During 2003, compensation practices for the retail sale of mutual funds came under fire. To a considerable extent, revelations at the end of 2002 about failures in the processing of mutual fund breakpoints triggered a more in-depth investigation into mutual fund marketing and compensation practice by securities regulators, Congress, and the states. By year end, several enforcement actions had been announced, and proposals for reform of certain compensation practices had been announced or published by the SEC and NASD, and introduced in Congress. As we begin 2004, mutual fund distributors and sellers face considerable uncertainty over the continued permissibility of compensation practices and arrangements utilized in the past. This article discusses the regulatory framework for these practices and arrangements, briefly noting recent enforcement actions and reform initiatives announced through February 2004.

OVERVIEW OF COMPENSATION PRACTICES

Compensation arrangements in the context of retail sales of mutual funds involve three types of arrangements: those between fund complexes and the firms selling the funds (the “selling firms”), those between firms and their own sales personnel, and those between fund complexes and sales personnel of their selling firms. This article focuses on the regulation of sales compensation practices primarily as it affects a broker-dealer selling mutual funds in the retail market (“selling firm”) and its sales representatives. Compensation arrangements for other broker-dealers who may be involved, such as those serving as principal underwriters or distributors for funds or third party wholesalers, or for funds distributed on a direct marketing basis (sometimes referred to as “no-load”), are discussed only peripherally.

Compensation practices for retail mutual fund sales have evolved through the years, along with the development of the “multi-class” structure now commonly employed by many mutual funds. Prior to the 1980s, compensation arrangements for mutual fund sales generally entailed a “package” of different compensation items, including a dealer concession, ongoing payments made under a Rule 12b-1 plan or other servicing plan, and so-called “revenue sharing” arrangements pursuant to which fund service providers, such as investment advisers, distributors, and other fund service agents, paid additional amounts to a selling firm out of their own revenues. The package also may have included cash contributions and other cash and non-cash assistance to the selling firm for its internal marketing and educational.
programs. In addition, selling firms may have been paid bonus amounts and ongoing payments, calculated as a percentage of assets that remained invested in the shareholder accounts opened as a result of the selling firm's efforts. In some cases, the additional payments may have been tied to a fund complex's designation as a "preferred fund" under a "preferred partner program" maintained by the selling firm, and as such have been referred to colloquially as "shelf-space payments." Also, some funds and fund service providers may have funded their additional payments through commissions on fund portfolio trades directed to selling firms by the executing firm, a practice sometimes referred to as "step-outs." Compensation arrangements for sales representatives also have evolved through the years. In recent years, many selling firms have offered cash and non-cash incentives to their sales representatives to encourage fund sales and have provided or made available training and education opportunities. Some selling firms have adopted compensation "grids" that effectively provide compensation incentives for sales representatives to market "preferred partner" funds over those funds not on the preferred list by allowing a higher portion (i.e., "payout ratio") of the "gross dealer concession" received by the firm for partnered funds than for non-partnered funds. In addition, sales representatives at selling firms maintaining preferred partner programs often could expect to receive marketing support from preferred fund wholesalers, which support could be in the form of financial and other assistance with client meetings and promotional mailings. Further, under some "preferred partner" programs, the preferred funds or their service providers may have absorbed the "ticket charges" the sales representatives otherwise would be required to pay to submit purchase orders for shares of preferred funds.

The following sections discuss the regulatory framework for three key compensation practices: 1) the use of non-cash compensation in connection with mutual fund sales; 2) marketing and compensation arrangements providing enhanced compensation to a selling firm as well as to its sales representatives for the promotion of certain fund securities over others, such as preferred funds over non-preferred funds, proprietary funds over non-proprietary funds, and Class B shares over Class A shares; and 3) the use of commissions for mutual fund portfolio trades as an additional source of selling compensation for selling firms (a practice sometimes referred to as "directed brokerage"). Responsibility for the regulatory framework is shared by the SEC and the NASD. The SEC has exclusive jurisdiction over mutual funds and their investment advisers and transfer agents, all of which are required to be registered with the SEC. The SEC and NASD share jurisdiction over firms involved in the distribution of fund shares as principal underwriters or wholesalers, and in the retail sale of fund shares, as selling firms. Such firms are required to be registered as broker-dealers with the SEC and, as such, must comply with the disclosure and recordkeeping rules adopted or enforced by the SEC for registered broker-dealers. They also must be admitted as member firms of the NASD, and as member firms must comply with the NASD's conduct and sales practice rules.

