

Notice to Members

SEPTEMBER 2003

REQUEST FOR COMMENT

ACTION REQUESTED BY OCTOBER 17, 2003

SUGGESTED ROUTING

Advertising/Investment Companies
Executive Representatives
Legal & Compliance
Mutual Fund
Registered Representatives
Senior Management

KEY TOPICS

NASD Rule 2830
Revenue Sharing
Investment Companies
Advertising
Variable Contracts

Compensation for the Sale of Investment Company Securities

NASD Requests Comment on Proposed Amendments to Rule 2830 (Investment Company Securities); **Comment Period Expires October 17, 2003**

Executive Summary

NASD proposes to amend Rule 2830 to require disclosure of revenue sharing and differential cash compensation arrangements relating to the sale of investment company securities. The proposal would require that a member disclose these compensation arrangements in writing when a customer first opens an account or purchases fund shares. The proposal also would require a member to update this information twice a year and make updates available to each customer.

NASD's proposal would:

- ▶ Broaden the definition of "cash compensation" in Rule 2830(b)(1)(C) to include cash payments received for inclusion of an investment company on a preferred sales list, in any other sales program (e.g., for shelf space) or as expense reimbursements;
- ▶ Add definitions of "differential cash compensation" and "gross dealer concessions" to Rule 2830(b); and
- ▶ Revise Rule 2830(l)(4) to ensure that members disclose revenue sharing arrangements and differential cash compensation arrangements to customers.

Questions/Further Information

Questions concerning this *Notice to Members* may be directed to Joseph P. Savage, Counsel, Investment Companies Regulation, Regulatory Policy and Oversight, at (240) 386-4534; or Angela C. Goelzer, Counsel, Investment Companies Regulation, Regulatory Policy and Oversight, at (202) 728-8120.

Request for Comment

NASD requests comment on the proposed amendments to Rule 2830 described in this *Notice*. Members wishing to comment must make a submission that is received by **October 17, 2003**. Members and interested persons can submit their comments using the following methods:

- ✦ mailing in written comments
- ✦ e-mailing written comments to pubcom@nasd.com
- ✦ submitting comments online at the NASD Web Site (www.nasd.com)

Written comments submitted via hard copy should be mailed to:

Barbara Z. Sweeney
NASD
Office of the Corporate Secretary
1735 K Street, NW
Washington, DC 20006-1500

Important Note: The only comments that will be considered are those submitted in writing by mail or e-mail.

Before becoming effective, any rule change resulting from this proposal must be adopted by the NASD Regulation Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the Securities and Exchange Commission (SEC).

Background

NASD members and their registered representatives are compensated for the sale of mutual fund shares in various ways, and the disclosure that investors receive depends upon the particular compensation arrangement. For example, member compensation that is deducted from a shareholder account or from fund assets, such as sales charges and Rule 12b-1 fees, is disclosed in the fee table that appears in the mutual fund prospectus. Other forms of member compensation, such as payments from a mutual fund adviser for “shelf space,” have been the subject of less prominent disclosure.

NASD reminds members that compensation arrangements may never undermine a member's obligation to properly supervise its registered representatives, or a registered representative's obligation to make only suitable recommendations to customers.¹ Members must adopt and implement procedures reasonably designed to ensure that all communications of their registered representatives concerning investment company products, whether written or oral, are accurate and complete.² In recommending an investment company, registered representatives must disclose all material information, including the fund's expenses and sales charges, investment objective and risks.

1. Rule 2830

NASD rules regulate various compensation arrangements that present specific investor protection concerns. For example, NASD Conduct Rule 2830 effectively prohibits the payment of any form of compensation from third-party offerors to a member's associated persons. Rule 2830(l)(4) provides that a member may not accept cash compensation from an investment company offeror unless the compensation is described in the investment company's prospectus. The rule also prohibits a member from entering into "special cash compensation arrangements" with an investment company offeror unless the prospectus discloses the details of the arrangements. Earlier this year, NASD fined and censured two members for failing to disclose special cash compensation paid to dealer firms and to a group of registered representatives for the sale of mutual fund shares.³

