

**NASD**  
**LETTER OF ACCEPTANCE, WAIVER AND CONSENT**  
**NO. CAF040003**

TO: Department of Enforcement  
NASD

RE: American Express Financial Advisors, Inc. Respondent  
CRD No. 6363

Pursuant to Rule 9216 of NASD Code of Procedure, Respondent American Express Financial Advisors, Inc. submits this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described in Part II below. This AWC is submitted on the condition that, if accepted, NASD will not bring any future actions against Respondent alleging violations based on the same factual findings.

Respondent understands that:

1. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by NASD's Department of Enforcement and National Adjudicatory Council ("NAC") Review Subcommittee or Office of Disciplinary Affairs ("ODA"), pursuant to NASD Rule 9216;
2. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against Respondent; and
3. If accepted:
  - a. this AWC will become part of Respondent's permanent disciplinary record and may be considered in any future actions brought by NASD or any other regulator against it;
  - b. this AWC will be made available through NASD's public disclosure program in response to public inquiries about Respondent's disciplinary record;
  - c. NASD may make a public announcement concerning this agreement and the subject matter thereof in accordance with NASD Rule 8310 and IM-8310-2; and
  - d. Respondent may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any allegation in

this AWC or create the impression that the AWC is without factual basis. Nothing in this provision affects any testimonial obligations or right to take legal or factual positions in litigation or other legal proceedings in which NASD is not a party.

Respondent also understands that its experience in the securities industry and disciplinary history may be factors that will be considered in deciding whether to accept this AWC. That experience and history are as follows:

Respondent has been an NASD member since 1972. It has no relevant formal disciplinary history.

I.

**WAIVER OF PROCEDURAL RIGHTS**

Respondent specifically and voluntarily waives the following rights granted under NASD's Code of Procedure:

- A. To have a Formal Complaint issued specifying the allegations against it;
- B. To be notified of the Formal Complaint and have the opportunity to answer the allegations in writing;
- C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and
- D. To appeal any such decision to the NAC and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, Respondent specifically and voluntarily waives any right to claim bias or prejudgment of the General Counsel, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

Respondent further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of Rule 9143 or the separation of functions prohibitions of Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

## II.

### ACCEPTANCE AND CONSENT

A. Respondent hereby accepts and consents, without admitting or denying the allegations or findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of NASD, or to which NASD is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by NASD:

#### SUMMARY

During 2001 and 2002 (the "relevant period"), Respondent sold shares issued by mutual funds without providing certain customers with the reduction in the front-end loads, or sales charges, also known as "breakpoint" discounts, described in the prospectuses of the funds. According to data submitted to NASD by Respondent, Respondent is estimated to have failed to give certain customers breakpoint discounts totaling approximately \$3,706,693 during the relevant period. By failing to give certain customers the benefit of applicable breakpoint discounts and by failing to disclose to those customers that they were not receiving the benefit of applicable breakpoint discounts, Respondent violated NASD Conduct Rule 2110.

#### BACKGROUND

Sales of mutual funds are a significant part of investing for the public. Recent estimates indicate that mutual fund assets total approximately \$7 trillion in 2003. One critical aspect of mutual fund sales is the cost to the investor who chooses to purchase shares of the fund. Broker-dealer firms are required to understand the costs of the product that they sell to their customers and to provide each customer with the discounts applicable to the sale.

Mutual fund costs borne by investors generally fall into two categories: sales charges collected directly from shareholders for specific transactions (such as a purchase, redemption, or exchange) and fees and operating expenses imposed continuously on fund assets.<sup>1</sup> A "front-end load" is an industry term for a sales charge that certain fund principal underwriters or distributors charge at the time an

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<sup>1</sup> Annual operating expenses are not charged directly to investors but are deducted from fund assets. These expenses include the management fee, an ongoing charge paid to an investment adviser who manages the fund's assets and selects its portfolio of securities. Some funds charge a Rule 12b-1 fee, named for the rule under the Investment Company Act of 1940 that authorizes mutual funds to pay for distribution expenses, including sales charges used to compensate sales professionals for selling fund shares, directly from a fund's assets. A fund may also pay a service fee to compensate sales professionals or other service providers for ongoing services to investors or their accounts. In addition, all mutual funds incur brokerage and other transaction-related costs that are borne indirectly by the investors in the funds.

investor buys shares. When an investor buys shares with a front-end load, the front-end load portion of the offering price is not invested in the fund, but instead is paid to the fund's principal underwriter or distributor, which in turn pays a part of this amount to the broker-dealers that sell fund shares to retail customers. Typically, front-end loads for shares of equity funds start at 4% to 5.75%.

A fund may offer different classes of shares. Typically, shares denominated as "Class A" charge a front-end load. Other classes (e.g., Class B, Class C, etc.) have differing sales charge and expense characteristics.<sup>2</sup> "No-load" funds do not have any front-end or deferred sales charges.

