

Notice to Members

AUGUST 2003

SUGGESTED ROUTING

Legal & Compliance
Senior Management
Accounting
Operations
Retail

KEY TOPICS

Mutual Funds
Mutual Fund Breakpoints
Customer Refunds
Net Capital Compliance

IMMEDIATE ACTION REQUIRED

Refunds to Customers Who Did Not Receive Appropriate Breakpoint Discounts in Connection with the Purchase of Class A Shares of Front-End Load Mutual Funds and the Capital Treatment of Refund Liability

Background

In late 2002, as a result of several routine examinations, NASD discovered that some members had failed to deliver breakpoint discounts to investors purchasing Class A shares of front-end load mutual funds. This led to a joint examination of 43 broker/dealers by NASD, the Securities and Exchange Commission ("SEC"), and the New York Stock Exchange ("NYSE"), which confirmed that broker/dealers were not uniformly delivering appropriate breakpoint discounts. In December 2002, NASD issued *Special Notice to Members 02-85*, which reminded members of their obligation to deliver all available breakpoint discounts to customers purchasing Class A shares of front-end load mutual funds.

In March 2003, NASD directed member firms that processed 100 or more automated purchases of front-end load mutual funds in either 2001 or 2002 to conduct a "self-assessment" of their record of delivering breakpoint discounts to customers. The self-assessment was designed to produce a statistically significant sample that would allow NASD to determine the scope of overcharges at individual member firms and to gauge the scope of the problem across the industry as a whole.

A preliminary analysis of the data obtained as a result of the self-assessment indicates that most members did not uniformly deliver appropriate breakpoint discounts; the degree to which firms applied the appropriate discount varied. It is imperative that

member firms make appropriate refunds to customers who did not receive discounts for which they were eligible and that members properly account for overcharge liabilities. This *Notice to Members* provides guidelines for firms to follow when calculating refunds to customers and discusses how firms must account for their anticipated refund liabilities.¹

Questions/Further Information

Questions regarding refunds may be directed to Janene Marasciullo, Senior Attorney, NASD Office of General Counsel, at (202) 974-2978. Questions regarding net capital issues may be directed to Susan DeMando, Director, Financial Operations, NASD, Member Regulation at (202) 728-8411.

Discussion

Refunds to Customers

NASD expects that members will make refunds to customers expeditiously where they are aware that customers did not receive the sales load discount to which they were entitled. A number of NASD member firms have already begun that process.² Members who have completed the self-assessment have already identified certain customers who did not receive available breakpoint discounts. Members should take immediate steps to make refunds to these customers in accordance with the calculation guidelines set forth below.

Additionally, NASD expects members to make refunds to any customers who come forward and assert that they did not receive all applicable breakpoint discounts. Once a member is in contact with a customer seeking a refund, the member firm must review its records to determine whether the customer is entitled to a refund and to determine the amount of the appropriate refund.³ A member may not place the burden of demonstrating entitlement to a refund upon the customer and, therefore, may not refuse to make a refund to a customer without first checking its own records to determine whether the customer is entitled to a refund. However, members may require documentation from customers where the availability of the breakpoint discount can only be determined by reference to records not held by the member.

NASD has taken steps to inform investors regarding the availability of breakpoint discounts and the problems that the financial industry experienced delivering breakpoint discounts in the past.⁴ NASD has also advised investors that they may be entitled to refunds if they did not receive appropriate breakpoint discounts on past mutual fund purchases.⁵ Therefore, NASD members should be prepared to make prompt refunds to those customers who were identified during the self-assessment as having been overcharged, as well as other customers who come forward seeking refunds on their own and are owed a refund based on the firm's assessment and in accordance with the guidelines set forth below.

Refund Calculation Guidelines

Members should make full refunds to customers who have valid claims that they were overcharged. To ensure that the refunds make customers whole and are distributed in a timely and equitable fashion, NASD has developed the following guidelines that firms must follow when providing refunds:

- ▶ Refunds should be made in cash sent to the customer, or through cash deposits made to an existing customer's account with notice to that customer.
- ▶ Refunds should be equal to the amount of the sales load overcharge plus interest at a simple rate of at least 2.5%, for overcharges that occurred between January 1, 2001, and the present. For transactions that took place prior to that time, members should use a comparable interest rate.⁶
- ▶ Refunds should be made regardless of the performance of the mutual fund purchased by the customer.

Making and Maintenance of Records

Members are reminded that, pursuant to NASD Rule 3110 and Exchange Act Rules 17a-3 and 17a-4, they must make and preserve records that reflect their determinations regarding customers' refund eligibility and the calculation and payment of any such refunds. Members should ensure that they maintain these records for the first two years in an easily accessible place.

Capital Treatment of Refund Liability

A member's obligation to provide refunds to customers who were overcharged may impact net capital. NASD provides the following guidance to member firms regarding the accounting treatment applicable to a member's obligation to provide refunds to customers who did not receive breakpoint discounts to which they were entitled. NASD has concluded that a member's refund obligation comes within the definition of "liability" set forth in the Financial Accounting Standards Board's Statement of Financial Accounting Concept No. 6 ("SFAC No. 6") because it meets each of the following characteristics:

- (a) It is a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand;
- (b) The duty or responsibility obligates a particular entity, leaving it no discretion to avoid the future sacrifice;⁷ and
- (c) The transaction or other event obligating the entity has already happened.

The recognition of this liability may impact a member's net capital computation, and compliance with net capital requirements set by SEC Rule 15c3-1, and other financial reporting.