Rule 2830(l)(5) prohibits the payment of most forms of non-cash compensation, such as lavish gifts and trips to resort locations, to registered representatives.⁴ NASD has made clear to its members that this prohibition will be enforced in a manner that is appropriate in light of the purposes of the rule. Thus, for example, NASD has narrowly interpreted the "training and education exception" to the rule, forbidding reimbursement for tours, golf outings, and other forms of entertainment in connection with so-called "training and education meetings."⁵

2. Proposed Amendments

NASD is now proposing a disclosure approach concerning two types of compensation arrangements that present investor protection concerns. These two types of compensation arrangements are:

- ♦ Revenue sharing arrangements, in which an investment adviser or other offeror agrees to pay an NASD member cash compensation not otherwise disclosed in the prospectus fee table (such as payments for "shelf space" to distribute the investment company's shares); and
- ♦ Differential cash compensation arrangements, typically occurring when a member provides higher payouts to its registered representatives for the sale of certain investment company products, such as investment companies that are proprietary funds of the member.

Revenue sharing and differential cash compensation arrangements may create incentives to inappropriately favor some funds over others, or to favor funds over non-fund investments. These compensation arrangements can create conflicts of interest by encouraging members and their registered representatives to recommend certain funds to maximize their compensation, rather than to best meet their customers' needs. They may provide point-of-sale incentives that could compromise proper customer suitability considerations and may present a situation in which the salesperson's interests are not, in some circumstances, fully aligned with the interests of customers.

Disclosure of revenue sharing and differential cash compensation arrangements would enable investors to evaluate whether a registered representative's particular product recommendation was inappropriately influenced by these arrangements. Disclosure of these arrangements could be an important adjunct to existing suitability, sales practice, and disclosure requirements and may help ensure that there is an appropriate match between the needs of an investor and the most appropriate investment company.

Congress and the SEC also are considering the adequacy of disclosure regarding mutual fund fees and broker/dealer compensation for fund sales, and Congress may enact legislation or the SEC may issue separate proposals addressing these matters. In July, SEC Chairman Donaldson asked his staff "to move ahead with the prospectus disclosure recommendations of the Task Force on Breakpoints and to develop additional investor protection initiatives concerning the costs and conflicts of interest in mutual fund investments." Chairman Donaldson also anticipated that "the Commission will consider additional regulation in this critical area of our markets in the near future."⁶ It is possible that Congressional or SEC action would require enhanced disclosure in the mutual fund prospectus, periodic reports, or confirmation statements. Such enhanced disclosure will be complementary to NASD's proposal. NASD will continue to work with Congress and the SEC on these investor protection initiatives.

The Proposal

1. Required Disclosure

NASD proposes to amend Rule 2830 to better ensure that members disclose to their customers information about revenue sharing and differential cash compensation arrangements. The proposal recognizes that both revenue sharing and differential cash compensation arrangements may come in a variety of forms. For example, revenue sharing arrangements may include cash payments from a fund's investment adviser and expense reimbursements. A differential cash compensation arrangement may consist of a system under which a firm imposes ticket charges on their registered representatives for the sale of some, but not all, investment companies. Thus, a registered representative may not have to pay a ticket charge for the sale of a proprietary investment company, but may have to pay one for the sale of a nonproprietary investment company.

Rule 2830(l)(4) would be revised to require that any member that within the previous twelve months has received from an investment company offeror cash compensation, or that uses differential cash compensation policies in compensating its associated persons, must disclose:

- ▶ That information about a fund's fees and expenses may be found in the fee table located in the fund's prospectus and that the fund's statement of additional information contains information about how the fund selects brokers.
- ▶ If applicable, that the member receives cash payments from fund offerors other than the sales charges (including Rule 12b-1 fees) and service fees disclosed in the prospectus fee table. The member also would have to list the offerors that made these payments to the member in descending order based upon the total amount of compensation received from each offeror. The member would not have to disclose the actual amounts of compensation received under these arrangements.⁷
- ▶ If applicable, that an associated person (including a registered representative or branch manager) receives different rates of compensation depending upon which investment company shares are purchased by a customer, the nature of these arrangements, and the names of the investment companies favored by these arrangements. This disclosure requirement would not apply to arrangements under which different associated persons receive different payout ratios, so long as an individual associated person receives the same payout ratio for all funds that he or she sells. This disclosure requirement also would not apply to differences in total compensation received by the associated person, such as for the sale of an investment company that provides a higher gross dealer concession to the member, provided that the payout ratios are the same for all funds that the associated person sells.
- ▶ A Web page or toll-free telephone number that a customer may use to obtain updated information about the member's revenue sharing and differential cash compensation arrangements. A member may choose not to maintain a Web page or toll-free number that provides updated information, but then must disclose that updated information will be sent to the customer on a semi-annual basis.

