Notice to Members

NOVEMBER 2003

SUGGESTED ROUTING

Legal and Compliance

Registered Representatives

Senior Management

KEY TOPICS

Charges for Services Performed

Fee-Based Compensation

NASD Rule 2110

NASD Rule 2430

ACTION REQUIRED

Fee-Based Compensation

NASD Reminds Members That Fee-Based Compensation Programs Must Be Appropriate

Executive Summary

Fee-based programs typically charge a customer a fixed fee or percentage of assets under management in lieu of transaction-based commissions. While NASD recognizes the benefits these programs offer for many customers, they are not appropriate in all circumstances. NASD therefore reminds members that they must have reasonable grounds for believing that a fee-based program is appropriate for a particular customer, taking into account the services provided, cost, and customer preferences.

Questions/Further Information

Questions concerning this *Notice* should be directed to Philip Shaikun, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8451.

Background and Discussion

NASD members increasingly are offering customers fee-based accounts that charge a fixed fee and/or percentage of assets under management ("fee-based programs") as an alternative to traditional commission-based charges for brokerage services. Many of these members have expanded their fee-based programs to cover traditional brokerage accounts that do not include investment advisory services.[1] Previously, these programs typically involved "wrap" accounts, where broker/dealers provide investors with a suite of services—asset allocation, portfolio management, execution and administration—for a single fee. Most traditional wrap accounts are considered advisory accounts subject to the Investment Advisers Act.[2]

The 1995 Report of the Committee on Compensation Practices (the "Tully Report")[3] labeled fee-based programs a "best practice" because they more closely align the interests of the broker/dealer and customer and reduce the likelihood of abusive sales practices such as churning, high-pressure sales tactics, and recommending unsuitable transactions.4 The Tully Report noted that fee-based programs are particularly appropriate for investors who prefer consistent and explicit monthly or annual charges and those that engage in at least a moderate level of trading activity.

On the other hand, the Tully Report acknowledged that fee-based programs may not fit the needs of certain investors. In this regard, commenters to the Tully Committee noted that accounts with low trading activity may be better off with a commission-based program. These accounts might include those comprised mainly of bonds or mutual funds, but also could contain individual capital appreciation equities where the customer has a stated buy-and-hold strategy.

Fee-Based Accounts Must Be Appropriate

It generally is inconsistent with just and equitable principles of trade—and therefore a violation of Rule 2110—to place a customer in an account with a fee structure that reasonably can be expected to result in a greater cost than an alternative account offered by the member that provides the same services and benefits to the customer.[5] Accordingly, before opening a fee-based account for a customer, members must have reasonable grounds to believe that such an account is appropriate for that particular customer. To that end, members should make reasonable efforts to obtain information about the customer's financial status, investment objectives, trading history, size of portfolio, nature of securities held, and account diversification. With that and any other relevant information in hand, members should then consider whether the type of account is appropriate in light of the services provided, the projected cost to the customer, alternative fee structures that are available, and the customer's fee structure preferences. In addition, members should disclose to the customer all material components of the fee-based program, including the fee schedule, services provided, and the fact that the program may cost more than paying for the services separately.

NASD recognizes that factors other than cost may properly be considered to determine whether an account is appropriate for a customer. Thus, for example, a customer may place a premium on the positive characteristics of fee-based programs identified in the Tully Report: having his or her interests aligned with that of the member and registered representative and the certainty and consistency of cost that many fee-based programs provide. These non-price factors may constitute significant benefits to a particular customer; therefore, a member may give them corresponding weight in determining the appropriateness of a fee-based account for that customer. Even where a fee-based account is determined to be appropriate, members still must comply with their longstanding obligations under Rule 2430.[6]

Absent inducement by the member, no liability under Rule 2110 (unless derivative of another rule violation) will attach to a member where it is disclosed to a customer that a potentially lower cost account is available, but the member can demonstrate that the customer nevertheless opted for a fee-based account for reasons other than pricing.[7] In such circumstances, the member should document the fact that the customer chose a fee-based account for reasons other than cost.

