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NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. Respondent.	Disciplinary Proceeding No. E8A2003062001 Hearing Officer – AWH **HEARING PANEL DECISION** June 28, 2007

Member firm found not liable for accepting additional cash compensation from investment companies, in violation of NASD Conduct Rules 2830(l)(4) and 2110.

Appearances:

Kevin G. Kulling, Esq., and Mark P. Dauer, Esq., for the Department of Enforcement.

_____, Esq., and _____, Esq., of _____, PC, for Respondent.

DECISION

Procedural History

On November 29, 2005, the Department of Enforcement filed the Complaint, alleging that, in violation of NASD Conduct Rules 2830(l)(4) and 2110, Respondent ("Respondent" or the "Firm") accepted additional cash compensation from certain investment companies during sales promotions that (1) the Firm designed, (2) the terms of which were not made available to all firms who distributed the investment company securities, and (3) the name of the Firm and the details of the sales promotions were not disclosed by the investment companies in a current prospectus or Statement of Additional Information ("SAI"). On March 2, 2005, Respondent filed an Answer in which it

admitted that it accepted cash compensation from certain investment companies in connection with sales promotions, but denied that such compensation was "special cash compensation," and that the cash compensation arrangements were not properly disclosed in a prospectus or SAI. The Answer also alleged that other NASD member firms participated in compensation arrangements similar to those at issue or were eligible to do so.

A hearing was held in Chicago, Illinois, on November 29, 2006, before an Extended Hearing Panel consisting of the Hearing Officer, a former member of the District 10 Committee, and a current member of the District 8 Committee. Because of the serious illness of the expert witness for Respondent, the hearing was continued until such time as the expert witness was well enough to testify. Accordingly, the continued hearing was later set for May 3, 2007, in New York, New York. However, because the expert witness passed away before the hearing date, the continued hearing was limited to the submission of summations by the parties on the existing evidentiary record, including the direct testimony of the late expert which had been submitted in the form of a written report.

The Sales Promotions

The essential facts regarding the sales promotions are not in dispute and most are recounted below from the parties' stipulations. To the extent appropriate, this Decision will make references to the transcript of the hearing, the exhibits of the parties, and the written submission of each party's expert witness.[1]

[1] References to the Department of Enforcement's exhibits are designated CX-; Respondent's exhibits, as RX-, the Stipulations, as Stip. ¶, the transcript of the hearing, as Tr.-; the summary of expert testimony from Lawrence Kosciulek, as Kosciulek summ._; and the affidavit of Terry K. Glenn, as Glenn aff._.

The Respondent

The Respondent Firm is a full-service national brokerage firm based in _____, _____, with approximately 7,000 financial consultants in nearly 700 offices in the United States. The Firm has been a member of NASD since August 1939. Respondent is, and was during all times relevant to the Complaint, a registered broker-dealer. It has no product sales quotas for registered representatives.[2]

The 2001 Sales Promotion

In about November 2000, the Firm contacted approximately 18 to 20 large mutual fund distributors whose mutual funds the Firm sold, and asked them to participate in an Individual Retirement Account ("IRA") sales promotion during 2001.[3] The purpose of the promotion was to highlight the IRA sales season. The promotion applied to sales of mutual funds made in IRA accounts between January 1, 2001, and April 15, 2001. Fourteen of the mutual fund distributors that were approached by the Firm agreed to and did participate in the 2001 sales promotion. They included Alliance, Blackrock, Davis (Premier and Founders funds), Evergreen, Franklin Templeton, Goldman Sachs, Hartford, Kemper, Liberty, Lord Abbett, MainStay, Nations, Pioneer, and Putnam.[4]

As part of the sales promotion, the mutual fund distributors agreed to pay cash compensation to the Firm and its representatives in amounts that represented a larger percentage of the dollar volume of fund sales than the percentage paid when the sales promotion was not in effect. The terms of the payments during the sales promotion

[2] Stip. ¶¶ 1-3.
[3] The largest 20 fund distributors represented about 95 percent of the Firm's mutual fund sales. Tr. 124.
[4] Stip ¶¶ 4-5. The mutual fund distributors are identified by their abbreviated names.

generally included (1) a full dealer reallowance[5] on sales of A shares, (2) a 50 basis point payout in addition to the regular commission on B shares, and (3) a 25 to 50 basis point payout in addition to the regular commission on C shares.[6]

