivered pursuant to proposed rule 15c2-3 in the course of examinations, and investigations, as well as enforcement proceedings against brokers, dealers and municipal securities dealers. However, no governmental agency would regularly receive any of the information described above.

3. Role of Improved Information Technology and Obstacles to Reducing Burden

Proposed Rule 15c2-3 would not require that a broker, dealer or municipal securities dealer file information or documents via electronic submission. However, most customer confirmations are generated by automated systems, which allow confirmations to be generated in a fraction of the time it would take to generate a confirmation manually.

4. Efforts To Identify Duplication

No duplication is apparent.

5. Effects On Small Entities

The requirements of proposed rule 15c2-3 are not unduly burdensome on smaller broker-dealers. Proposed rule 15c2-3 would require additional information to be provided to investors at the time they make an investment decision. As a general matter, small brokerage firms use third-party service providers, or vendors, to generate the data necessary to send confirmations. They may also use vendors to actually send confirmations to investors. Therefore, the firms' vendors would be required to reprogram their software and update their systems to generate the data that would allow their clients to comply with proposed rule 15c2-3. The staff understands from discussions with vendors that the allocation of costs would coincide roughly with the volume of the client's transactions, so that a broker, dealer or municipal securities dealer that executes fewer transactions involving covered securities would be allocated less of its vendor's costs than a broker, dealer or municipal securities dealer that executes more such transactions. Small brokers, dealers and municipal securities dealers typically execute fewer transactions than larger brokers, dealers and municipal securities dealers.

6. Consequences of Less Frequent Collection

One of the primary purposes of proposed rule 15c2-3 is to provide customers with important information about fees at the time they make an investment decision in order to inform that decision. Less frequent dissemination of trade information to customers would substantially lessen the rule's investor protection functions.

7. Inconsistencies With Guidelines In 5 CFR 1320.5(d)(2)

The collection of information would not be conducted in a manner that is inconsistent with 5 CFR 1320.5(d)(2).

8. Consultations Outside the Agency

All Commission rule proposals are published in the Federal Register for public comment. The comment period for the release that discusses proposed Rule 15c2-2 is 60 days. This comment period will afford the public an opportunity to respond to proposal.

9. Payment or Gift to Respondents

Not applicable.

10. Assurance of Confidentiality

Not applicable.

11. Sensitive Questions

Not applicable. Questions of a sensitive nature are not asked.

12. Estimate of Respondent Reporting Burden

Annual burden. Proposed rule 15c2-2 potentially would apply to all of the approximately 5,338 brokers, dealers and municipal securities dealers that are registered with the Commission and that are members of NASD. It would also potentially apply to approximately 62 additional municipal securities dealers. It is important to note, however, that the confirmation is a customary document used by the industry.

Proposed rule 15c2-3(d) would require brokers, dealers and municipal securities dealers to make records of their disclosure sufficient to demonstrate compliance with the delivery requirements of paragraphs (a) and (b) of proposed rule 15c2-3. The brokers, dealers or municipal securities dealers would have to preserve those records for the period specified in Exchange Act rule 17a-4(b), or, in the case of records of oral communications or the disclosures, for the period specified in Exchange Act rule 17a-4(b) with regard to similar written communications and records. While this requirement often can be satisfied by maintaining a copy of the disclosure document that was provided to the customer, in the case of disclosure

solely by means of oral communications, this provision would require the broker, dealer or municipal securities dealer to have compliance procedures in place that are adequate to demonstrate that it provided the required disclosure. Based on discussions with industry participants, the Commission staff estimates that the annual burden to brokers, dealers and municipal securities dealers to develop and implement such compliance procedures would be approximately 2 million hours.[2]

Based on discussions with industry representatives, the Commission staff estimates that there are 1 billion confirmations delivered annually to customers in connection with securities transactions involving mutual fund shares, UIT interests and college savings plan securities. Proposed rule 15c2-3 would require brokers, dealers and municipal securities dealers to provide disclosure to customers about costs and conflicts at the point of sale for each of these transactions. The information that would be required to be delivered pursuant to proposed rule 15c2-3 would be derived from information that brokers, dealers and municipal securities dealers would otherwise prepare in order to fulfill their confirmation disclosure requirements under proposed rule 15c2-2.

The Commission staff further estimates from information provided by industry participants that it will take, on average, about one minute to deliver to customers the point of sale disclosure required under proposed rule 15c2-3. The Commission staff also estimates from information provided by industry participants that the annual burden to brokers, dealers and municipal securities dealers to deliver at the point of sale the disclosure that would be required under proposed rule 15c2-3, and to maintaining systems that would permit such disclosure, would be 16.7 million hours.[3] As a result, the Commission staff estimates that the total annual burden to brokers, dealers and municipal securities dealers to comply with the requirements of proposed rule 15c2-3, would be 18.7 million hours.[4]

Based on discussions with industry participants, the Commission staff estimates that the annual cost to brokers, dealers and municipal securities dealers for call center services and other service providers which would assist with development and implementation of procedures sufficient to demonstrate compliance with the delivery requirements of paragraphs (a) and (b) of proposed rule 15c2-3 would be approximately $40 million.[5]

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2 The staff estimates that the burden to the 10 vendors to maintain their systems would be 500,000 million hours annually, or 50,000 hours per vendor. The staff estimates that the burden allocated to each client on a pro rata basis would be 100 hours annually per broker, dealer or municipal security dealer that uses vendors' services (500,000 hours/5,000 = 100 hours). The staff estimates, based on discussions with industry representatives, that the 400 brokers dealers and municipal securities dealers that use proprietary confirmation delivery systems, on average, would have a burden of 3,750 hours annually for maintaining systems. Thus, the annual burden for maintaining systems is estimated to be 2 million hours ((5,000 x 100) + (400 x 3,750) = 2,000,000).

