

**JOINT
SEC/NASD/NYSE REPORT OF EXAMINATIONS OF
BROKER-DEALERS REGARDING DISCOUNTS ON
FRONT-END SALES CHARGES ON MUTUAL FUNDS**



New York Stock Exchange, Inc.



**Office of Compliance Inspections and Examinations
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Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds

Executive Summary

The Staff from the Securities and Exchange Commission (“Commission”) Office of Compliance Inspections and Examinations, NASD and the New York Stock Exchange (“NYSE”) conducted an examination sweep of 43 registered broker-dealers that sell mutual funds with a front-end sales load. The purpose of the examinations was to determine whether investors are receiving the benefit of available discounts on front-end sales charges in mutual fund transactions. Examinations were conducted between November 2002 and January 2003. This is a report by Staff of the Commission, NASD and NYSE summarizing the results of these examinations.¹

Mutual funds sold through broker-dealers may include a sales charge (also called a “load”), which compensates the broker-dealer selling the fund’s shares. Mutual funds with front-end sales loads often offer investors the opportunity for a reduction in sales loads as the dollar value of the shares purchased by an investor or a member of his/her family increases. The levels at which the front-end sales charge is reduced are determined by the mutual funds and are generally termed “breakpoints.” Typical breakpoint discounts apply to purchases at \$50,000, \$100,000, \$250,000, \$500,000 and \$1 million, although some funds provide a breakpoint at \$25,000.

The dramatic growth in the number of fund families, share classes, and, to a lesser extent, customer account types, has increased the complexity of applying breakpoints appropriately. In addition, in the past, broker-dealers dealt directly with mutual fund transfer agents and disclosed the customer’s identity to them. This allowed the mutual fund’s transfer agent the ability to verify breakpoint discounts. In recent years, many firms began to utilize omnibus accounts and accounts that do not provide individual information to the mutual fund transfer agent. Depending on the methodology that the broker-dealers and fund companies utilize for this process, the amount of customer information provided to the fund’s transfer agents may be limited; therefore, broker-dealers must take additional steps to ensure that appropriate sales charges are assessed.

In light of NASD findings in several routine examinations, the Commission and NASD became concerned that broker-dealers may not be uniformly applying appropriate sales charges and providing breakpoint opportunities to investors. Accordingly, the Staff launched a multi-faceted action plan designed to address the issue. First, all broker-dealers conducting a public business were required to review the adequacy of policies and procedures in this area, make necessary changes, and report information concerning their mutual fund business. The results of those reports are discussed in Section VI of this report. Second, the Commission and NASD, along with the NYSE, initiated an

¹ This report represents the findings and views of the Staff of the Commission, NASD and NYSE, and not the Commission itself. For purposes of this report, Staff of the Commission, NASD and NYSE are collectively referred to as “Staff.”

examination sweep of 43 broker-dealers that sell front-end load mutual funds to evaluate whether samples of transactions received the sales load discounts offered by the fund. The results of the examinations are discussed in Section V and summarized below. Third, NASD, the Securities Industry Association (“SIA”) and the Investment Company Institute (“ICI”) formed a working group to explore and recommend ways in which the mutual fund and broker-dealer industries can prevent breakpoint problems in the future, and improve systems and disclosure.²

The findings in this report are based on limited samples of transactions at each of the 43 broker-dealers examined. In summary, the examinations revealed the following:

- Most of the firms examined, in some instances, did not provide customers with breakpoint discounts for which they appear to have been eligible. Overall, examiners identified a significant number of transactions that appeared to be eligible for a discount, though did not receive a discount or incurred other unnecessary sales charges. Three firms did not provide a discount in all sampled transactions that appear to have been eligible for a discount, and two firms provided customers with all available discounts.
- In instances where investors were not afforded the benefit of a breakpoint discount for which they appear to have been eligible, the average discount not provided was \$364 per transaction.
- The most frequent causes for not providing a breakpoint discount were not linking a customer’s ownership of different funds in the same mutual fund family, not linking shares owned in a fund or fund family in all of a customer’s accounts at the firm, and not linking shares owned in the same fund or fund family by persons related to the customer (e.g., spouse, children)³ in accounts at the firm. Many of the problems do not appear to be intentional failures to charge correct loads.
- Breakpoint issues were found in all types and sizes of firms, but were less frequent in firms that complete purchases of funds by sending paper applications directly to the fund’s transfer agent.

² “SEC and NASD Action Plan on Mutual Fund Sales Load Charges,” SEC Release 2003-07 (January 16, 2003); “NASD Announces Joint NASD/Industry Breakpoint Task Force,” NASD News Release (February 18, 2003). NYSE is a member of the working group.

³ It is important to note that these findings are based on examiners’ review of the records available at each firm. It is possible that the customers who purchased funds in some of these transactions were informed of the opportunity for a breakpoint discount and declined to provide the firm with information about persons related to the customer who held fund shares, or declined to allow the broker-dealer or the fund transfer agent to link these accounts to compute and provide the lower sales charge. Most firms examined did not document this occurrence.

- While most of the firms had written supervisory procedures addressing breakpoints, they often were not comprehensive; six firms did not have any written supervisory procedures relating to breakpoints.
- Many firms can improve their compliance and supervisory systems and controls with respect to disclosing breakpoint opportunities and obtaining information from customers about related accounts, creating exception reports to identify breakpoint issues, and enhancing supervision and training. Most firms that sell front-end load mutual funds to investors report that they are undertaking significant reviews of their supervisory practices in this regard and a number have already implemented changes.

The limited nature of the examination sweep and the transactions reviewed does not permit examiners to determine the extent of the breakpoint problem at other firms, or at all firms in the industry. The examination findings at the firms examined cannot be extrapolated to other firms or to the industry as a whole. Based on the findings from the examinations, however, we conclude that broker-dealers who have sold mutual funds with front-end loads must take steps to review transactions to determine whether appropriate breakpoint discounts were provided.⁴ These next steps are described generally in section VII of this report.

I. Background: Growth in Mutual Fund Sales

More than half of all U.S. households own mutual funds. There are an estimated 93.3 million individual shareholders of mutual funds.⁵ In fact, mutual fund shareholder accounts have risen from 61.9 million in 1990 to 244.4 million in 2000, and to 251 million as of June 2002.⁶ Mutual fund assets have also risen, from \$1.1 trillion in 1990 to \$7.0 trillion in 2000, and as of mid-2002 were \$6.1 trillion.⁷ The number of funds offered has also increased: in 1990, there were a total of 3,079 mutual funds and, by 2001, the number grew to 8,307 – a 169% increase since 1990.⁸

As described in this report, mutual funds are sold in a variety of ways. Many mutual funds are sold without a load, either directly by the fund or in defined contribution retirement plans. These transactions do not have a front-end sales load. It is estimated

⁴ Examiners conducted exit interviews with the firms examined and will ensure that the firms address examination findings appropriately, including by rebilling or refunding applicable sales charges.