The 2002 Sales Promotion

Between approximately February 1, 2002, and April 30, 2002, the Firm repeated its IRA sales promotion for the 2002 IRA sales season. The Firm approached approximately 18 to 20 mutual fund distributors, nine of which had also participated in the 2001 promotion. Seventeen distributors agreed to and did participate in the 2002 promotion, which involved terms substantially similar to those of the 2001 promotion. They included Alliance, American Skandia, Delaware, Dreyfus, Eaton Vance, Evergreen, Franklin Templeton, Goldman Sachs, Liberty, Lord Abbett, MainStay, One Group, Oppenheimer Funds, MFS, Pioneer, Putnam, and Scudder.[7]

Additional Facts about the Promotions

For both promotions, the Firm offered to its clients more than 1,400 mutual funds from at least 14 fund families, covering all investment styles and strategies, as well as share classes. The promotions were available to all registered representatives at the Firm and did not involve the sale of proprietary funds. Over two years, approximately 30,000 investors purchased mutual funds in their retirement portfolios during the promotions,

[5] A full dealer reallowance is the payment by the distributor to the broker-dealer of the full gross sales charge paid by the customer purchasing A shares of a fund. Tr. 143.
[6] Stip. ¶¶ 6, 8.
[7] Stip. ¶¶ 9-11.

producing total sales of $126 million.[8] Those sales generated additional compensation of $308,000 to Respondent.[9]

The Firm did not contact other NASD members or the fund distributors to determine whether other NASD members participated in sales promotions with distributors under terms comparable to those offered to the Firm. The Firm has not conducted an IRA mutual fund sales promotion since 2002.[10]

Eight mutual fund distributors made general disclosures in their prospectuses or SAIs that they might be paying additional compensation to unnamed broker-dealers or their agents in connection with the sale of shares of their funds.[11] They included Alliance, Davis, Hartford, Nations, MainStay, Putnam, American Skandia, and One Group. For example, the Alliance Growth and Income Fund included the following disclosure in its SAI:

> In addition to the discount or commission paid to dealers or agents, the Principal Underwriter from time to time pays additional cash or other incentives to dealers or agents, in connection with the sale of shares of the Fund. Such additional amounts may be utilized, in whole or in part, to provide additional compensation to registered representatives who sell shares of the Fund.[12]

Of the eight mutual fund distributors, five stated that they would have made the same promotional arrangement with any other NASD member firm upon request of that

[8] Stip. ¶¶ 12-13, 16.
[9] The $308,000 figure was provided to the Firm from the fund distributors. Tr. 93. Enforcement's exhibit CX-20 shows that it received a total of $480,899.42. The exhibit was based on a CD provided by an employee of Respondent. However, the Extended Hearing Panel does not find the higher figure to be reliable because the accounting systems from which that figure was derived were not equipped to separately identify enhanced compensation or IRA campaign amounts from other amounts. Tr. 92, 116.
[10] Stip. ¶¶ 15, 17; Tr. 73.
[11] CX-4-12.
[12] CX-4, p. 10.

firm.[13] One stated that it would have made the same arrangement with any broker-dealer that was "comparable" to Respondent.[14] One stated that it was available to all NASD members with which it had a "meaningful relationship."[15] The eighth distributor stated that the promotion was made available only to Respondent, but that it had entered into a total of 35 arrangements pursuant to which it paid additional dealer compensation.[16] Two other distributors also stated that the same arrangement was available to any NASD member who requested it.[17]

Six mutual fund distributors made disclosures in their prospectuses or SAIs that named Respondent and the terms of the additional compensation, disclosures that Enforcement considered to be appropriate and consistent with NASD Rules. Those distributors were Eaton Vance, Evergreen, MFS Distributors, Oppenheimer Funds, Pioneer, and Delaware.[18] For example, Eaton Vance made the following disclosure in its Supplement to Prospectus:

> For the period of February 1, 2002 through April 15, 2002, Eaton Vance Distributors ("EVD") will pay to [the Firm] the following additional compensation for sales of shares by [the Firm] to its individual retirement plan account rollover clients. For Class A shares, EVD will pay [the Firm] the full commission and fees disclosed in the relevant Fund's Prospectus plus any amounts that EVD is entitled to receive for such sales. For Class B and Class C shares, and for shares of EV Classic Senior Floating-Rate Fund and Eaton Vance Prime Rate Reserves, EVD will pay the full commission and fees disclosed in the relevant Fund's Prospectus plus an additional 0.50%.[19]

[13] Alliance, Hartford, Nations, MainStay, and One Group. Tr. 40-41, 46, 48-50, 52, 64.
[14] Davis. Tr. 44.
[15] Putman. Tr. 58-59.
[16] American Skandia. Tr. 61-63.
[17] Columbia and BlackRock. RX-9, 11.
[18] CX-13.
[19] *Id.*, p. 1.