Rule 2830 also would be amended to provide that the required disclosures must be updated on a semi-annual basis and must be made in writing to the customer:

- ▶ At the time that the customer establishes an account with the member or the member's clearing broker;
- ▶ If no account is established, at the time that the customer first purchases shares of an investment company;

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- ♦ For accounts that are in existence at the time that the proposed revisions to Rule 2830 become effective, at the later of ninety days after the effective date or the time at which the customer first purchases fund shares following the effective date.

The proposal would retain, with modification, the current requirements in Rule 2830(l)(4) regarding prospectus disclosure of cash compensation arrangements.⁸ The modifications are designed to clarify a member's obligation not to accept any sales charges or service fees that are not described in a current fund prospectus. If a special sales charge or service fee arrangement is made available to some, but not all, members who distribute a fund's securities, the arrangement must be described in the fund's prospectus. Thus, consistent with current policy, if an offeror pays a higher percentage of a mutual fund's sales charges to one member than it pays to other members, the details of this special cash compensation arrangement would have to be disclosed in the fund's prospectus. NASD has interpreted Rule 2830(l)(4) to allow this required disclosure to be presented in a fund's Statement of Additional Information (SAI).⁹

NASD seeks comment on whether SAI disclosure is an effective means to communicate with investors about special cash compensation arrangements. Should NASD require prospectus, rather than SAI, disclosure of these arrangements? Should the current requirements of Rule 2830(l)(4) be eliminated in light of the disclosure that would be required by the proposed amendments? If prospectus disclosure requirements are retained, should NASD provide additional guidance concerning the circumstances under which Rule 2830(l)(4) mandates disclosure and the level of detail that may be deemed appropriate?

2. Cash Compensation

The definition of "cash compensation" set forth in Rule 2830(b)(1)(C) would be amended to include cash payments received as a condition for inclusion of the investment company on a preferred or select sales list, in any other sales program (e.g., for shelf space), or as expense reimbursement.¹⁰ The definition also would be clarified to expressly include gross dealer concessions.

3. Differential Cash Compensation

Rule 2830(b)(1) would be amended to add a definition of "differential cash compensation." The definition is designed to encompass any compensation arrangement under which a member pays an associated person different rates of compensation depending upon which investment company securities (or classes thereof) are sold. For example, a differential cash compensation arrangement would be deemed to exist whenever a member pays an associated person a higher percentage of the member's "gross dealer concessions" for the sale of one fund's securities than the percentage paid for sale of the same dollar amount of another fund's securities. A differential compensation arrangement also would be found when a member sponsors a cash sales contest with sales targets that favor certain funds, or when a member imposes or waives ticket charges for the sale of certain funds. The proposed definition

would not be limited to differential cash compensation arrangements favoring proprietary funds. Also, the definition would encompass payments to any associated person, including a registered representative or branch manager.

NASD requests comment on whether money market funds should be excluded from the differential cash compensation provision. For example, a differential cash compensation arrangement could be deemed to exist whenever payout ratios are higher for the sale of one investment company than for another investment company that is not a money market fund. This provision would permit lower payouts for money market funds without mandating disclosure.

4. Gross Dealer Concessions

Integral to the proposed definition of “differential cash compensation” is NASD’s proposed definition of “gross dealer concessions.” Gross dealer concessions would be defined as the total amount of any compensation received by a member from an offeror for the sale of investment company securities, including all discounts, concessions, service fees, commissions, and asset-based sales charges.