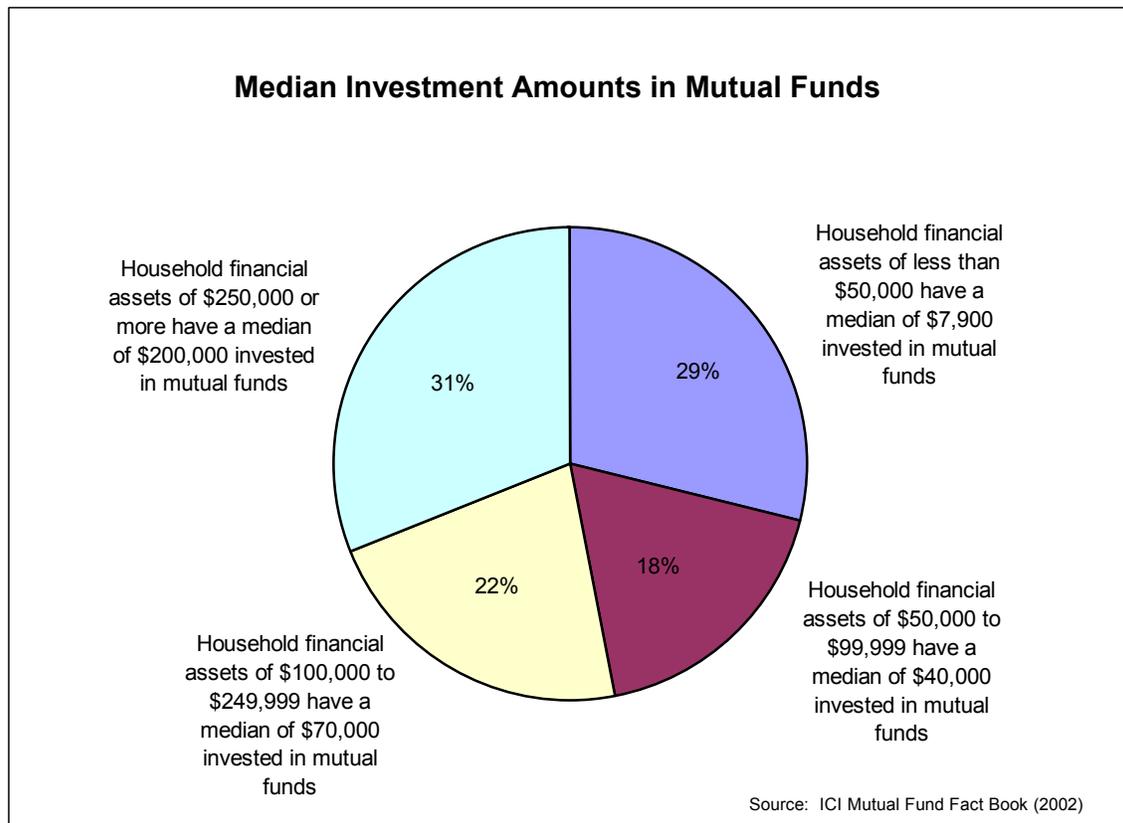
⁵ See Investment Company Institute, “2001 Profile of Mutual Fund Shareholders,” page 1 (based on a survey of households in May 2001).

⁶ See ICI Mutual Fund Fact Book 2002 and report entitled “Supplemental Data for Quarter Ending June 30, 2002” dated October 24, 2002.

⁷ See ICI Mutual Fund Fact Book.

⁸ See ICI Mutual Fund Fact Book.

that 37% of all mutual fund shareholders purchase shares through a broker-dealer (or from an insurance agent, financial planner or bank representative).⁹ These transactions may have a front-end sales load. According to the ICI, it is estimated that less than 7% of all mutual fund sales in 2002 were of front-end load funds. There is no data available that indicates how many of these fund shareholders have purchased fund shares in amounts that would qualify for a breakpoint discount (often \$50,000 is the minimum amount to qualify for a breakpoint discount). We note, however, that households have a median investment of approximately \$40,000 in mutual funds, divided among three to four funds (see chart below).



II. Breakpoints and How They Work

A. Front-End Load Funds

Investors purchase mutual fund shares at the public offering price. Mutual fund transactions are either in fund classes that are “no-load” funds, in which no commission is charged, or in other fund classes that impose sales charges. Investment company groups may offer many different mutual funds from which an investor may choose. A “multi-class” fund is a single mutual fund with different classes, each with a different sales charge, distribution fee, and other expenses. Each is a class of the same underlying fund, participating in the same portfolio of investments. The primary differences among

⁹ ICI 2001 Profile of Mutual Fund Shareholders.

the classes are the type and amount of fees charged to the investor. The three most common mutual fund classes are: Class A, Class B and Class C.¹⁰ Typically, shares charging a front-end load are designated as Class A shares. Funds may also offer other classes of shares that have front-end sales charges. These funds have sales charges that are applied at the time the fund shares are purchased to compensate the broker-dealer that sells the fund shares, and are based on a percentage of the purchase price.¹¹

Mutual funds with a front-end sales load typically establish a schedule or table of sales load percentages that are used to calculate the sales load that an investor pays. Generally, as the dollar value of share purchases made by an investor or related accounts increases, the front-end sales load declines. For example, sales loads on equity funds typically start anywhere from 4% to 5.75% for purchase amounts up to \$49,999. Typically, the sales load percentage applied to purchase amounts between \$50,000 and \$99,999 may decline by 0.5% to 1.0%; similar discounts may exist for purchases at \$100,000, \$250,000 and \$500,000. Generally, purchases of \$1 million or more are not charged any sales load. The purchase levels at which the sales load decreases are called "breakpoints."¹²

A fund's schedule of front-end sales loads typically is included in its prospectus, and often a more detailed summary is included in the fund's statement of additional information.¹³ Front-end sales load schedules and breakpoints differ across fund groups and may even differ among funds within the same family.

¹⁰ Class B shares typically do not have a front-end sales load. Instead, they may impose a contingent deferred sales load, a 12b-1 fee (which are fees paid by the fund out of fund assets to cover the costs of marketing and selling fund shares), and other annual expenses. Class B shares also might convert automatically to a class with a lower 12b-1 fee if the investor holds the shares long enough. Class C shares might have a 12b-1 fee, other annual expenses, and either a front or back-end sales load. The front or back-end load for Class C shares tends to be lower than for Class A or Class B shares. Unlike Class B shares, Class C shares generally do not convert to another class, and tend to have higher annual expenses than either Class A or Class B shares.

¹¹ The maximum front-end sales load percentage that a broker-dealer can accept for selling fund shares is limited to 8.5% of the offering price by NASD Rule 2830(d)(A).

¹² Information about mutual fund breakpoints is available in the "Investor Information" section of the Commission's website, at <http://www.answers/breakpt.htm>, including an explanation of breakpoints, how they are calculated, and the specific steps investors can take to check whether or not they are entitled to the benefit of a breakpoint, and whether they have received any breakpoint discounts to which they may be entitled. Information is also available on NASD's website at http://www.nasdr.com/alert_breakpoint.htm, including a "mutual fund expense analyzer" to help investors calculate the impact of breakpoint discounts on their investments.

¹³ Rule 22d-1 and Form N-1A under the Investment Company Act require that funds fully set forth the terms of any price schedules. Form N-1A requires descriptions of letters of intent and rights of accumulation in the prospectus or in the statement of additional information. Typically, the prospectus is provided to the investor with the confirmation of the trade.

B. Discounts Frequently Offered

A front-end load fund typically offers investors several ways to take advantage of lower sales charges. The prospectus and statement of additional information describe these options, and often state that the investor should advise the broker-dealer or fund of his/her desire to take advantage of these opportunities as well as provide information about related accounts. These discounts are described below.

Quantity Discounts Typically Available - Funds typically offer investors two principal options that enable them to take advantage of breakpoints in sales loads for purchases made over time. These two options are called a letter of intent and a right of accumulation. The existence of these two options is described either in the fund's prospectuses or in its statement of additional information, and in applications to purchase fund shares supplied by a fund. Each is described below.

A letter of intent is a written statement by an investor to a fund in which the investor states that he/she intends to purchase a stated dollar amount of fund shares over a specified period (frequently, 13-months). As a result, the customer is charged the reduced sales charge that applies to the total amount of the customer's intended purchase on his/her very first purchase and all subsequent purchases. Most funds offer "look-back" provisions that permit shareholders to create a letter of intent at any time and include all purchases made during a previous period (usually 90 days) prior to creating the letter of intent. Letters of intent help investors plan their investment strategy since investors may not want to make a single large purchase of fund shares. For example, an investor may want to use dollar cost averaging to accumulate a desired investment over time. If a shareholder fails to fulfill his/her obligation by not placing orders to purchase the intended total value of fund shares, the shareholder must reimburse the amount of the discount either by payment or by selling shares from the shareholder's account.

A right of accumulation permits an investor to aggregate shares owned in related accounts in some or all funds in the fund family to reach a breakpoint discount. Funds typically allow investors to aggregate fund shares owned by a person or a group of persons related to the investor (family members or members of certain organizations). This option also gives a fund shareholder the ability to have earlier purchases of shares of funds in his/her accounts and in related accounts count towards the reduction of the sales charge on a current purchase. Some examples of ways that funds allow share purchases to be combined include:¹⁴

- aggregation with prior A share purchases;
- aggregation with prior purchases of all share classes;
- aggregation with holdings of a spouse and minor children;
- aggregation with holdings of others (including one's grandchildren or domestic partner);

¹⁴ Many funds calculate amounts to be aggregated using the current value of the fund holding, while a few funds use the greater of the initial purchase price or the current market value.

- aggregation with purchases in certain trust accounts;
- aggregation with the purchase of variable annuities; and
- aggregation with holdings in other accounts, such as IRA accounts and 529 plans.