Conduct Rule 2830(1)(4) and its History

The precursor to Conduct Rule 2830(l)(4) (the "Rule") was subparagraph (l)(1)(C) of the Investment Company Rule which placed the onus of disclosure on the underwriter of investment company securities, not on the broker-dealer. Among other things, an underwriter was prohibited *from paying* any concession, fee, or commission which was not disclosed in the prospectus of the investment company. Further, the Rule provided that:

> If the concessions are not uniformly paid to all dealers purchasing the same dollar amounts of securities from the underwriter, the disclosure shall include a description of the circumstances of *any general variations* from the standard schedule of concessions. If special compensation arrangements have been made with individual dealers, which arrangements are *not generally available* to all dealers, the details of the arrangements, and the identities of the dealers, shall also be disclosed. (Emphasis added).[20]

The Rule had three levels of disclosure. First, there was a general requirement that the underwriter had to disclose in the prospectus any concession paid to broker-dealers.[21] Second, if the concession was not uniformly paid to all broker-dealers, the underwriter had to describe any "general variations from the standard schedule of concessions." Finally, "special compensation," not "generally available to all dealers," had to be described in detail and the individual dealer(s) identified. The Rule, then, acknowledged that there was a difference between "special compensation," and "general variations from the standard schedule" of concessions. The Rule did not define "special compensation."

[20] The Rule was implemented on March 10, 1981. *Notice to Members 81-8*, 1981 NASD LEXIS 325 *16.
[21] The Rule described "concession" as any discount, concession, fee or commission. *Id*, at *15.

In October 1996 NASD proposed amendments to the Rule.[22] In addition to noting that Rule 2830 did not contain a definition of special compensation, NASD recognized that certain offerors of investment securities took the position that cash compensation arrangements with individual dealers did not constitute "special" cash compensation and, therefore, did not have to be disclosed with the specificity required for "special" compensation. Those offerors specifically asserted that because the arrangements were "generally available" to all dealers "upon request," they were not "special" arrangements. NASD acknowledged that the offerors' position presented an "interpretive ambiguity" in the disclosure Rule, and resulted in a "wide array of disclosure practices by offerors regarding special cash compensation, ranging from specific to very general disclosure or, in some cases, no disclosure."[23]

Among other things, the proposed amendments would place the onus on the *member* not to participate in the sale of investment company securities unless the compensation that may be received by the member or its associated persons is described in the prospectus of the investment company. Moreover, the proposed Rule would require the prospectus disclosure to include, among other things, the following statement:

> "In addition to the compensation itemized above, certain broker/dealers and/or their salespersons may receive certain compensation for the sale and distribution of the securities or for services to the fund."

[22] *Notice to Members 96-68*, 1996 NASD LEXIS 81 (Oct. 1996).
[23] *Id.*, at *5. The proposed amendments also pertained to non-cash compensation, which is not at issue in this proceeding.

When additional descriptive information[24] is included in the Statement of Additional Information ("SAI"), the prospectus would be required to include the following statement:

> (2) "For additional information regarding such compensation, reference the description of the underwriters in the Statement of Additional Information."

Without any further action on the October 2006 proposed amendments, in August 1997 NASD again noted the interpretive ambiguity of the then current Rule and requested comments on appropriate ways to amend Rule 2830 and its disclosure requirements.[25] After considering the comments, NASD filed a proposed Rule change with the SEC.[26] However, the proposed Rule change did not include a definition of "special cash compensation," or resolve or comment on (1) the difference between "special compensation" and "general variations from the standard schedule" of concessions, and (2) the "interpretive ambiguity" in the disclosure Rule.