**USE OF NON-CASH COMPENSATION IN CONNECTION WITH MUTUAL FUND SALES**

The use of non-cash compensation in connection with mutual fund sales is strictly regulated by the NASD’s non-cash compensation rules ("non-cash rules”), included in its conduct rules governing member activity in investment company securities. The non-cash rules address the use of non-cash compensation in arrangements between mutual fund distributors and selling firms, as well as between selling firms and their sales representatives. In addition, the non-cash rules also address the receipt of non-cash compensation by sales representatives from “offerors.”

**Who Is an Offeror?** For purposes of the non-cash rules, an “offeror” includes an investment company, adviser to an investment company, fund administrator, underwriter, and any affiliated person of such entities. Thus, non-cash items provided by a fund adviser, underwriter, or its affiliated transfer agent would be subject to the non-cash rules.

**Limits on Non-Cash Compensation.** The non-cash rules prohibit a member from receiving any non-cash compensation from an offeror, except as explicitly permitted by the rules. The non-cash rules permit a selling firm to receive payments or reimbursements from an offeror for the selling firm’s expenses in connection with provision of training and education by the selling firm to its sales representatives, so long as certain conditions are met. In addition, a selling firm can receive contributions from an offeror to a non-cash incentive program provided by the selling firm for its sales representatives so long as the selling firm's program complies with applicable conditions for non-cash incentive programs and the offeror does not participate in the organization of the program. The non-cash rules prohibit sales representatives from receiving non-cash items from their selling firms or offerors in connection with the sale or distribution of mutual funds except as explicitly permitted by the rules. As discussed below, these exceptions allow them to receive...
or benefit from certain small items, occasional meals and entertainment, and certain training and education meetings, whether sponsored by their selling firms or offerors. However, non-cash items received as incentive awards can be provided only under programs organized by their firm and must meet certain strict conditions.

**What Is Non-Cash Compensation?** The non-cash rules define the term as any form of compensation received in connection with the sale and distribution of mutual funds and are not limited to cash compensation, including but not limited to merchandise, gifts and prizes, travel expenses, meals, and lodging. Informally, NASD staff has indicated that a cash payment “earmarked” for a particular expense, such as travel expenses, should be treated as non-cash compensation. Also, an arrangement offering a choice between cash and a non-cash item would be treated as non-cash even if a registered person elects to receive cash in lieu of the non-cash item.

**Development of Non-Cash Rules.** The current non-cash rules were adopted in 1998 and became effective January 1, 1999, after a more than 10-year effort to develop rules that addressed incentives for those persons involved in point-of-sale activities. This focus led some to question whether the rules were intended to be limited to such persons. In a notice issued in 1999 shortly after the effective date of the non-cash rules, the NASD confirmed that the non-cash rules apply to officers and managers of member firms if they receive, directly or indirectly, compensation in connection with the sale and distribution of mutual funds, even though they may not be involved in “point-of-sale” activities. In other words, the non-cash rules are not limited to those registered persons functioning as “sales representatives,” and apply to all persons associated with a member firm. Applying the same reasoning, the NASD also affirmed that the non-cash rules apply to firms providing wholesaling services.

