

Special Notice to Members

DECEMBER 2002

SUGGESTED ROUTING

Legal and Compliance
Operations
Senior Management

KEY TOPICS

Mutual Funds Transactions
Breakpoints

IMMEDIATE ACTION REQUIRED

NASD Requires Immediate Member Firm Action Regarding Mutual Fund Purchases and Breakpoint Schedules

Executive Summary

Mutual funds that are sold with front-end sales loads often offer investors the opportunity to pay reduced sales loads under a variety of circumstances. The specified levels of dollar investment at which the front-end sales charge is reduced are set by the mutual fund company and are generally termed "breakpoints." As set by the mutual fund, the breakpoint levels can be reached through aggregating investments in specified related accounts.

As a result of recent and ongoing examinations, NASD and Securities and Exchange Commission (SEC) staff are concerned that some member firms have not been charging investors the correct sales loads in many instances, particularly for mutual fund transactions involving letters of intent and rights of accumulation. NASD is directing each of its member firms that sells mutual fund shares to immediately review the adequacy of its policies and procedures to ensure that they are designed and implemented so that investors are charged the correct sales loads on mutual fund transactions. This review must include an assessment by each firm of whether it has been charging investors the correct sales loads. Firms must promptly adopt and implement any changes to their policies and procedures that are necessary to ensure that investors are charged the correct sales loads on mutual fund transactions in the future. Finally, each firm must retain a record of its review and the results for examination by NASD.

In order for a customer purchasing a mutual fund through an NASD member firm to incur the most beneficial (the lowest) front-end sales charge percentage, complete information relating to the customer and certain related accounts is necessary. The required

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information relates to the customer's account and related and linked accounts and includes the dollar size of the pending transaction, the dollar size of anticipated transactions, and amounts previously invested in the specific fund and other related funds, valued as specified in the prospectus.

With the advent of automated processing and settlement systems in the mutual fund industry, such as Fund/SERV, it is essential for members to enter correctly into these systems the breakpoint information pertaining to customer transactions. Members must have procedures reasonably designed to ascertain all information necessary to establish the correct breakpoint level; training and procedures to ensure that personnel understand the proper steps for inputting the information correctly into the automated processing and settlement system; and supervisory procedures that reasonably ensure compliance in this area. Due to the fact that automated processing and settlement systems may not disclose to the mutual fund company the identity of the member's customer, members cannot rely on the mutual fund company to allocate the correct breakpoint to a transaction or override the member's failure to do so.

After consultation with SEC staff, NASD is issuing this *Notice to Members* to alert members to this important issue and to specify appropriate member action that must be taken immediately to ensure that their customers receive the advantage of breakpoints to which the customers are entitled, namely, a reduction in the sales charges commensurate with the size and nature of the customers' transactions.

Questions/Further Information

Questions regarding this *Notice* may be directed to Marc Menchel, Senior Vice President and General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8071, or Daniel Sibears, Senior Vice President and Deputy, Department of Member Regulation, Regulatory Policy and Oversight, NASD, (202) 728-8221.

Discussion

Mutual funds sold with a front-end sales charge often have a breakpoint schedule that affords investors the opportunity to receive a discount on the front-end sales charge based on the specified dollar amounts of a transaction or series of transactions. For example, a mutual fund might charge a front-end sales load of 5.75% for all purchases less than \$50,000; reduce that front-end sales charge to 4.50% for purchases aggregating at least that amount, but less than \$100,000; and further reduce, or eliminate, the sales charge for various greater levels of aggregate purchases. Each mutual fund and family of funds can, in accordance with applicable law and disclosure requirements, set the terms concerning breakpoints. The terms for breakpoints thus vary from fund to fund.

Investors may be entitled to a reduced front-end sales charge based on a single transaction because of its dollar amount. In addition, investors may become entitled to receive breakpoints by using letters of intent or based on rights of accumulation. A letter of intent ("LOI") is a statement signed by the investor indicating his intent to purchase a certain amount of fund shares over a stated period of time. A right of accumulation ("ROA") is the discount or breakpoint

received in a current mutual fund transaction based on the cumulative value of previous transactions. In the case of either LOIs or ROAs, the other purchase transactions that are credited towards the discount may occur in accounts that are related or linked to the investor and in different mutual funds that are part of the same fund family.

Dramatic growth in the number of fund families, share classes, and, to a lesser extent, customer account types, has underscored the need to assure that breakpoints are applied appropriately. Breakpoint schedules, and the conditions under which discounts are available, differ among fund families, as noted above. For example, different fund families establish different opportunities to link accounts, transactions, and share classes. Sales charge discounts related to reinstated transactions¹ and exchanges also differ among fund families.

Prior to the advent of automated processing and settlement systems for mutual fund transactions, many members dealt directly with the fund complexes in the settlement of transactions on a basis in which the customer's identity was disclosed. This allowed the mutual fund company the opportunity to apply breakpoints in cases where the discount may not have been properly applied by the member effecting the transaction. NASD understands that many firms now utilize automated processing and settlement systems, such as Fund/SERV,² in which the underlying customer's identity may not be disclosed. The mutual fund company may be unable to monitor the application of the appropriate discount.

The terms of the dealer agreement with a mutual fund company or complex generally require the member in its

capacity as the dealer to assure that the member provides the appropriate breakpoint in a given transaction or series of transactions. Whether or not the terms of the dealer agreement imposes this obligation, 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 company³; and (5) have in place appropriate and sufficient procedures, including supervisory procedures, with respect to breakpoint calculations.

In addition to the rights and obligations created by virtue of applicable clearing agreements and dealer agreements, 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). Introducing firms must, therefore, determine (based on the services offered by their clearing firms, other systems

utilized to effect mutual fund transactions, or a combination of both) that they have the capacity and capability to ensure that customers receive the benefit of all applicable discounts.

Conclusion

NASD and SEC staff consider it essential that mutual fund executions are effected on the terms most advantageous to the customer. Determining the correct sales charge is an obligation held by members and requires a high degree of vigilance to ensure that customers receive the full benefit of available price discounts to which they are entitled. Such vigilance includes extensive product and customer knowledge on the part of registered representatives and related personnel and requires appropriate training, policies and supervisory procedures.

Endnotes

- 1 A fund may offer its shareholders a "reinstatement privilege" to redeem or sell shares in the fund and allow the shareholder to reinvest some or all of the proceeds, by paying a reduced sales load or no sales load, within a specified period of time (for example, 180 days), in the same share class of that fund or another fund within the same fund family subject to other terms and conditions.
- 2 FundSERV is a mutual fund transaction processing and settlement service offered by the National Securities Clearing Corporation.
- 3 NASD has reason to believe that in certain cases members have incorrectly transmitted breakpoint information through Fund/SERV by populating the wrong fields in their transaction input system. Members must assure themselves that personnel understand and adhere to the appropriate protocols in submitting information.