Supervisory Procedures

Members should implement supervisory procedures to require a periodic review of fee-based accounts to determine whether they remain appropriate for their respective customers.[8] As part of that review, members should consider whether reasonable assumptions about market conditions upon which the member based its initial determination of appropriateness have changed, as well as any changes in customer objectives or financial circumstances.

Members also may wish—but are not required—to create reports that compare the asset-based fees to those that would have been generated in the same account on a commission basis. Since the appropriateness of a fee can be based upon factors other than cost to the customer, a retrospective finding that a customer would have been charged less in a commission-based account is not conclusive that the account is inappropriate for that customer. However, such a finding should cause the member to give careful scrutiny to those issues. Finally, members should review their sales literature, marketing material, and other correspondence related to fee-based programs to ensure the information is balanced and not misleading, and should include in training materials guidelines regarding the establishment of fee-based accounts.

Endnotes

1 A 1999 SEC proposal to specifically exempt from the Investment Advisers Act these fee-based brokerage programs is awaiting final action. Under the proposal, only non-discretionary accounts where incidental advice is provided would be exempt. Exchange Act Release No. 42099 (November 4, 1999).

2 This *Notice to Members* is focused on brokerage accounts that do not require registration under the Investment Advisers Act, but members nonetheless must ensure that advisory products and services are appropriate for a customer and that charges for such services are reasonable.

In determining whether a broker/dealer meets the definition of "investment adviser," the SEC has excluded circumstances where advice given is solely incidental to typical brokerage services, such as execution and administration. The SEC has commented that the exception "amounts to a recognition that brokers and dealers commonly give a certain amount of advice to their customers in the course of their regular business and that it would be inappropriate to bring them within the scope of the [Advisers Act] merely because of this aspect of their business." Exchange Act Release No. 34-42099 (November 4, 1999).

3 SEC Committee on Compensation Practices, Report on Broker-Dealer Compensation (April 10, 1995), available at *www.sec.gov/news/studies.shtml* (last modified July 25, 2003).

4 Fee-based programs do not always align the interests of representative and customer: for example, income-producing securities may be more appropriate for certain investors, but because such securities may result in lower fees than would be produced by a portfolio of capital appreciation stocks, there could be an economic disincentive to recommend these securities. Some commenters also have expressed concern that fee-based programs might encourage account neglect. These concerns are most pronounced when the registered representative has discretionary authority over the account.

5 Depending on the facts and circumstances surrounding the establishment of, and transactions in, a fee-based account, failure to obtain and assess for suitability the aforementioned information could result in a violation of Rule 2310. *See Wendell Belden*, Exchange Act Release No. 47859 (May 14, 2003). NASD construes *Belden* as supporting the principle that the manner of purchase of a recommended security by an associated person, where that security otherwise would be suitable based on the investor's investment objectives, risk tolerance, and financial means, can render that recommendation unsuitable, and therefore violative of 2310, if there is an alternative basis upon which the security can be purchased to the pecuniary advantage of the investor.

6 Rule 2430 requires that charges for services "shall be reasonable and not unfairly discriminatory between customers." See *Notices to Members 92-11* and *75-65*. In referring to the predecessor rule to current Rule 2430, *Notice to Members 75-65* states that charges must be "fair under the relevant circumstances and a member should be prepared to justify that its prices are fair as to each customer and transaction." This standard remains applicable today.

7 Evidence of such disclosure does not, by itself, demonstrate that a customer opted for a fee-based account for non-pricing reasons. A member must also establish the specific reasons given by the customer for choosing a fee-based account after receiving the disclosure.

Customer consent is not a defense to an otherwise unsuitable recommendation pursuant to Rule 2310 and therefore would be irrelevant if the facts established a suitability violation in accordance with the *Belden* decision.

8 NASD believes that, absent unusual circumstances, it would be reasonable to conduct a review annually. Of course, reviews undertaken with greater frequency may prove to be of greater benefit to members and their customers. On those occasions where members review their customer accounts for business reasons, including determining profitability, they may not ignore relevant information related to whether the account is appropriate for the customer because the review was not conducted for that purpose.