The SEC, in its request for comments on the proposed NASD Rule change, noted that the proposed Rule change contained a disclosure requirement that "is similar to the current requirement in subparagraph (l)(1)(C) of the Investment Company Rule," except that the proposed Rule had been modified to reference only "cash compensation," rather than both cash compensation and non-cash compensation. As noted above, subparagraph (l)(1)(C) has three levels of disclosure: the standard schedule of concessions uniformly paid to all broker-dealers, any general variation from the standard schedule which is not

[24] The additional information would include a description of the categories of compensation, the identification of the party(ies) making the payments, and, where possible, the basis on which each payment is calculated. *Id*., at *7.
[25] *Notice to Members 97-50.*
[26] *SR-NASD-97-35,* Exchange Act Release No. 34-38993, 1997, SEC LEXIS 1784 (Aug. 29, 1997).

uniformly paid to all dealers, and special compensation not generally available to all broker-dealers.

The SEC approved the proposed Rule change, noting that NASD "is considering future action regarding cash compensation arrangements" and "continuing to consider the most appropriate regulatory approach to cash compensation."[27] NASD announced the approval of the proposed Rule by the SEC in NASD Notice to Members 98-75 and announced that the amendments would be effective January 1, 1999. In that NTM, NASD stated that it was continuing to examine and develop an approach to the payment of certain types of cash compensation that may create point-of-sale incentives that might compromise the requirement to match the investment needs of the customer with the most appropriate investment product. NTM 98-75 did not contain a definition of "special compensation" or comment on the "interpretive ambiguity."

The current version of Conduct Rule 2830(l)(4), which was announced in NTM 98-75 and became effective January 1, 1999, provides that, in connection with the sale and distribution of investment company securities:

> No 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.

[27] *SR-NASD-97-35*, Exchange Act Release No. 34-40214, 1998 SEC LEXIS 1485 (July 15, 1998).

In September 2003, more than a year after the promotions at issue in this case were in effect, NASD again solicited comments on a proposal to amend Rule 2830.[28] Among other issues, NTM 03-54 requested comments on whether, if prospectus disclosure requirements are retained, NASD should provide additional guidance concerning the circumstances under which Rule 2830(l)(4) mandates disclosure, and specify the level of detail that may be deemed appropriate. The amendment proposed to Rule 2830(l)(4) would substitute the words "sales charges or service fees" for "cash compensation." The NTM proposal would also eliminate the term "special cash compensation," and substitute the term "special sales charge or service fee." However, the NTM did not propose a definition of "special sales charge or service fee" or refer to any "interpretive ambiguity" in the Rule.

Discussion

Definition of Special Compensation

In this case of first impression, the Department of Enforcement takes the position that the plain language of Rule 2830(l)(4) compels the conclusion that "special" compensation is any compensation that surpasses the usual compensation, i.e., the standard commission that all members receive when they sell mutual funds. Enforcement reads the current version of the Rule as providing two levels of disclosure: (1) the general requirement that any compensation paid to broker-dealers has to be disclosed in the prospectus, i.e., the standard commission all members receive; and (2) if the compensation is not uniformly made available on the same terms to all broker-dealers, the requirement that the details of the compensation and the identity of the broker-dealer must be disclosed, i.e., "special compensation" not made available to all broker-dealers.

[28] *Notice to Members 03-54.*

But for the history of the Rule, Enforcement's plain language interpretation of it would be as persuasive as it is logical and reasonable. However, NASD has yet to define the term "special compensation," and it has not resolved the "interpretive ambiguity" in the Rule which has been evident since 1996. Indeed, the situation here, regarding the eight distributors who are alleged not to have made the appropriate disclosure, is analogous to that in 1996 when NASD noted that a number of offerors maintained that because the arrangements were "generally available" to all dealers "upon request," they were not "special" arrangements, and, therefore, did not have to be disclosed with the specificity required for "special" compensation. That "interpretive ambiguity" in the disclosure Rule resulted in a "wide array of disclosure practices regarding special cash compensation, ranging from specific to very general disclosure or, in some cases, no disclosure."

Given the absence of a definition of "special compensation" and the various disclosures of the 14 fund distributors in this case, the interpretive ambiguity persists to this day.[29] In soliciting comments on the present Rule when it was proposed, the SEC noted that the disclosure requirement proposed was similar to the then current version of the Rule which had three levels of disclosure. The second level – any general variation from the standard schedule of concessions uniformly paid to all broker-dealers – is not mentioned in the proposed Rule. The difference between "general variations from the standard schedule" and "special compensation" has never been resolved. "Special compensation" is a term of art yet to be defined.