### BREAKPOINTS

Mutual funds that sell shares charging front-end loads usually offer discounts at certain pre-determined levels of investment, which are called "breakpoints." Front-end loads and breakpoints can vary among funds within a fund complex or across fund complexes. For example, a mutual fund might charge an investor 5.75% of the sales price for purchases of less than \$50,000, but reduce the sales charge to 4.75% for investments between \$50,000 and \$99,999. An investor can usually procure discounts on sales charges at investment levels of \$50,000, \$100,000, \$250,000, and \$500,000. At the \$1 million investment level, generally there is no sales charge.

Generally, an investor can procure a breakpoint discount through either a single purchase large enough to reach a breakpoint, or through multiple purchases in a single mutual fund or any of the funds in a fund complex the aggregate value of which is large enough to reach a breakpoint. An investor may aggregate current purchases with prior purchases in one or more accounts over time to meet an applicable breakpoint threshold through a "right of accumulation." Many mutual funds also offer breakpoints through a "letter of intent," which is a written statement of intent by an investor to purchase a certain amount of mutual fund shares over what is usually a thirteen-month period.

Finally, many mutual funds aggregate purchases by an individual with shares held by members of the same family or the same household and through other related accounts, such as trust accounts and IRAs. The criteria for breakpoints for each mutual fund are set out in the fund prospectus and statements of additional information. The specific criteria for breakpoints, which are determined by the mutual funds, vary among different mutual funds and among different mutual fund families, and can vary by fund.

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<sup>2</sup> For example, Class B shares generally carry "contingent deferred sales charges," which means that a charge is assessed if shares are redeemed within a certain number of years after purchase. Class B and Class C shares generally impose higher Rule 12b-1 fees, but impose no front-end load.

Mutual funds are required to disclose the schedule of available breakpoints in their prospectuses and disclose how an investor may qualify for breakpoints either in their prospectuses or in their statements of additional information, both of which are filed with the SEC on Form N-1A. Mutual funds generally incorporate by reference into their prospectuses the information included in their statements of additional information.

### **BROKER-DEALER'S RESPONSIBILITY TO ENSURE CUSTOMER RECEIVES APPROPRIATE BREAKPOINTS**

When a broker-dealer sells Class A shares of a mutual fund to its customers, the customer generally pays a front-end sales charge, and the broker-dealer and, in most cases, the individual registered representative, receives a portion of that sales charge or sales load. A broker-dealer that sells shares bearing a front-end load must take steps reasonably designed to: (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) ensure that the personnel processing these transactions are appropriately trained so 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. NASD addressed these matters in *Special Notice to Members 02-85* (December 2002).

### **BROKER-DEALER SELF-ASSESSMENTS**

From November 2002 through January 2003, the SEC, NASD, and the New York Stock Exchange reviewed thousands of mutual fund transactions at forty-three broker-dealers that sold mutual fund shares with front-end loads. Examiners found widespread failures to deliver breakpoint discounts to eligible customers among the transactions reviewed.

In addition to alerting member firms to this issue and directing firms to take measures to ensure that customers receive appropriate breakpoint discounts in the Special Notice to Members mentioned above, as a result of the examination findings, in March 2003 NASD directed broker-dealers that processed 100 or more automated purchases of front-end load Class A mutual fund shares in either 2001 or 2002 to conduct a "self-assessment" of their record of delivering breakpoint discounts to customers, based on the customers' accounts and related accounts

held at the broker-dealer. The self-assessment was designed to produce a statistically significant sample that would allow NASD to assess the scope of overcharges at individual firms and to gauge the scope of the problem across the industry as a whole. The self-assessment is described in *Notice to Members 03-47* (August 2003).

The results of the self-assessment and the specific remedial measures were addressed in a joint NASD-SEC news release dated November 3, 2003. In that release, NASD and the SEC noted that appropriate breakpoints were not delivered in about one of five eligible transactions,<sup>3</sup> and that industry-wide, overcharges averaged \$243, and reached as high as \$10,000 in one transaction. Based on this data reported by Respondent and other NASD member firms, NASD estimates that broker-dealers, in the aggregate, failed to deliver at least \$86 million in breakpoint discounts to eligible customers in 2001 and 2002.

### RESPONDENT'S OVERCHARGES

Based on the self-assessment data submitted by Respondent, the statistical analysis directed by NASD reflected to a 90% confidence level that (i) Respondent failed to give its customers breakpoint discounts in 29.70% of eligible mutual fund transactions in 2001 and 2002, and (ii) this resulted in missed breakpoints that would have reduced customers' charges by at least \$3,706,693 on their purchases of mutual fund shares with front-end loads during the relevant period.