Letters of intent and rights of accumulation may be combined for further benefits. A customer may also receive a breakpoint discount on a single transaction that meets a breakpoint.

Other Sales Charge Waivers - Most fund families also offer investors a *right to exchange* their holdings of a fund within the fund family for another fund within the fund family, without an additional sales charge. Various conditions and restrictions may apply, depending on the fund family. The prospectus will outline the terms governing whether an investor can avoid paying a sales charge on an exchange. Some of those conditions and restrictions relate to:

- time frame (e.g., shares must be held for at least one day prior to the exchange);
- exchanges may be limited to the same class of fund previously held;
- exchanges may be limited to a maximum number per year; and
- fees may be charged for certain exchanges.

Some families of funds offer a *reinstatement feature*. This permits an investor who previously owned shares in a mutual fund to repurchase shares in the same fund (or in another fund within the same fund family) without paying a sales load. Some restrictions may apply; for instance, there may be a time limit (e.g., six months or a year from the date of initial sale) within which the reinstatement feature must be exercised, or it is lost. Funds may also limit the use of their reinstatement feature by an investor to one time for any given group of shares. Contingent deferred sales charges, paid by the investor at the time of sale, may be reimbursed upon reinstatement, depending upon the terms stated in the prospectus. Additionally, some fund families permit reinstatement at net asset value if the monies being reinstated are coming from the sale of shares from a different fund family where the customer previously paid a sales charge.

III. Transaction Types and Mechanics of Fund Share Purchase Transactions

The primary entities involved in processing the purchase and sale of fund shares through a broker-dealer are the broker-dealer that has the direct relationship with the customer, and the fund's transfer agent, which has a contractual relationship with the fund to process orders in fund shares and maintain necessary books and records. Once a customer of a broker-dealer has decided to purchase a mutual fund, the broker-dealer may process the order in a number of ways. These include paper applications sent to the fund's transfer agent, wire orders sent to a fund's transfer agent,¹⁵ and orders sent

¹⁵ If a firm wires a transaction, that means that the firm sends the order to the fund's transfer agent via facsimile, telephone or computer terminal.

electronically to the fund's transfer agent, generally through Fund/SERV, which provides an electronic communication and order processing service.

The primary arrangements for processing orders -- using paper applications and electronically through Fund/SERV -- are described below.

Paper Applications - A recent survey by NASD of broker-dealers who sell mutual funds indicated that approximately 52% of mutual fund purchase transactions are completed by using the written application that the fund includes with its prospectus. These applications request all necessary personal information about the shareholder as well as the options the shareholder wishes to utilize, including letters of intent and rights of accumulation. If the letter of intent option is elected, the application form typically asks the investor to indicate the total dollar amount of mutual fund shares that he/she intends to purchase within the required time period. Similarly, if the right of accumulation option is elected, the application form typically asks the investor to list all accounts that he/she wants to be considered in applying the right of accumulation. The customer's account number at the broker-dealer is included on the application form for future reference. When the application is completed, the application and the investor's check are sent to the fund's transfer agent.

In paper application transactions, the mutual fund's transfer agent, rather than the broker-dealer, calculates the sales charge based on the information provided in the application. The transfer agent establishes an account for the shareholder on its records that captures all relevant information from the paper application. All of the transfer agents recently examined by the staff stated that, as an additional safeguard, they conduct an automated search of their shareholder master file maintained for all funds in the mutual fund family to determine if the shareholder or a related person has an account that was not listed on the application. If they find related accounts, they will link them in their system and apply breakpoints accordingly.

Fund/SERV - To facilitate electronic communication of order information between broker-dealers and fund transfer agents, many broker-dealers and mutual funds use Fund/SERV, a centralized, automated processing system for mutual fund purchases and redemptions offered by the National Securities Clearing Corporation. Fund/SERV was created in 1986 and acts as a communications medium and automated order-processing service for fund share transactions between broker-dealers and funds. Fund/SERV generally has the capability of accepting and transmitting as much information about the transaction and purchaser as the parties wish to share. Both broker-dealers and mutual fund groups are members of Fund/SERV, and pay the costs associated with its operations. A recent NASD survey of broker-dealers that sell mutual funds indicated that 45% of mutual fund purchase transactions are communicated directly to the fund's transfer agent using this service.

If a broker-dealer and a fund decide that they will use Fund/SERV to facilitate transactions, the responsibilities for processing fund transactions and recordkeeping are allocated as the entities decide. Fund/SERV provides two primary models to process

fund purchase orders: (a) fund shareholder information is “owned” by the fund; or (b) fund shareholder information is “owned” by the broker-dealer. Each model is described below.

Information Ownership by a Fund - This model is essentially an electronic version of the traditional application method. Broker-dealers request information from investors wishing to open a fund account and place purchase orders for fund shares. Broker-dealers may use a fund's standard application form or their order entry screens to capture information about an investor’s purchase and the options that the investor wishes to elect, such as a letter of intent or a right of accumulation. The information in a broker-dealer’s possession is used to complete the on-line, standard screen template supplied by Fund/SERV. The information is transmitted through Fund/SERV to the fund’s transfer agent, which then opens an account in the name of the shareholder on the transfer agent’s books. Information in a shareholder’s account history will include all options the shareholder has elected to use including use of a letter of intent or a right of accumulation, allowing the fund’s transfer agent to calculate appropriate sales charges and breakpoints. The transfer agent sends to each shareholder confirmations, periodic statements, fund financial reports, dividends, distributions, and tax reporting forms.

Information Ownership by a Broker-Dealer - In this model, the broker-dealer provides Fund/SERV and the fund’s transfer agent with purchase data without the personal information about fund shareholders and the options they have elected to use, including letters of intent and rights of accumulation. The name of the broker-dealer is listed as the purchaser for all transactions. Under this model, the broker-dealer, and not the transfer agent, has the customer information required to calculate appropriate sales loads and breakpoint discounts.

A broker-dealer may establish a single omnibus account registered in its name and using its tax identification number on the books of the transfer agent for each class of shares of each fund that it makes available to its customers. All shares of that class owned by its customers are aggregated and held in this single account.

Alternatively, a broker-dealer may open a separate account on the books of a fund’s transfer agent for each of its customers that own shares of a particular class of shares, all in the name of the broker-dealer. Typically, the only individual identifying characteristic of these accounts is the investor’s account number. The transfer agent processing system will use the field that contains the breakpoint information provided by the broker-dealer to calculate the sales load. If there is no entry in the breakpoint field, the transfer agent will use the dollar value of the current transaction to calculate the load.

The fund’s transfer agent will update either the broker-dealer’s omnibus account or the individual account for the number of shares purchased for each

transaction processed. The transfer agent typically sends the broker-dealer a report on the day following the transaction, which the broker-dealer uses to update the individual accounts of its customers that purchased fund shares. The broker-dealer is also responsible for confirming transactions to its customers and for all other communications with its customers that own fund shares, such as periodic statements and tax reporting.

IV. Roles of Entities in Mutual Fund Transactions

Mutual Funds - Mutual funds must make appropriate disclosure in the fund prospectus, statement of additional information, and/or any other disclosure document provided to customers of all terms relating to the fund, including, among other things, a description of the procedures to purchase shares, together with any minimum investment requirements, as well as any breakpoint discounts. Funds disclose the availability of letters of intent and rights of accumulation in the prospectus or the statement of additional information, and typically in the account application form.

A fund sells its shares through its principal underwriter, also called a “distributor.” The distributor may have selling agreements with many broker-dealers, and each broker-dealer may have agreements with many funds. While many of these agreements do not specifically address any party’s role and responsibilities with regard to assessing breakpoint availability to customers, some agreements provide that the broker-dealer will assess breakpoint availability.