In determining the amount of this liability, members should consider that SFAC No. 6 specifically recognizes that the amount of a liability does not need to be certain before it is recorded. SFAC No. 6 ¶ 46.⁸ Accordingly, approximations and estimates may be used to record a liability. Id. Thus, firms must determine their probable liability based upon currently available information in accordance with SFAC No. 6 and generally accepted accounting principles ("GAAP").⁹

Segregation and Protection of Funds Necessary to Satisfy Refund Liability to Investors

Regardless of the methodology that a firm uses to determine the amount of its liability, each member must, to the extent necessary, segregate the funds needed to satisfy its liability through either a Special Reserve Bank Account for the Exclusive Benefit of Customers ("Special Reserve Bank Account") or through an account established for the benefit of customers in accordance with section (k)(2)(i) of Exchange Act Rule 15c3-3 ("A Special Account"). To ensure that firms properly segregate the funds set aside to satisfy their refund liability, NASD provides the following guidelines for setting aside and protecting the funds necessary to satisfy a member's refund obligation:

- ▶ Member firms that are fully subject to the Customer Protection Rule (SEC Rule 15c3-3), must, beginning with their next and on all subsequent Reserve Requirement computation dates (whether weekly or monthly):
 - ▶ Include the refund liability amount as a credit in the Reserve Formula; and
 - ▶ Pay investor refunds as soon as feasible, while continuing to include the refund liability amount as a credit in the Reserve Formula.
- ▶ Member firms that are exempt from the Reserve Requirement computation of the Customer Protection Rule must pay the amounts owed to any investor making a claim within two business days of determining the proper amount of the claim. To the extent that such member firms do not pay all claims within two business days of determining the proper amount of the claim, these member firms must:
 - ▶ Immediately establish a *separate* Special Account for the benefit of customers in accordance with the requirements of paragraph (k)(2)(i) of SEC Rule 15c3-3;
 - ▶ Deposit the remaining amount of the liability into that Special Account; and,
 - ▶ Pay the investor refunds as soon as feasible from and through the separate Special Account, while continuing to hold any unpaid refund liability in that account.

Conclusion

Firms must take prompt and immediate action to provide refunds to customers in accordance with the guidelines set forth above. Failure to provide such refunds will subject firms to disciplinary action, separate and apart from any disciplinary actions that may result from the initial failure to deliver breakpoint discounts. Furthermore, firms must treat their refund obligations as liabilities on their financial statements and must ensure that they are operating in net capital compliance after accounting for these liabilities. Finally, firms must take appropriate actions to segregate and protect the funds necessary to satisfy their refund liability.

Endnotes

- 1 NASD, in coordination with SEC staff, is determining the nature and scope of further regulatory action against certain firms based upon their record of delivering breakpoint discounts.
- 2 Any firm that has already provided its customers with refunds should contact NASD if it used an alternative methodology to determine whether it calculated its refunds in a satisfactory manner.
- 3 Firms that do not respond appropriately to customer requests for refunds may be subject to disciplinary action by NASD.
- 4 NASD Investor Alert, "Mutual Fund Breakpoints: A Break Worth Taking," available at www.nasd.com/investor/alerts/alert_breakpoint.htm; Report of Joint NASD/Industry Task Force on Breakpoints, available at www.nasdr.com/breakpoints_report.asp.
- 5 NASD has already stated that investors have a right to receive a refund to compensate them for sales load overcharges. See July 22, 2003, NASD Press Release, "Joint NASD/Industry Breakpoint Task Force Issues Report," in which NASD Chairman Robert Glauber stated, "NASD is committed to helping investors receive refunds for missed breakpoints." See also February 18, 2003, NASD Press Release, "NASD Announces Joint NASD/Industry Breakpoint Task Force." NASD recognizes that some refund claims may prove to be without merit or be time-barred. However, NASD expects members who receive claims for refunds to carefully review the merits of each claim and provide refunds in all cases where there is a timely and meritorious claim for a refund.
- 6 The 2.5% rate is based on data posted on the Federal Reserve Web Site for simple average dealer rates on negotiated six month CDs nationally traded in the secondary market from January 2001 until June 2003. See <http://www.federalreserve.gov/releases/h15/data/m/cd6m.txt>. Data posted on the Federal Reserve Site for six month CDs for periods prior to January 2, 2001, may be considered for determining refunds relating to overcharges outside of the period covered by the self-assessment.
- 7 Members are obligated to provide all breakpoint discounts disclosed in a mutual fund's prospectus. However, the Financial Accounting Standards Board has recognized that "although most liabilities rest generally on a foundation of legal rights and duties, existence of legally enforceable claim is not a prerequisite for an obligation to qualify as a liability if for other reasons the entity has the duty or responsibility to pay cash, to transfer assets, or to provide services to another entity." SFAC No. 6, ¶ 36.

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- 8 The fact that members may not currently know the identity of all investors who are entitled to refunds is not relevant to the determination of whether the refund obligation is a liability. See SFAC No. 6 (explaining that “the identity of the recipient need not be known to the obligated entity before the time of settlement.”).
 - 9 Members should be aware that NASD, in reviewing members’ determinations of their probable liability for the years 2001 and 2002, will use, as a reference for comparison, statistically significant extrapolations of each member’s total liability for that period derived from each member’s data provided in response to the self-assessment. NASD recognizes that a member’s determination of its liability under GAAP may vary from these extrapolations. NASD will communicate to each member that was

subject to the self-assessment its extrapolated total liability for years 2001 and 2002. NASD recognizes that some firms may have refund obligations as a result of transactions that were executed prior to the self-assessment period. In this regard, a significant number of valid customer claims may result in the need for firms to calculate the liability for transactions executed prior to 2001, in accordance with GAAP and SFAC No. 6. The existence of pre-2001 claims and refunds, and the recording of attendant liabilities, may be covered in NASD examinations. In all cases, members should be prepared to demonstrate that the calculation of probable liability is in accordance with GAAP.