3 (1 billion transactions at one minute per point of sale disclosure = 1 billion minutes; 1 billion minutes/60 minutes per hour = 16.7 million hours.)

4 (16.7 million hours per point of sale disclosure + 2 million hours to develop and implement compliance procedures = 18.7 million hours.) The staff notes that due to the rounding limitations of Form 83I, the total annual burden on Form 83I is 17,999,982 hours.

One-time burden. The Commission staff anticipates that one of the primary burdens to the industry of proposed rule 15c2-3 would be a one-time burden associated with reprogramming software and other such activities that will enable confirmation delivery systems to generate the information at the point of sale. Based on discussions with industry representatives, the Commission staff does not expect that brokers, dealers or municipal securities dealers would require new systems to be developed. Rather, the reprogramming and updating of current systems will enable brokers, dealers and municipal securities dealers to have access to such information at the point of sale, and to provide such information to investors at that time.

Based on discussions with industry participants, the Commission staff estimates that the one-time burden to brokers, dealers and municipal securities dealers to reprogram software and conduct such other activities that will enable confirmation delivery systems to generate information required by proposed rule 15c2-3 to be delivered at the point of sale would be approximately 7 million hours.[6] The staff anticipates that this burden will be incurred within the first year after proposed rule 15c2-3 is adopted and not in later years. We note that some, but not all of the burdens for complying with proposed rule 15c2-3 would be shared with burdens for complying with proposed rule 15c2-2. The estimates of burdens and costs in this section reflect this shared burden. However, if proposed rule 15c2-3 is adopted and proposed rule 15c2-2 is not, the burdens for complying with proposed rule 15c2-3 may increase.

13. Estimate of Total Annualized Cost Burden

Annual costs. Based on discussions with industry participants, the Commission staff estimates that the annual cost to brokers, dealers and municipal securities dealers for call center services and other service providers which would assist with development and implementation of procedures sufficient to demonstrate compliance with the delivery requirements of paragraphs (a) and (b) of proposed rule 15c2-3 would be approximately $40 million.[7]

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5 Based on discussions with industry representatives, the staff estimates that the annual cost would be $7,400 per broker, dealer or municipal securities dealer. (5,400 brokers, dealers and municipal securities dealers x $7,400 =$39,996,000.) The staff notes that due to the rounding limitations of Form 83I, the total annual burden on Form 83I is $39,999,960. This estimation also reflects a correction from the Commission's previous Paperwork Reduction Act submission.

6 The staff estimates that the total one-time burden to the 10 vendors would be 1,040,000 hours, or 104,000 hours per vendor. Although the staff understands from discussions with vendors that this burden would be allocated to all of the vendors' clients in a manner that reflects the volume of transactions the broker, dealer or municipal securities dealer effects, for purposes of this calculation, the staff assumes that the burden would be allocated to each client on a pro rata basis (208 hours per broker, dealer or municipal security dealer that uses vendors' services). In addition, the staff estimates, based on discussions with industry representatives, that 400 brokers dealers and municipal securities dealers use proprietary confirmation delivery systems that each of them, on average, would have a one-time burden of 22,400 hours. Thus, the total one-time burden is estimated to be 7 million hours ((5,000 x 208) + (400 x 14,900) = 7,000,000 hours).

7 Based on discussions with industry representatives, the staff estimates that the annual cost would be $7,400 per broker, dealer or municipal securities dealer. (5,400 brokers, dealers and municipal securities dealers x $7,400 =$39,996,000.) The staff notes that due to the rounding limitations of Form 83I, the total annual burden on Form 83I is $39,999,960.

One-time cost. Based upon discussions with industry participants, the Commission staff anticipates that there would be one-time external costs for out-sourced services, including call center services for brokers, dealers and municipal securities dealers that may use such services for delivery of point of sale information for transactions placed by telephone. The staff anticipates that these costs would be passed on to brokers, dealers and municipal securities dealers in the form of higher fees. While the staff is currently unable to determine the number of brokers, dealers and municipal securities dealers that utilize such outsourced services, based on discussions with industry representatives the staff estimates that the cost per broker, dealer or municipal securities dealer would be approximately $18,500. Assuming that all of the approximately 5,400 brokers, dealers and municipal securities dealers subject to proposed rule 15c2-3 use such out-sourced services, the total one-time external cost would be about $100 million. We note that this assumption may result in a significant overstatement of these external costs. This cost is not included in the annualized burden because the staff estimates that it be incurred within the first year after proposed rule 15c2-2 is adopted and not in later years.

14. Estimate of Cost to Federal Government

Proposed rule 15c2-3 would not require that any documents be submitted to the federal government, thus no costs to the federal government are imposed directly by the rule. Costs to the federal government are attributable to ensuring compliance with and enforcing the rule. The cost to the federal government attributable to the operation of proposed rule 15c2-3 is estimated at $20,000 per year (500 reviews at one hour at a cost of $40.00 per hour, including overhead). It should be noted that the National Association of Securities Dealers, Inc. and the New York Stock Exchange conduct their own examinations to determine compliance with confirmation rules.

15. Explanation of Changes in Burden

Not applicable. Proposed Rule 15c2-2 would be a new rule.

16. Information Collection Planned for Statistical Purposes

Not applicable. There is no intention to publish the information for any purpose.

17. Explanation as to Why Expiration Date Will Not Be Displayed

Not applicable.

18. Exceptions to Certification

Not applicable.

B. Collection of Information Employing Statistical Methods

The collection of information does not employ statistical methods, nor would the implementation of such methods reduce the burden or improve the accuracy of results.