Broker-Dealers - Broker-dealers who sell fund shares to retail customers must disclose breakpoint discount information to their customers and must have procedures reasonably designed to ascertain information necessary to determine the availability and appropriate level of breakpoints.¹⁶ In addition, broker-dealers may violate NASD rules if they sell

¹⁶ NASD Notice to Members 02-85 states in part that a broker-dealer must 1) ensure that its registered representatives and other personnel engaged in processing these transactions understand the terms of offerings and reinstatements; 2) ascertain the information that should be recorded on the books and records of the member or its clearing firm, which is necessary in determining the availability and appropriate level of breakpoints; 3) apprise the customer of the breakpoint opportunity and inquire whether the customer has positions or transactions away from the member which should be considered in connection with a pending transaction; 4) make sure that the personnel processing these transactions are appropriately trained in order to ensure that the information pertaining to all aspects of a mutual fund order, including any applicable breakpoint, is accurately transmitted in a manner retrievable by the mutual fund company; and 5) have in place appropriate and sufficient procedures, including supervisory procedures, with respect to breakpoint calculations. Also, NASD Notice to Members 94-16 states that if a proposed fund or fund family offers breakpoint discounts, members and their respective representatives should disclose the existence of the breakpoints to enable a customer to evaluate the desirability of making a qualifying purchase. *See also In re Mason, Moran & Co.*, Exch. Act Rel. 4832 (Apr. 23, 1953) (while registrant claimed it complied with disclosure requirements of the federal securities laws by furnishing the customer with a prospectus which included breakpoint information, the Commission held that while the prospectus requirements were intended to provide the investor with more information than had theretofore been generally available in the ordinary securities transaction, these requirements were not intended to abrogate the greater disclosure duties traditionally imposed on brokers and dealers in a fiduciary position).

to a customer mutual fund shares in an amount slightly below the breakpoint without disclosing to the customer the advantage of making purchases at or above the breakpoint.¹⁷ The Commission has brought a number of enforcement actions under the anti-fraud provisions when broker-dealers sell funds in a manner designed to avoid providing breakpoint discounts.¹⁸

¹⁷ See NASD Rule IM-2830-1; see also In re Mason, Moran & Co., Exch. Act Rel. 4832 (Apr. 23, 1953) (“...where registrant recommended purchases of investment company shares in amounts slightly below the minimum break-point amount, or where it could reasonably anticipate the likelihood of aggregate purchases in excess of the break-point within a short period, it was required to inform the customer that substantial unit price savings would be available for purchases at or above the break-point amount, and that purchases slightly below the break-point would allow registrant a greater profit than purchases at the minimum break-point amount.”).

¹⁸ See, e.g., Irish v. SEC, 367 F.2d 637 (9th Cir. 1966), *cert. denied*, 386 U.S. 911 (1967) (affirming Commission decision sanctioning broker-dealer for among other things, selling fund shares to investors in a manner to avoid providing breakpoint discounts); In re Sandra Simpson and Daphne Pattee, Exch. Act Rel. No. 45923 (May 14, 2002) (Commission affirmed ALJ decision sanctioning registered representative for conducting transactions for customers to avoid providing breakpoint discounts); In re Russell C. Turek, Exch. Act Rel. No. 45459 (Feb. 20, 2002) (Commission sanctioned registered representative for, among other things, failing to inform customers of the availability of breakpoint discounts); In re J. Stephen Stout, Exch. Act Rel. No. 43410 (Oct. 4, 2000) (Commission affirmed ALJ decision sanctioning registered representative for, among other things, failing to minimize sales charges on mutual fund transactions); In re Robert J. Check, Exch. Act Rel. No. 26367 (Dec. 16, 1988) (customers were entitled to refunds due to denied breakpoint discounts (for letters of intent or rights of accumulation), plus amounts for lost appreciation. Branch manager found to have failed to supervise registered representative who did not provide customers with breakpoint discounts (for letters of intent or rights of accumulation) in violation of Section 17(a)(2) of the Securities Act); In re Paine, Webber, Jackson & Curtis, 43 S.E.C. 1052, 1054 (1969) (sanctioning broker-dealer and registered representatives for effecting transactions in mutual funds in a manner resulting in unnecessary sales loads and failing to disclose availability of breakpoint discounts and letters of intent); In re Mason, Moran & Co., Exch. Act Rel. No. 4832 (April 23, 1953).

Clearing broker-dealers act as order processing, settlement, and recordkeeping agents for the introducing brokers that do not maintain their own back office facilities to perform these functions. In particular, clearing broker-dealers may be used by introducing broker-dealers to route mutual fund transactions to the fund's transfer agent, confirm transactions, receive and disburse cash, receive and deliver securities, provide safekeeping and prepare and maintain customer account statements. Clearing broker-dealers do not typically have direct relationships with customers. Our inquiry indicates that clearing firms generally do not provide assistance in the determination of whether breakpoints are available to customers of the introducing firm.¹⁹

Transfer Agents - Mutual fund transfer agents act as intermediaries between funds and broker-dealers that sell fund shares and may be affiliated with the fund. Mutual fund transfer agents issue, transfer, redeem, and account for the fund's shares. They maintain an account, either in the name of the shareholder or in the name of the broker-dealer, and perform detailed recordkeeping. This processing entails calculating the offering price that applies to a transaction, the sales load breakpoint that is available to a shareholder (if it has information with which to do so), determining the number of shares that are to be issued or redeemed, updating shareholders' records, and moving monies, as appropriate, between the broker-dealer, the shareholder and the fund. A transfer agent may take on other responsibilities such as confirming transactions to shareholders and tax reporting, depending on the contractual agreement between a broker-dealer and the mutual fund.

Commission staff reviewed 11 transfer agents that process approximately 55% of all fund shareholder transactions. Generally, transfer agents indicated that they rely on broker-dealers that sell the fund shares to retail investors to provide information about individual shareholders. All the transfer agents reviewed indicated that when/if they receive information about individual shareholders, they use tax identification numbers, account numbers and/or names and addresses to search for shareholder-related accounts in a transfer agent's database. Each transfer agent indicated that when they identify related accounts, they apply sales charge discounts.

V. Broker-Dealer Examinations

A. Examination Design and Methodology

Firms Selected For Review - The Staff selected particular broker-dealers to examine in order to provide a cross-section of all types of broker-dealers that sell front-end load mutual funds to retail customers. The 43 broker-dealers selected for the review provided diversity in factors such as: 1) the size of the firm, as well as local, regional, and national firms; 2) the types of transactions (trades done on an application basis, trades communicated through Fund/SERV on an omnibus and disclosed basis); 3) the systems,

¹⁹ See NASD NTM 02-85 ("the introducing broker must ensure that its customer receives the appropriate breakpoint in a given mutual fund transaction absent a clearing arrangement in which the clearing broker expressly assumes this agency obligation in accordance with NASD Rule 3230(a)").

both manual and automated, used to collect and manage mutual fund and customer account information; and 4) the supervisory systems and procedures for the review and determination of sales charges.

While we desired to focus on a wide variety of firms, we included in our sample the largest firms in terms of mutual fund sales. Large firms selected maintain approximately 40% of all customer accounts in the brokerage industry.²⁰ The remaining firms examined as part of the sweep maintain approximately another 10% of industry customer accounts. Thus, firms in our exam sweep maintain approximately 50% of all customer accounts in the industry.²¹

The 43 firms examined included 15 small, 17 medium and 11 large firms in terms of mutual fund sales volume.²² Most firms did not exclusively process transactions through one method. The firms collectively indicated an overall mutual fund revenue in excess of \$7 billion dollars for the period October 2001 through September 2002. The firms executed on average, approximately 22.8 million mutual fund transactions per month.

Examination Methodology - In evaluating whether the firms examined provided appropriate breakpoint discounts, examiners focused on: how well the broker-dealers collected and utilized information from mutual funds about the availability of sales charge discounts; and how well they combined that information with their own customer data to identify opportunities to provide those discounts to their customers. The examination process was designed to focus on the following:

- the transaction input process, to determine how mutual fund transactions were entered into the firm's transaction system, and the extent to which order entry mechanics affected a firm's ability to provide available sales charge discounts.
- the processes and systems employed by broker-dealers to identify, and then effectively utilize opportunities to reduce investor sales charges in purchases of front-end load mutual funds. This included a review of practices regarding:
 - rights of accumulation in single accounts and in qualified linked accounts;
 - letters of intent; and
 - reinstatements and exchanges.

²⁰ Based on Focus Annual Schedule I.

²¹ Our information database did not separately identify customer accounts that held mutual funds, although it is presumed that the same firms would have the most mutual fund accounts.

²² The firms examined were characterized utilizing the following parameters: Small - Less than \$10,000,000 in reported mutual fund revenue, Medium - \$10,000,001 to \$100,000,000 in reported mutual fund revenue, Large - \$100,000,001 or greater in reported mutual fund revenue.