5. Alternative Approaches

NASD seeks comments on alternatives to the proposed amendments. For example:

- ♦ As proposed, a member would provide the required disclosure when a customer first establishes an account with a member or the member’s clearing broker, or when the customer first purchases investment company shares. Are these the most appropriate times for a customer to receive the information? Would it be more appropriate for a customer to receive the information when he or she first receives a recommendation to purchase investment company shares, rather than at the opening of a brokerage account?
- ♦ Would investors be well served by disclosure that provides a general “warning label” urging them to seek information from the member or its associated person concerning revenue sharing and differential cash compensation arrangements, rather than receiving a list of relevant funds?
- ♦ In addition to the proposed disclosure, should NASD require disclosure of the actual dollar amounts paid under revenue sharing and differential cash compensation arrangements?
- ♦ What are the costs and benefits of the proposed amendments and the alternative approaches?
- ♦ Are there any other types of arrangements that should be covered by the rule due to the conflicts of interest that may be presented?

With regard to disclosure of revenue sharing arrangements:

- ♦ NASD specifically seeks comment on whether it would be appropriate for Rule 2830 to establish a de minimis threshold below which disclosure of revenue sharing would not be required and, if so, the appropriate level of a threshold for disclosure.
- ♦ As proposed, a member that receives revenue sharing payments would be required to list the offerors that make the payments in descending order based upon the amount received by each. NASD requests comment on whether other listing requirements would be more appropriate. For example, offerors could be grouped according to the size of their revenue sharing payments (e.g., by highest to lowest quartile or quintile), without ranking the offerors in descending order within each group. Another alternative might be to list offerors according to revenue sharing payments per \$10,000 in fund sales, rather than based on total payments per fund.

NASD also seeks comment on whether the proposed definition of differential cash compensation should be broadened. As proposed, differential cash compensation would include arrangements in which a registered representative receives a higher percentage of the gross dealer concession for one fund than he or she would receive for the sale of another investment company. One alternative would be to expand this definition to include other circumstances in which the sale of the same dollar amount of different funds results in differing levels of compensation. For example, a registered representative may receive identical payout ratios for the sale of different funds, but the sale of one may result in higher compensation because the gross dealer concession is greater in absolute dollars.

More generally, NASD seeks comment on whether the proposal should be expanded to require disclosure of revenue sharing and differential compensation arrangements with respect to products other than investment companies, such as variable annuities. Would imposition of the proposed disclosure requirements solely on investment companies create incentives for registered representatives to favor other investment products?

Endnotes

- 1 NASD strictly monitors its members' sales practices in connection with the distribution of mutual funds and related investment products. For example, NASD's heightened scrutiny of sales practices in connection with the distribution of both mutual funds and variable annuities has resulted in over 75 disciplinary actions since the beginning of 2001.
- 2 See, e.g., *Notice to Members 98-107* (NASD Reminds Members Of Their Obligation To Disclose Mutual Fund Fees) and *Notice to Members 94-16* (NASD Reminds Members Of Mutual Fund Sales Practice Obligations).
- 3 See *NASD Regulatory and Compliance Alert* (Spring 2003). The respondents did not admit or deny the allegations but consented to the entry of findings.
- 4 See *Notice to Members 98-75* (amending Rules 2820 and 2830 to limit the extent to which members may pay or accept non-cash compensation).
- 5 See *NASD Regulatory and Compliance Alert* (Summer 2000).
- 6 SEC Press Release No. 2003-84 (July 22, 2003).
- 7 The proposal would not require a member to disclose receipt of non-cash compensation permitted by Rule 2830(l)(5), such as gifts under \$100, occasional meals, tickets to theater and sporting events, and reimbursement for associated persons' expenses in attending permissible training or education meetings.
- 8 Rule 2830(l)(4) provides in part that "[n]o member shall accept any cash compensation from an offeror unless such compensation is described in a current prospectus of the investment company. When special cash compensation arrangements are made available by an offeror to a member, which arrangements are not made available on the same terms to all members who distribute the investment company securities of the offeror, a member shall not enter into such arrangements unless the name of the member and the details of the arrangements are disclosed in the prospectus."
- 9 See *Notice to Members 99-55* (Question #18).
- 10 Thus, the definition of "cash compensation" would include payments, made from an offeror other than an investment company, received by members for the sale of fund shares or payments based on the amount of fund assets held in accounts at the member. The definition would not include directed brokerage to a member. Of course, the prohibitions of Rule 2830(k) would still apply even after adoption of the proposed amendments. Rule 2830(k) generally prohibits a member from directly or indirectly seeking brokerage commissions as a condition to the sale or distribution of investment company securities.