**Items Outside the Rules.** In interpretive guidance, the NASD has clarified that certain non-cash items are not subject to the non-cash rules’ proscriptions or conditions. For example, the NASD has explained that, if the non-cash compensation is in the form of a promotional item, i.e., merchandise sporting the offeror’s logo, and has a nominal value, such as a polo shirt or golf balls, the item would not be subject to the non-cash compensation provisions, presumably because the item would not be considered to be in connection with the sale or distribution of investment company securities. Also, the NASD has indicated that gifts of a personal nature, such as a wedding gift, would not be subject to the rules. The NASD also has explained that the provision of business development and education enhancement items by an offeror to sales representatives would be permitted, so long as the provision of the items is not preconditioned on the achievement of a sales target. In addition, the NASD has explained that an offeror could reimburse a sales representative for the costs of a “prospecting trip” so long as the payment is made through the member and the record-keeping requirements of the non-cash rules are satisfied. This guidance appears to be perceived by some firms as allowing offerors and their representatives to attend, pay for, or reimburse the costs of “client appreciation” dinners with customers of sales representatives at selling firms.

**Exceptions for Permissible Non-Cash Compensation.** The non-cash rules effectively permit a member or associated person to receive non-cash compensation in circumstances specified in four “exceptions.” The exceptions, discussed below, differentiate between incentive and non-incentive based compensation.

**Non-Incentive Small Gifts, Meals, and Entertainment.** The exceptions allow associated persons to receive small
gifts (up to an annual amount per person set by the NASD) occasional meals or entertainment from their member firms as well as offerors provided certain substantive conditions are satisfied. Whether given by the member firm or an offeror, the item may not be preconditioned on achievement of a sales target, and in the case of meals and entertainment, they may not be so frequent or extensive as to raise any question of propriety. The NASD has explained that holiday parties sponsored by an offeror ordinarily would be treated as entertainment or gifts and therefore would need to comply with the “entertainment” exception of the non-cash rules.

Non-Incentive Training and Education Meetings. The non-cash compensation exceptions allow associated persons to receive compensation in the form of meals, lodging, and transportation in connection with attending training and education meetings, provided that certain conditions are met. In particular: 1) the associated persons must obtain their member firm’s approval prior to attending the meeting; 2) in granting approval, the member firm may not precondition attendance on the achievement of a sales target or any other incentives pursuant to an permissible non-cash compensation arrangement; 3) the location must be appropriate for the purpose of the meeting; 4) the payment or reimbursement of expenses by an offeror must not be applied to the expenses of any guest of an associated person attending the meeting; and 5) payment or reimbursement by the offeror may not be preconditioned by the offeror on the achievement of a sales target or any permitted non-cash compensation arrangement. On its face, the rule would appear to prohibit an offeror from reimbursing attendees directly for their travel expenses. In interpretive guidance, the NASD general counsel’s office has clarified that an offeror can directly reimburse attendees for their personal travel expenses so long as the record-keeping conditions of the rule are met. Significantly, not all of the conditions apply to a training and education meeting sponsored by a member firm for its own associated persons. For example, the NASD has explained that a member firm could reimburse its associated persons for the expenses of guests attending a training and education meeting but that an offeror could not.

The basis for selecting attendees for a training and education meeting is a critical condition. Basing the selection on mutual fund sales production requirements will disqualify the event as a training and education event, even if the content, location, and conduct of the meeting otherwise satisfy the conditions for the training and education exception. However, while attendance at a meeting may not be conditioned on achieving a sales target, the NASD has explained that a member can designate invitees to “recognize past performance or encourage future performance.” The NASD has not further clarified the extent to which an offeror could use past sales production as a criterion for selecting attendees without causing the selection to be preconditioned upon achievement of a sales target.

Location of a training and education meeting also can raise interpretive issues. The training and education exception explains that an appropriate location is “an office of the offeror or the member, or a facility located in the vicinity of such office, or a regional location with respect to regional meetings.” The NASD has explained that regional locations may be used where “attendees are from a number of offices in a region of the country.” Where multiple offerors contribute to a meeting, presumably any one of their offices could serve as a qualifying local area for a meeting.