- the supervisory systems and procedures established by broker-dealers to ensure that sales charges were accurately calculated and billed; and
- the nature and frequency of training provided to salespeople about mutual fund sales charge discounts.

Examiners reviewed the books and records of each brokerage firm under examination. Examinations did not cover accounts held by customers outside of the firm examined. Thus, these examinations did not identify instances in which customers may have been entitled to a breakpoint discount based on their combined ownership (or ownership by persons related to the customer) of shares in the same fund or same fund family held in accounts at other broker-dealers, investment advisers or other financial institutions, or owned directly with the fund.

Transactions Sampled - Examiners reviewed samples of front-end load mutual fund purchase transactions at each firm. Generally, samples were drawn from four sources: 1) transactions effected through an intermediary processing service (i.e., Fund/SERV);²³ 2) transactions effected directly with a mutual fund via applications;²⁴ 3) top revenue-producing customer accounts (5-10 accounts); and 4) transactions just below the breakpoint.²⁵ Samples were selected in order to identify transactions most likely to be eligible for a breakpoint discount, and thus cannot be considered to be purely random. The sample size averaged 218 transactions, but ranged from 36 to 462 transactions depending on the firm examined. The initial sample was limited in size in order to allow examiners to quickly learn whether, in a limited sample, there were failures to provide breakpoint discounts. From this initial sample, examiners identified those transactions in which a breakpoint discount was available. This sub-sample averaged 128 transactions, but varied between 4 and 288 transactions at each firm. Generally, transactions reviewed were from the October 1, 2001 to September 30, 2002 period.

B. Findings

- **Most of the 43 Firms Examined Appeared Not to Provide Customers With Sales Charge Discounts in Some Instances**

Examinations revealed, at most firms, transactions that were eligible for a breakpoint discount but did not receive a reduced sales charge. Overall, examiners sampled more than 9,000 mutual fund transactions. Examiners sought to include

²³ An initial sample of transactions, usually 60 from September 2002, was taken from a run of 2,000 consecutive transactions in front-end load mutual fund purchases with a minimum principal amount of either \$2,500, \$5,000, or \$10,000. If several transactions were found that appeared to have missed breakpoint opportunities within the sample of 60, the sample size was expanded to 150 to 300 transactions, if possible. The additional sample transactions were either consecutively drawn or were drawn from transactions related to the review of the original sample.

²⁴ This sample normally consisted of 20 transactions with a principal amount of at least \$2,500.

²⁵ Where possible, examiners identified 20 transactions that were close to breakpoint levels.

transactions in this sample that were most likely to be eligible for a discount (as a result, these findings are not based on a random sample). Of the more than 9,000 transactions reviewed, examiners identified 5,515 transactions that appeared to be eligible for a reduced sales charge. Of these 5,515 transactions, examiners found 1,757 transactions that did not receive a breakpoint discount or appear to have incurred other unnecessary sales charges (representing 19% of all of the transactions reviewed, and 32% of the transactions that were eligible for a discount). The number of transactions that appear to have been eligible for a discount, but did not receive it, ranged at each firm from none to 201. The median percentage of transactions that did not receive a discount, of the transactions that appeared to be eligible for a discount, was 30% at each firm (that appeared to have transactions that did not receive a discount). Examiners found that three firms failed to provide a breakpoint discount in all sampled transactions that appear to have been eligible for a discount, and two firms provided all appropriate breakpoint discounts in the transactions sampled.

Examiners found that, of the 1,757 transactions that did not receive a breakpoint discount or did not receive other sales charge waivers:

- 362 (21%) were due to not linking fund shares held by accounts related to the customer (e.g., spouse, children) held at the firm;
- 330 (19%) were due to not considering the customer's ownership in related funds in the same family;
- 244 (14%) were due to customers not receiving the retroactive benefit of a letter of intent;
- 241 (14%) were due to not considering multiple purchases by the customer in the same fund family on the same day;
- 205 (12%) were due to not considering other types of accounts of the individual investor (e.g., IRAs) at the firm;
- 151 (9%) were due to the purchase of shares of funds in several different, though similar, mutual funds;
- 114 (6%) were due to customers not receiving discounts available as a result of aggregation with prior purchases in the same fund and the same account;
- 55 (3%) were due to customers not receiving waivers available for repurchasing fund shares;
- 29 (2%) were due to customers not receiving a discount on a single trade that exceeded the dollar amount for a breakpoint discount;
- 11 (.6 %) were due to customers not receiving the benefit of a letter of intent on file;
- 8 (0.5%) were due to customers not receiving waivers when a customer exchanged shares in one fund for other shares in the same fund family; and
- 7 (.4%) were due to transactions just below the breakpoint, and where the customer had sufficient funds in their account to purchase shares to meet the breakpoint discount level.²⁶

²⁶ Examiners found some instances in which transactions fit into more than one category, and utilized the category that was the primary cause of not providing the discount in these calculations.

Specific findings in each area are described below.

- **Discounts Not Provided Averaged \$364 Per Transaction**

The discounts apparently not provided in the sample amounted to a total of \$637,023.69 and averaged \$364 per transaction. The single largest discount not provided on a transaction was \$10,289, and the smallest was \$2.

- **Most Instances in Which Discounts Were Not Provided Were Apparently Caused by Not Considering the Customer's Ownership of Funds in the Same Fund Family, and Not Linking Ownership of Funds by Persons Related to The Customer**

Of the total number of transactions that did not receive a breakpoint discount, most resulted primarily from not aggregating certain types of transactions that would provide a breakpoint discount under a fund's right of accumulation and not linking accounts related to the customer.

As previously described, mutual funds have numerous provisions allowing shareholders to aggregate purchases and receive a breakpoint discount. Examiners reviewed the most popular categories to determine whether there was a pattern in the type of right of accumulation that was not being captured and therefore the benefit not given to the customer. Hence, examiners reviewed transactions in the following categories: 1) multiple purchases in the same fund family on the same day; 2) subsequent purchases in the same fund, in the same account; 3) purchases where the customer owned other mutual funds in the same fund family; 4) purchases in the same fund family in other types of accounts of the individual customer, such as IRAs and 529 Plans; and 5) purchases in accounts held by persons related to the customer (e.g., spouse, children). Findings in this area are described below.

- **Customers Owned Funds in the Same Mutual Fund Family**

The most frequent reason that eligible discounts were not provided was not linking fund shares owned by the customer with shares owned by the customer in other funds in the same fund family to reach a breakpoint amount. In fact, 776 (or 44%) of the 1,757 transactions that examiners found did not receive a discount for which they appeared to be eligible, were due to not considering the customer's ownership of funds in the same fund family (e.g., in the XYZ Growth Fund, and in the XYZ Bond Fund). Of these, there were: 330 transactions in which the customer did not receive a breakpoint discount for owning shares of other mutual funds in the same fund family in the same account; 241 transactions in which the customer did not receive a breakpoint discount for making multiple purchases in the same fund family on the same day; and 205 transactions in which the customer did not receive a breakpoint discount for owning shares in the same fund family in the customer's other accounts at the firm.

➤ **Persons Related to the Customer Held Shares in the Same Fund or the Same Fund Family**

The second most frequent reason that eligible discounts were not provided was not linking a customer's purchase of fund shares with shares owned in the same fund or fund family by persons related to the customer (e.g., the customer's spouse or minor children). Examiners found that 362 of the 1,757 transactions (21%) that were not provided a discount, were not afforded the benefit of a right of accumulation because the transaction was apparently not aggregated with fund holdings by related persons.²⁷

It is important to note that these findings are based on examiners' review of the records available at each firm. It is possible that the customers who purchased funds in some or all of these transactions were informed of the opportunity for a breakpoint discount based on shares in the fund/fund family held by related persons, and declined to provide the firm with information about related accounts that would allow the broker-dealer or the fund transfer agent to compute and provide the lower sales charge. In the instances described above, the firms examined did not document this occurrence.

- **Some Firms Did Not Provide Discounts on a Single Trade or Multiple Trades in the Same Fund That Were Eligible For Discounts**

Eight of the 43 firms examined (19%) appeared to not provide a discount on a single trade in which the customer was entitled to a lower sales charge as a result of investing in dollar amounts that exceeded the breakpoint level. Twenty-nine transactions at eight firms did not receive the benefit of reduced sales charges, in a median amount of \$585.