[29] RX-1, a letter from the Clifford Chance law firm on behalf of Alliance, and RX-10, a letter from the law firm of Morgan Lewis on behalf of Scudder, respond to an 8210 request for information regarding the fund distributors' participation in Respondent's promotion. Both firms assert that the disclosures made by their clients are consistent with industry practice and do not contravene the Rule.

Definition of "Made Available"

Even assuming that Respondent received "special compensation" during the course of the IRA promotions, the Rule requires the identity of the member and the details of the arrangements only when the arrangements are not "made available" on the same terms to all members who distribute the securities.

Enforcement asserts that the additional cash compensation received by Respondent was *not made available* to *all* who distributed the investment company securities, and that this type of member-initiated promotion would not be generally known or made available because it did not originate with the mutual fund distributor. Respondent points to the evidence that ten of the fund distributors responding to the staff's inquiries stated that the compensation arrangements *would have been made available* upon request by an NASD member.

Enforcement makes the reasonable argument that the plain meaning of "made" is the past tense of "make" and presumes action or some affirmative step. On the other hand, Respondent argues, along with the ten fund distributors who stated that they would make the arrangement available on request, that by offering the arrangements upon request, the additional disclosures are not required by the Rule. That argument is also reasonable, given the history of the Rule and NASD's acknowledgment in 1996 that a number of offerors took the position that arrangements which were generally available to all dealers upon request were not "special" arrangements, and, therefore, did not have to be disclosed with the specificity required for "special" compensation. "Generally available" was not, and has not since that time, been defined. The current version of the Rule requires additional disclosure when the special cash compensation arrangements are

not "made available on the same terms" to all members. However, neither NASD nor the SEC commented on the change from "generally available" to "made available" or the meaning of either expression. As noted above, in announcing the SEC approval of the proposed amendments to the Rule, NASD stated that it was continuing to examine and develop an approach to the payment of certain types of compensation that may create point-of-sale incentives. Accordingly, there is substantial uncertainty as to the proper interpretation of the words "made available" in the Rule; that is, whether it means that the fund distributors must affirmatively solicit all members, or make it available to all who request it and qualify for it according to the terms of the offer.

Conclusion

In the face of the substantial uncertainty surrounding the application of the Rule to the promotions at issue, and in the absence of meaningful guidance on (1) the distinction between "cash compensation" and "special cash compensation" arrangements, and (2) the meaning of "made available," the Extended Hearing Panel concludes that Respondent has not been put on sufficient notice that the receipt of cash compensation in connection with the IRA promotions would violate Rule 2830(l)(4) as charged in the Complaint.[30] Accordingly, the Complaint is *dismissed*.

[30] *See Kevin Upton v. SEC*, 75 F.3d 92; 1996 U.S. App. LEXIS 688, at *19 (2nd Cir. 1996) ("Because there was substantial uncertainty in the Commission's interpretation of Rule 15c3-3(e), Upton was not on reasonable notice that FiCS's conduct might violate the Rule."); *Valicenti Advisory Services, Inc.*, 1997 SEC LEXIS 1395, at *63 (July 2, 1997) ("[I]t would be particularly inappropriate to impose such severe sanctions in the absence of clear pronouncements from the Commission regarding the proper methods for calculating and presenting performance data."); *Kevin B. Waide*, Exchange Act Release No. 30,561, 1992 SEC LEXIS 827 (April 7, 1992) (rejecting NASD's retroactive application of markup rule although the new standard was "implicit in existing requirements" and a reasonable interpretation of the rule); *Partnership Exchange Securities Company*, Exchange Act Release No. 34,399, 1994 SEC LEXIS 2413 (July 19, 1994) (setting aside NASD disciplinary action where application of mark-up rule to DPP securities was "a matter of first impression"); *Lowell H. Listrom & Co.*, Exchange Act Release No. 19,414, 1983 SEC LEXIS 2676 (Jan. 10, 1983) ("[T]he present language of the interpretation and its accompanying materials is not sufficiently clear to have put applicants on notice that their sales would be improper.").

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Alan W. Heifetz
Hearing Officer
For the Extended Hearing Panel