Finally, through interpretive guidance, the NASD has set content and conduct standards for training and education meetings qualifying for the exception. In particular, the NASD has indicated that it interprets the exception as applying to an event that is “first and foremost intended to provide training or education to an associated person,” and as such should “occupy substantially all of the work day.” Thus, while payment or reimbursement for any associated meals, lodging, and transportation would be permissible, the exception would not allow for payment or reimbursement for entertainment, such as golf outings or tours, held in conjunction with a training or education meeting. In a letter sent to member firms, the NASD clarified that offerors may organize golf outings, tours, or other forms of entertainment in conjunction with a training or education meeting, but the offeror may not pay for or reimburse the costs of these events.

Incentive Non-Cash Compensation Programs. The non-cash exceptions allow an associated person to receive compensation under an incentive non-cash compensation arrangement only if the arrangement is sponsored by his/her member firm (or an affiliate), the non-cash compensation is based on the total sales production of associated persons with respect to all fund securities distributed by the member, and credit given for each sale is equally weighted. In other words, the manner in which credit is given for each sale cannot result in more credit given to a proprietary fund sale than a non-proprietary fund sale. During the rulemaking history for the non-cash rules, the NASD articulated a concern with compensation
Incentives operating at point-of-sale. In the NASD’s view, the total production and equal weighting requirements would serve to limit the impact of non-cash sales incentives at point-of-sale. The NASD has indicated a little flexibility with the total production requirement to the extent that a deviation from the requirement still would be consistent with the policies and purpose of the rule and would serve some other compliance objective. For example, the NASD has not objected to a program under which no production credit would be given for sales resulting from exchanges of one variable contract for another.

The NASD has indicated that a non-cash compensation arrangement could combine mutual fund production with variable insurance contract production. (Variable contracts are subject to similar non-cash rules.) Further, the NASD has indicated that member firms can combine various product lines subject to the non-cash rules with other products and transactions in an incentive program, so long as the elements of the program applicable to those securities subject to non-cash rules meet the total production and equal weighting requirements. For example, the NASD has confirmed that a broker-dealer could include fixed insurance products, which are not subject to NASD regulation, in an incentive program and the NASD’s total production and equal weighting requirements would not apply to the fixed insurance products. However, separate contests for proprietary variable contracts sponsored by an affiliate of a member firm, such as an insurer would not be permissible, nor would separate contests for IRA, Roth IRA, and non-IRA products. On the other hand, a non-cash compensation arrangement could be limited to a specific division of a firm, such as the institutional sales division, so long as the arrangement was based on the entire universe of products that the division was authorized to sell and otherwise complied with the non-cash rules.

There are no explicit restrictions or limits on the types or dollar value of non-cash compensation awarded under a permissible non-cash incentive compensation arrangement. Thus the same rules apply whether the non-cash compensation is an all-expense-paid trip to a resort or a valuable piece of merchandise.

**Recordkeeping and Supervision Requirements.** The non-cash rules require a member firm to maintain records of all compensation (cash and non-cash compensation) received by the member firm or its associated persons from offerors. These records are required to include the names of the offerors, the names of the associated persons receiving the compensation, the amount of cash, the nature and, if known, the value of non-cash compensation received. The non-cash rules do not specify any particular supervision or compliance requirements, such as mandating principal review and approval of non-cash compensation arrangements. The SEC’s recordkeeping rules for broker-dealers also require that registered broker-dealers maintain compensation records for associated persons. These records are required to include a description of any non-monetary compensation received by associated persons. The SEC has clarified that non-monetary items of “little value” do not need to be recorded under these requirements.