Examiners also identified 114 (6%) transactions in which the customer did not receive discounts for which he/she appeared to be eligible, as a result of aggregation with prior purchases in the same fund and in the same customer account.

Examiners further identified concerns with certain transactions in which investment amounts that would have reached a breakpoint were divided into separate transactions that individually did not reach any breakpoint level.²⁸ In 10 of the 43 firms examined, examiners found 151 transactions in which investments of a customer were divided into smaller transactions in different, though similar funds.²⁹

²⁷ Thirty-two firms had evidenced deficiencies in this area with a median number of 16 deficiencies.

²⁸ It is possible that these investors were willing to forego breakpoint discounts in order to gain added diversification.

²⁹ At one firm, examiners determined that a customer purchased five high-yield tax-free funds from different investment companies although each of the funds had similar holdings.

- **Firms Generally Provided Breakpoint Discounts for Customers Who Stated That They Intended to Purchase Additional Shares Over Time, But Often Did Not Provide Retroactive Discounts That Were Available**

As described above, many mutual funds allow investors to receive breakpoint discounts if they state that they intend to purchase a specified minimum number of shares over time (a letter of intent). Examiners found that customers rarely used letters of intent, but examiners could not confirm whether firms fully disclosed this option to customers on a consistent basis. When customers did utilize letters of intent, firms correctly applied reduced sales charges, in most cases. The exams identified few instances where firms failed to give those customers the benefit of letters of intent, where letters of intent were on file. These instances were concentrated at five of the 43 firms examined.³⁰ Thus, there does not appear to be a systemic problem associated with providing the customer with the benefit of letters of intent that are on file or have been entered into the firm's database.³¹

In addition to focusing on letters of intent that were filed, examiners also analyzed whether customers would have benefited from signing a letter of intent and applying it retroactively to take advantage of a breakpoint. As described above, many mutual funds allow customers to aggregate other purchases made, looking back 90 days to achieve quantity discounts. Of the transactions sampled, examiners identified 244 transactions at 20 firms where the customer would have benefited from a retroactive application of a letter of intent (a median of 10 transactions per firm).³² (See section on written supervisory procedures and exception reports to further illustrate firm practices).

Some positive practices with respect to letters of intent were evident from our exam sweep. One firm's system tracks purchases made pursuant to a letter of intent, and maintains a list of current letters of intent. Pursuant to firm procedures, the letter of intent list is used to remind the customer two months before the letter's expiration to ensure that customers have a final opportunity to meet the agreed-upon breakpoint level. One firm generates a cover letter that accompanies a new letter of intent sent to customers for signature. The cover letter provides disclosure regarding the effects of the letter of intent, and the length of time the customer has in which to utilize its benefits. It also suggests that the customer review the prospectus carefully regarding sales loads. Another firm maintains a tracking log for letters of intent, and places a note on the on-line trading screen indicating that there is a letter of intent in effect, so that the registered

³⁰ The median number of discounts not provided at these firms was two.

³¹ While many firms were unable to determine how many letters of intent they had on file, examinations indicated that approximately one out of 2,000 customer accounts holding mutual funds had a letter of intent on file.

³² It was not possible for examiners to confirm whether registered representatives specifically disclosed to customers the availability of retroactive letters of intent at the time of purchase or whether they later discussed this with customers when it became clear that customers' purchases had reached a breakpoint level.

representative will be aware of it when placing future orders. Firm procedures require the registered representative to review this screen to determine whether a letter of intent exists prior to submitting new orders for funds.

- **Examiners Found a Few Questionable Transactions Just Below the Amount That Would Qualify For a Breakpoint Discount**

Examiners reviewed transactions to determine whether there were indications of transactions in amounts just below a breakpoint level. Staff reviewed 560 transactions executed just below breakpoint levels to determine whether customers had sufficient funds in their account to invest for the purpose of reaching the breakpoint. Of the transactions reviewed, seven transactions at four separate firms were in amounts just \$2,500 below a breakpoint level, and the customer had funds available in the account to purchase the remaining amount needed to reach the breakpoint. In these seven transactions, if the customers would have invested the amount needed to reach the breakpoint they would have saved a median of \$225 in sales charges.³³

- **Other Questionable Sales Charges Identified**

Examiners also identified other questionable transactions that did not receive eligible sales discounts with respect to reinstatements and exchanges. Examiners identified 55 instances at 11 firms in which a customer repurchased shares in a fund and paid a sales charge on the transaction, although the customer was entitled to have the sales charge waived. In some instances, customers did not receive reduced or waived sales charges when they effected inter-fund exchanges. Examiners identified eight instances at seven firms in which a customer exchanged shares in a fund for other shares in the same fund family, paid a sales charge on the transaction, although the customer was entitled to have the sales charge waived.³⁴

- **Breakpoint Issues Were Found in all Types of Firms, but Less Frequently in Firms That Complete Purchases of Funds by Sending Applications Directly to the Fund's Transfer Agent**

Examiners compared methods of processing mutual fund transactions to determine whether there were a greater number of transactions that did not receive a breakpoint associated with a particular method of processing transactions. It appears that firms that processed most of their transactions using paper applications had a lower number of missed breakpoint opportunities, resulting in a smaller amount of discounts not provided. The five firms identified that used paper applications as their primary

³³ Examiners could not conclude whether these investors were fully apprised of the breakpoint level and nonetheless elected not to invest a greater amount in order to reduce the sales charge. Firms did not document this occurrence.

³⁴ In some situations, customers may be entitled to a reduced sales charge when they sell certain mutual fund shares and use the proceeds to purchase front-end load shares in other fund families.

method of processing transactions had an average of 15 transactions that did not receive a breakpoint discount, averaging \$235, while the six firms that predominately used Fund/SERV had an average of 31 transactions that did not receive a breakpoint discount, averaging \$364.³⁵

- **Firms of All Sizes Evidenced Questionable Calculation of Breakpoints**

Examiners sought to determine whether there were a greater number of transactions that did not receive a breakpoint discount at different firms, depending on their size. Examiners found that the percentage of missed breakpoint opportunities appeared to be slightly higher in large-size firms, while the amount of the discount not received was higher in medium firms. A comparison is set forth below:

Firm Size	# of Firms	Transactions in Which Discount Was Not Provided, % of Sub-Sample (median)	Discount Not Provided (median amount)
Large	11	31%	\$206
Medium	17	30%	\$430
Small	15	21%	\$380

- **Most Firms Have Written Supervisory Procedures Concerning Breakpoints, Although Many Were Not Comprehensive**

NASD rules require members to “establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives and associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations.” Similarly, NYSE rules require member firms to maintain and enforce written supervisory procedures.³⁶

Examiners assessed the adequacy of the written supervisory procedures of the 43 firms examined with respect to sales of mutual funds with front-end sales loads. In particular, examiners reviewed the extent to which the firms’ written supervisory procedures cover the following topics: breakpoints, rights of accumulation, letters of intent, account linkages, fund linkages, same-day transactions, exchanges, and reinstatements.

Most firms’ written supervisory procedures generally addressed breakpoints. In fact, 37 out of 43 broker-dealers (86%) had written supervisory procedures addressing

³⁵ Other firms were not included because they did not have a predominant method of processing transactions.

³⁶ NASD Rule 3010 and NYSE Rule 342.

breakpoints, although not all of these firms had comprehensive supervisory procedures in every area. Specifically, examiners found the following:

- 28 (65%) had procedures addressing letters of intent;
- 27 (63%) had procedures addressing rights of accumulation;
- 10 (23%) had procedures addressing account linkages, while only six addressed fund linkages;
- 10 (23%) had procedures addressing exchanges; and
- 9 (21%) had procedures addressing same-day transactions.

All 43 broker-dealers require registered representatives to inform their customers about breakpoints, although 17 broker-dealers do not require this disclosure to be documented in the books and records of the firm. Of the 26 broker-dealers that do require the disclosure to be documented, examiners found a variety of provisions (as described in the discussion of disclosure practices, below).

Approximately two-thirds of firms (65%) had procedures governing the use of letters of intent, but those procedures failed to provide specific details regarding retroactive application of letters of intent (as noted above, examiners found instances where retroactively applying a letter of intent would have provided the customer with a reduced sales charge). Some firms' staff focused on daily purchase reports to see if large purchases had been given the benefit of letters of intent or rights of accumulation. However, without a more systematic or automated approach, firms generally are unable to identify all accounts that could benefit from letters of intent.