### NASD CONDUCT RULE 2110

NASD Conduct Rule 2110 requires member firms to observe high standards of commercial honor and adhere to just and equitable principles of trade and prohibits material misstatements and omissions. Because of the large number of mutual funds offering different discounts and employing different criteria for determining breakpoint eligibility, many broker-dealers have experienced operational challenges and other difficulties in assuring that customers consistently receive the applicable discounts. Nevertheless, each broker-dealer is responsible for exercising due care, based on information reasonably ascertainable by the broker-dealer, to provide the appropriate breakpoint discounts. In pricing mutual fund transactions, Respondent owed its customers a duty to provide available breakpoint discounts, and by its failure to do so in eligible transactions, as well as by its failure to disclose to certain customers that they were not receiving the benefit of applicable breakpoint discounts during the relevant period, Respondent violated NASD Conduct Rule 2110.

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<sup>3</sup> For purposes of the self-assessment, "eligible transactions" were automated purchases of Class A shares of at least \$2,500 in which a sales charge of 1% or more was charged to the customer and a breakpoint discount was applicable.

B. Respondent also consents to the imposition, at a maximum, of the following sanctions:

1. A censure.
2. A fine of \$3,706,693, of which one half shall be paid to NASD and one half shall be paid to the U.S. Treasury pursuant to related SEC proceedings being instituted against Respondent on this date.
3. Respondent agrees to complete the following undertakings within the time periods specified below, unless extended in writing by NASD staff for good cause shown:
  - a. provide written notification to each customer who purchased front-end load mutual funds through Respondent from January 1, 1999 through November 3, 2003, that Respondent experienced a problem delivering breakpoint discounts and that as a result, the customer may be entitled to a refund. Respondent shall notify customers using the form letters to be provided by NASD staff without any modification to the content unless written approval is granted by NASD staff. The letter and claim form must be delivered to each individual customer who purchased Class A shares with a front-end load on an automated basis by January 15, 2004, and to each customer who purchased Class A shares at NAV, purchased any other front-end load shares, or purchased on an application basis by February 17, 2004, whether or not the customer still maintains an account with Respondent. After Respondent has been notified by a customer that he or she may not have received all applicable breakpoint discounts, Respondent will review its records and any other available information to determine whether the customer is entitled to a refund and to determine the amount of the refund.
  - b. perform a trade-by-trade analysis of all front-end load mutual fund purchases of \$2,500 or more, including paper application transactions, from January 1, 2001 through November 3, 2003. Respondent will review all other purchases by each customer who had such a purchase (including paper application transactions), regardless of dollar amount, during the period January 1, 2001 through November 3, 2003, and undertake vigorous efforts to locate each customer identified as entitled to a refund. This review must be completed, and all overcharges identified refunded, by March 31, 2004.
  - c. provide refunds to all customers who did not receive all applicable breakpoint discounts, as described in *Notice to*

*Members 03-47.* This obligation applies to customers identified through the self-assessment, those entitled to a refund as a result of the trade-by-trade review described above, and other customers entitled to a refund who come forward (including claims related to breakpoints that accrued by virtue of purchases or mutual fund holdings made or held away from Respondent), including those who respond to the letter discussed in II.B.3.a., above. Such refunds must be made promptly and, in any event, no later than 90 days after any inquiry made by a customer.

d. provide to NASD, by April 16, 2004, a report on Respondent's refund program, which report shall include, among other things: (1) a detailed description of the efforts made to locate customers identified as entitled to refunds; and (2) the results of Respondent's refund program, including the number of customers identified as entitled to refunds, the dollar amount of refunds owed, the number of customers located and unable to locate, and dollars owed to customers located and not located.

e. not later than six months after the date of this order, Respondent's chief executive officer shall certify in writing to NASD staff that Respondent has implemented procedures, and a system for applying such procedures, that can reasonably be expected to prevent and detect failures by Respondent to provide appropriate breakpoint discounts for which customers are eligible on purchases of front-end load mutual funds, based on information reasonably ascertainable by Respondent.

Failure to comply with this undertaking may result in further disciplinary action against Respondent.

### III.

#### OTHER MATTERS

- A. Respondent understands that it may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Respondent understands that it may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by NASD, nor does it reflect the views of NASD or its staff.
- B. Respondent agrees to pay any monetary sanctions imposed on it within ten days of notice that this AWC has been accepted.

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Failure to comply with this undertaking may result in further disciplinary action against Respondent.

III.

**OTHER MATTERS**

- A. Respondent understands that it may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Respondent understands that it may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by NASD, nor does it reflect the views of NASD or its staff.
- B. Respondent agrees to pay any monetary sanctions imposed on it within ten days of notice that this AWC has been accepted.
- C. Respondent specifically and voluntarily waives any right to claim that it is unable to pay, now or at any time hereafter, any monetary sanction imposed in this matter.

The undersigned certifies on behalf of Respondent that I have read and understand all of the provisions of this AWC and have been given a full opportunity to ask questions about it, and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein, has been made to induce me to submit it.

January 5, 2004  
Date

American Express Financial Advisor's Inc  
Respondent  
By: [Signature]  
[Name and title]

Reviewed by:

[Signature]  
Counsel for Respondent

Accepted by NASD:

Feb 5, 2004  
Date

  
Director, Department of  
Enforcement

Signed on behalf of the Director  
of ODA, by delegated authority