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ATTACHMENT A

Text of Proposed Amendments

Rule 2830(b)(1)(C) is revised to read as follows:

(C) “Cash compensation” shall mean any cash payment received in connection with the sale or distribution of investment company securities, including but not limited to:

- (i) any discount, concession, gross dealer concession, fee, service fee, commission, asset-based sales charge, loan, override, cash employee benefit; or
- (ii) any cash payment received as a condition for inclusion of the investment company on a preferred or select sales list; in any other sales program; or as an expense reimbursement.

New Rules 2830(b)(1)(F) and (G) are inserted as follows:

(F) “Differential cash compensation” shall mean

- (i) the payment by a member to its associated persons of a higher percentage of the member’s gross dealer concessions for the sale of a stated dollar amount of the securities of a particular investment company (or any class thereof) than the percentage of its gross dealer concessions that the member pays to its associated persons for the sale of the same dollar amount of securities of another investment company (or any class thereof); and
- (ii) other practices of a member that cause an associated person to earn different rates of compensation for investment company products (or classes thereof) depending on the product sold, including but not limited to a member’s payment of additional cash compensation or the imposition or waiver of ticket charges for associated persons concerning the sale of particular investment company securities.

(G) “Gross dealer concessions” shall mean the total amount of any discounts, concessions, fees, service fees, commissions or asset-based sales charges provided by the offeror to the member in connection with the sale and distribution of investment company securities.

Rule 2830(l)(4) is revised to read as follows:

(A) No member shall accept any sales charges or service fees from an offeror unless such compensation is described in a current prospectus of the investment company. When special sales charge or service fee arrangements are made available by an offeror to a member, which arrangements are not made available on the same terms to all members who distribute the investment company securities of the offeror, a member shall not enter into such arrangements unless the name of the member and the details of the arrangements are disclosed in the prospectus.

(B) Any member that has within the previous 12 months received from an offeror any form of cash compensation, other than sales charges or service fees disclosed in the prospectus fee table, or that employs policies that involve differential cash compensation, must:

(i) disclose that information about an investment company's fees and expenses may be found in the fund's prospectus and that the company's policies regarding selection of brokers (including soft dollar practices) may be found in the fund's statement of additional information;

(ii) disclose, if applicable, that the member receives cash payments from an offeror, other than sales charges or service fees disclosed in the prospectus fee table, the nature of any such cash payments received in the past 12 months, and the name of each offeror that made such a cash payment, listed in descending order based upon the amount of compensation received from each offeror;

(iii) disclose, if applicable, that the associated person receives different rates of compensation for different investment company products that may provide an incentive to offer specific products to the customer, a description of the differential cash compensation policy, and the names of the investment company or companies whose sales the policy favors; and

(iv) provide a reference (or in the case of electronically delivered documents, a hyperlink) to the web page or toll-free telephone number described in paragraph (D). If the member elects not to maintain a web page or toll-free telephone number as described in paragraph (D), the member must disclose that updated information described in this paragraph (B) will be sent to the customer on a semi-annual basis.

(C) The disclosure required by paragraph (B) must be updated on a semi-annual basis and must be made in written documentation:

- (i) at the time that the customer establishes an account with the member or the member's clearing broker;
- (ii) if no such account is established, by the time the customer first purchases shares of an investment company; or
- (iii) with respect to accounts existing when paragraph (B) becomes effective, the later of (a) 90 days after the effective date, or (b) the time the customer first purchases shares of an investment company after the effective date (other than purchases through reinvestment of dividends or capital distributions or through automatic investment plans).

(D) Any member that receives cash payments from investment companies and their affiliates, other than sales charges or service fees disclosed in the prospectus fee table, or that employs policies that involve differential cash compensation, must either:

- (i) maintain a web page or toll-free telephone number that is available to the public and that provides updated information described in paragraph (B); or
- (ii) send updated information described in paragraph (B) in written form on a semi-annual basis to its customers who originally received this disclosure.

(E) Other than disclosures regarding differential cash compensation, the requirements of Rule 2830(l)(4)(B) shall not apply to cash compensation in the form of a sales charge or service fee disclosed in the prospectus fee table of the offeror's investment company.