Most firms did not have specific procedures concerning account linkages and fund linkages. Of the firms that had procedures addressing account linkages, most did not contain language specifically requiring registered representatives to ask customers about any related accounts that could be linked. As noted above, not considering fund shares owned by persons related to the customer was apparently a significant cause for discounts not being provided.

Not surprisingly, five of the ten firms with the largest number of discounts not provided lacked any written supervisory procedures that specifically addressed rights of accumulation and letters of intent. On the other hand, nine of the ten firms with the least number of discounts not provided had specific written supervisory procedures that addressed both rights of accumulation and letters of intent.

- **Few Firms Require Breakpoint Disclosure in Writing**

Firms' written supervisory procedures generally state that the registered representative must describe to customers the availability of breakpoints, rights of accumulation, and letters of intent. Although all broker-dealers require that their registered representatives disclose mutual fund breakpoints to customers, few require that

this disclosure be made in writing to the customer other than in the prospectus or statement of additional information when recommending a purchase of a mutual fund.³⁷

Methods used to document breakpoint disclosures varied dramatically among firms. Six firms' documentation of disclosure consisted of the customer's signature on the prospectuses' receipt form. Four firms required a notation of breakpoint disclosure by a registered representative on order tickets, four firms required breakpoint letters to be sent to clients, three firms required disclosure forms to be signed by the customer, and one firm only required documentation if the trade met certain thresholds.

Those firms that do provide written disclosure to customers have developed a variety of disclosure instruments. For example, a small broker-dealer that transacted its mutual fund business almost entirely by paper applications provided its registered representatives with a "Breakpoint Disclosure Letter" that highlighted these options in addition to the language contained in the paper application. This firm's letter for front-end load shares provides four different types of disclosure: mutual fund name; investment amount; sales charge; and the sales charge at the next breakpoint. Disclosure could be improved if dollar amounts of subsequent breakpoints were listed. This breakpoint letter also provides space for the registered representative to list other fund families held by the client, and discloses the sales charge or charges that would be available pursuant to rights of accumulation.³⁸

- **Less Than Half of the Firms Generated or Used Exception Reports to Aid in Determining Whether Applicable Breakpoints Were Provided**

Less than half of the firms generated or used exception reports to aid in determining whether applicable breakpoint discounts were provided. Of those firms that had exception reports, none were able to adequately detect all transactions in which customers did not receive the appropriate sales charge. Some areas covered by the reports included rights of accumulation, letters of intent, fund linkages, exchanges, and reinstatements. For example, one firm has an exception report that identifies only mutual fund transactions that individually or combined total over \$100,000 in a single day, though not over time. Another firm generates a report that shows trades greater than

³⁷ Typically, broker-dealers' account statements and confirmations disclose the gross amount invested and the number of shares purchased. Account statements, at a minimum, show the names of funds owned by the customer, the number of shares owned, the value of each investment at the statement date, and the total value of shares held. This does not allow the customer to easily determine whether he/she was charged the appropriate sales charge. The staff notes that the Commission has received few complaints from customers concerning failures by broker-dealers to provide appropriate breakpoint discounts. In fact, the Commission's Office of Investor Education and Assistance reports receiving just ten customer complaints concerning breakpoint discounts in the last two years.

³⁸ Other broker-dealers rely on prompts contained in the firm's proprietary electronic order entry system reminding the registered representative to inform customers of breakpoints associated with load fund purchases.

\$45,000, a report of accounts that have generated greater than \$20,000 in mutual fund commissions and a report of accounts having five or more mutual fund trades in one day.

- **Most Firms Rely on Registered Representatives to Determine Whether a Customer is Entitled to a Breakpoint Discount**

Most firms indicated that they rely on their registered representatives to ensure that a breakpoint discount is received. These firms stated various responsibilities for which they rely on the registered representative, including, disclosing breakpoint opportunities, determining the breakpoint discount, tracking the letters of intent, entering the information correctly into the order system, providing the trader who inputs the trade with linkage information so the customer receives the appropriate breakpoint, identifying related accounts properly, and notifying the customer of any possible reduced sales charges.

While these firms place primary responsibility with the registered representative, some of the firms indicated that registered principals and/or the supervisory office conduct a supervisory review of all mutual fund transactions. Additionally, about half of the firms examined stated that a second person at the firm must review transactions before processing.³⁹

To assist in the supervisory review, one firm indicated that supervisors review all transactions greater than \$10,000 on a monthly basis and conduct a 13-month review of the trade history on each account. Another firm's supervisors use the daily trade blotter to select accounts near breakpoint levels. One firm has in place a system that rejects any order within \$1,000 of a breakpoint and sends a message indicating the amount needed to reach the next breakpoint. If the registered representative still wants to enter the order, he/she must obtain approval from the branch office manager or the Compliance Department. Some of the firms indicated that they place the responsibility for determining whether a customer is entitled to a breakpoint on the firm's automated compliance system. Finally, two firms indicated that they do not conduct any type of supervisory review of a customer's potential entitlement to a breakpoint. A few firms stated that they rely on the mutual fund company or the firm's clearing firm to calculate appropriate breakpoints.

- **Many Firms Cannot Link Accounts Held by the Customer or Persons Related to the Customer to Determine Rights of Accumulation**

As described in this report, in order to accurately compute the proper front-end sales load on a customer's mutual fund purchase, a broker-dealer must have procedures reasonably designed to ascertain all information necessary to establish the correct breakpoint level.⁴⁰ A broker-dealer can do this in a number of ways, as described below.

³⁹ Some of these firms only require a second review for larger trades (e.g., greater than \$25,000).

⁴⁰ NASD Notice to Members 02-85.

When recommending the purchase of a fund that provides breakpoints, a broker-dealer should ask the customer about holdings in the fund/fund family and holdings in any related accounts. Many broker-dealers utilize the fund's own application, which requests the necessary information, or broker-dealers can obtain the information from the customer on its own forms or orally. Of course, customers may decline to provide information about related accounts.

Of the 43 firms examined, examiners found that most firms do not have automated systems in place that aid the registered representatives in identifying related accounts. Other firms have automated systems that link accounts in various ways - these systems link all of a customer's accounts by last name, address, tax identification number, and/or registered representative. These systems assist the registered representative in identifying related accounts.

- **Most Firms Provide Some Form of Training to Personnel**

Forty-two of the 43 firms (98%) indicated that they provide some form of training on mutual fund sales, and 36 of the firms (84%) indicated that they provide some form of training relating to mutual fund sales charge discounts. Seven firms (16%) acknowledged that they do not provide training on mutual fund breakpoints and/or sales charges. Responses from the firms indicated five common methods of training in this area:

- annual compliance meetings;
- continuing education programs;
- on-line resources;
- compliance bulletins/updates; and
- presentations conducted by representatives of mutual fund families.

For those firms that do require training in this area, most of the firms examined provide the training on an annual basis, primarily through the firm's annual compliance meeting and/or continuing education program. In addition, some firms indicated that such training is required for all new employees upon hire.

VI. Broker-Dealers Report They Are Reviewing Their Practices

Clearly, the results of these examinations warrant that broker-dealers who sell fund shares that offer breakpoint discounts, review and improve their practices to ensure that customers receive appropriate breakpoint discounts. These firms must ensure that they have adequate supervisory and compliance procedures so that customers receive the appropriate sales charge discounts, including breakpoint discounts. As discussed in NASD Notice to Members 02-85, broker-dealers must review their practices to:

- ensure that registered representatives and other personnel engaged in processing these transactions understand the terms of offerings and reinstatements;

- ascertain the information that should be recorded on the books and records of the member or its clearing firm, which is necessary in determining the availability and appropriate level of breakpoints;
- apprise the customer of the breakpoint opportunity and inquire whether the customer has positions or transactions away from the member which should be considered in connection with a pending transaction;
- make sure that the personnel processing these transactions are appropriately trained in order to ensure that the information pertaining to all aspects of a mutual fund order, including any applicable breakpoint, is accurately transmitted in a manner retrievable by the mutual fund company; and
- have in place appropriate and sufficient procedures, including supervisory procedures, with respect to the availability of breakpoint opportunities and breakpoint calculations.⁴¹

The Commission staff and NASD are acting to remind firms of their responsibilities. In December 2002, the NASD issued a notice to all of its members reminding them of their obligations, accompanied by a letter from Commission Staff.⁴² Then, on January 16, 2003, the Commission staff and NASD sent a letter to all broker-dealers that conduct business with the public requiring them to provide the following information:

- 1) a description of the steps the firm had taken in response to NASD Notice to Members 02-85 regarding sales loads on mutual fund transactions;
- 2) a description of the results of the firm's review of the adequacy of its policies and procedures related to breakpoints; and
- 3) whether the firm is in compliance with its policies and procedures and NASD rules relating to breakpoints.

Most of the firms that sell mutual funds with front-end loads responded that they have conducted a review of the adequacy of the firms' policies and procedures related to breakpoints.⁴³ Most stated that they had adequate procedures in place regarding breakpoints and that they were in compliance with their own policies and procedures and NASD rules relating to breakpoints. A small number of firms indicated that they were either not in compliance with their own breakpoint policies and procedures or not in compliance with NASD rules regarding breakpoints, or did not respond to the question. Regulators will follow-up with these firms.

⁴¹ NASD Notice to Members 02-85.

⁴² NASD Notice to Members 02-85.

⁴³ According to NASD's January 16, 2003 electronic survey of firms, 1,956 of 5,182 firms responding reported front-end load mutual fund revenue in 2002.

Most firms have reported that they have taken steps to ensure enhanced focus on breakpoints. Among the steps taken by firms (and the number of firms taking the step) were the following:

- review of mutual fund transactions (365);
- improving policies and procedures (339);
- reiterating breakpoint issues to firm employees (281);
- providing new training for employees on breakpoints (200);
- discussion of respective responsibilities with clearing firms (140);
- enhancing or adopting new supervisory or compliance reviews or exception reports (133);
- distributing NASD notice to members on breakpoints to employees (121);
- making systems changes to create better automated exception reports (91);
- developing/sending forms to mutual fund investors requiring their signature to acknowledge their understanding of breakpoints (87);
- contacting mutual funds or transfer agents to get information and discuss responsibilities (61);
- setting up a task force to review breakpoint compliance (50);
- providing additional customer disclosure (34);
- requiring certain breakpoint information on order tickets (27);
- adding breakpoints to areas for audit review (20);
- employing a consultant to conduct a review (12); and
- limiting number of mutual funds sold (1).

VII. Conclusions and Remedial Actions

The limited nature of the examination sweep and the transactions reviewed does not permit examiners to determine the extent of the breakpoint problem industry-wide. Results of the examinations confirm, however, that there are transactions that did not receive eligible breakpoint discounts at a variety of broker-dealers, at most firms examined, and in a number of transactions that regulators conclude are serious enough to warrant additional action to determine the scope of the problem. As a result:

- Broker-dealers engaged in front-end load mutual fund transactions will be immediately required by NASD to conduct an assessment of a sample of their front-end load mutual fund sales transactions. The purpose of the sample is to provide the firm and regulators with an indication of whether the firm has provided appropriate discounts to customers. To ensure the highest degree of integrity in the process, NASD, in consultation with the SEC, will develop a standard methodology to be utilized for the sample that will be designed to provide a representative sample of the firm's transactions and opportunities for a breakpoint. It is estimated that approximately 2,000 firms sell front-end load

mutual funds.⁴⁴ Firms will be required to submit the results of the sample analysis to NASD within a specified deadline.⁴⁵

Following the receipt of each firm's sample review, additional actions will be taken as appropriate based on the results of each sample review, which may include requiring firms to contact customers, and/or conducting a larger review of transactions over a longer period of time. Firms will be required to refund to customers any amounts that are found to have been overcharged. Regulators will also consider disciplinary or enforcement actions.

As noted in this report, broker-dealers have already been directed to review their policies and procedures to ensure that they are adequate to assess and provide appropriate breakpoint discounts, and broker-dealers are doing so. In addition, NASD is leading a Task Force of industry participants, the NYSE, the Investment Company Institute and the Securities Industry Association to identify and recommend changes to prevent abuses and eliminate errors in the calculation of sales loads in the future. Specifically, the Task Force is charged with finding possible universal order processing solutions to ensure delivery of eligible breakpoint discounts in mutual fund transactions.

While the Task Force is actively engaged in developing future improvements, all broker-dealers that sell front-end load mutual funds are obligated to review past transactions to ensure that customers have been charged appropriate sales charges.

Appendix: Results of NASD Survey

⁴⁴ According to the NASD's January 16, 2003 electronic survey of firms.

⁴⁵ Examiners will test the efficacy of the self-assessment process during subsequent examinations. For example, self-assessments will become part of the subject firm's examination file and self-assessment results may be tested for accuracy during the routine and special examinations. Firms that fail to follow the self-assessment methodology or that misrepresent results may be subject to investigation and potential disciplinary action.

Appendix: Results of NASD Survey

On January 16, 2003, NASD conducted an on-line survey of its member broker-dealers through NASD's website. The purpose of the survey was to obtain additional statistical information concerning broker-dealers' sales of mutual funds. As of February 14, 2003, a total of 5,182 broker-dealers had responded to the survey (a 93.4% response rate). Of these firms, 2,977 reported that they did not generate any income from the sale of front-end load funds within the past five years, and were therefore excluded from the analysis that follows. A total of 1,956 firms reported that they generated revenue from the sale of front-end load funds in 2002. The survey responses for those firms, which have not been verified by NASD, are summarized below.

- **Of the broker-dealers that sell mutual funds with front-end loads, one-third (32.8%) of their revenue from mutual funds is derived from the sale of front-end load funds. The majority of firms that sell front-end load funds report that they generated \$500,000 or less in revenue from sales of front-end load funds.**

Reported Revenue in 2002 From Sales of Front-End Load Funds	Firms Reporting	% of Firms
\$1 to \$500,000	1583	80.9%
\$500,000 to \$1 million	116	5.9%
\$1 million to \$5 million	140	7.2%
\$5 million to \$20 million	81	4.1%
\$20 million to \$100 million	29	1.5%
\$100 million to \$1 billion	7	0.4%

- **About half of all mutual fund transactions are reported to be processed via the funds' application, slightly less than half are reported to be processed electronically through Fund/SERV.**

Method Used to Place Orders for Mutual Fund Shares	Firms Reporting	Average % Transactions Based on Indicated Firm Use
Application	1598	51.9%
Wire order	195	2.9%
Through Fund/SERV	1638	45.2%

- **45% of the broker-dealer revenue from the sales of mutual funds is generated by sales of Class A shares.**

Mutual Fund Class Type	Firms Reporting	% of Mutual Fund Revenue in 2002	2002 Total Industry Mutual Fund Revenue by Class Type
Class A Shares	1579	45.0%	\$3,843,840,302
Class B Shares	1246	33.9%	\$2,898,719,703
Class C Shares	1017	16.8%	\$1,436,879,863
Other front end loaded classes	441	4.2%	\$361,829,102

- **Of the total revenue generated by all broker-dealers selling front-end load mutual funds, approximately 90% is generated by 117 broker dealers.**
- **Many broker-dealers report having 75 or fewer selling agreements with different mutual fund families. Almost half of broker-dealers report having fewer than 25 selling agreements.**

Selling Agreements	Firms Reporting	% of Firms With Selling Agreements
1 to 25	960	47.7%
25 to 50	419	20.8%
50 to 75	208	10.3%
75 to 100	110	5.5%
100 to 125	82	4.1%
125 or more	235	11.7%

- **Most broker-dealers reported that they do not maintain automated databases that provide mutual fund breakpoint information and link related customer accounts. Even fewer link these databases. The firms with the highest levels of revenue from the sale of front-end load funds were most likely to maintain databases, while the firms with the lowest levels of revenue were least likely to do so.**

Database	Fund Revenue \$1-\$1 mil	Fund Revenue 1mil-\$5 mil	Fund Revenue \$5 mil-\$20 mil	Fund Revenue \$20 mil-\$100 mil	Fund Revenue \$100 mil-\$1 bil	% of All Firms
Maintain a Database of Mutual Fund Information Regarding Breakpoints	31.1%	39.3%	37.0%	51.7%	100%	32.5%
Maintain a Database of Customer Information With Linking Capability	24.2%	28.6%	28.0%	34.6%	71.4%	25.0%
Ability to Link the Above Two Databases	14.4%	18.0%	14.5%	18.5%	57.1%	14.9%