**Recent Enforcement Actions.** During 2003, the NASD took administrative action against two member firms for failure to comply with rules governing the use of non-cash compensation. One action concerned entertainment provided in connection with a training and education meeting for a real estate investment trust (“REIT”). Although the action did not involve mutual funds, the action concerned other provisions of NASD rules identical to the non-cash rules and, for that reason, is instructive for mutual fund non-cash arrangements. In that action, the NASD claimed that the training and educational meetings hosted by the REIT sponsor failed to comply with the relevant conditions because the sponsor provided entertainment in conjunction with the meeting, paid for expenses associated with the guests of sales representatives attending the meeting, and provided less than 13 hours of training over a three-day period. The other action concerned internal non-cash sales contests sponsored for sales representatives of a selling firm for sales of certain mutual funds and variable contracts. In that action, the NASD asserted that the selling firm’s incentive programs awarding non-cash items did not satisfy the incentive exception of the non-cash rules because sales production amounts used to determine awards were not based on total fund and variable contract sales. The NASD also asserted that the selling firm did not maintain supervisory and compliance policies, procedures, and surveillance programs to prevent and detect violations of the non-cash rules.

**ENHANCED COMPENSATION ARRANGEMENTS**

As noted above, mutual fund compensation practices have entailed enhanced compensation for the promotion of certain fund securities over others, such as preferred partner funds over non-preferred partner funds, proprietary funds over non-proprietary funds, and Class B shares over Class A shares. Recent scrutiny has focused on dis-
Disclosure requirements for enhanced compensation arrangements. The following paragraphs discuss disclosure considerations in connection with 1) preferred partner programs, 2) differential compensation arrangements for sales representatives, and 3) B share sales. The common theme with all three practices is the management of conflicts of interest created by differentials in compensation.

**Payments for Preferred Partner Programs**

**Disclosure Requirements and Practices.** It has long been recognized that the antifraud provisions of the federal securities laws call for disclosure to customers of compensation received by broker-dealers in effecting transactions for their accounts.\(^{58}\) Indeed, the SEC rule (the “confirmation rule”) mandating the delivery by a broker-dealer of a transaction disclosure document—more commonly known as a confirmation—is codified as Rule 10b-10 under Section 10(b) of the 1934 Act, that act’s antifraud provision.\(^{59}\) The confirmation rule requires disclosure to a broker-dealer’s customers of, among other things, compensation received or earned by the broker-dealer in connection with effecting a transaction.\(^{60}\) This disclosure requirement applies to remuneration received from third parties as well as from customers.\(^{61}\) In the SEC’s view, third party remuneration “presents a potential for abuse since there is a prima facie problem in representing fairly the rights of parties having conflicting interests.”\(^{62}\)

In adopting the confirmation rule, the SEC reserved authority to exempt a broker-dealer from the confirmation rule with regard to specific transactions or classes of transactions for which the broker-dealer provided alternative procedures to effect the purposes of the rule.\(^{63}\) Pursuant to this authority, the SEC staff in 1979 issued a letter (the “1979 letter”) to the Investment Company Institute, a trade association for the investment company industry, giving no-action assurance for the use of confirmations for mutual fund transactions that omitted information about remuneration received by the selling firm provided that the prospectus for the mutual funds contained disclosure of sales charges, breakpoints, and maximum dealer discounts.\(^{64}\)

In granting the relief, the staff relied on a 1977 SEC release which had explicitly acknowledged that, if information about the source and amount of third-party remuneration was disclosed in a prospectus, then the confirmation for the transaction did not have to repeat the information.\(^{65}\)

The registration statement form currently used to register shares of mutual funds is Form N-1A. This form contemplates three parts to the registration statement: a prospectus that must be given to all purchasers, a statement of additional information (“SAI”) that must be made available to purchasers upon request, and supplemental information included in “Part C” of the registration statement that is available from the SEC. The form requires disclosure about sales compensation in all three parts. As a practical matter, NASD rules also impose prospectus disclosure requirements in the case of cash compensation arrangements. These requirements arise from NASD rule provisions prohibiting a member firm from receiving any cash compensation from an offeror (such as a fund or fund distributor) unless the compensation is described in the prospectus.\(^{66}\) The same rule provisions also prohibit a member firm from participating in “special cash compensation” arrangements, not made available on the same basis to all member firms distributing the fund shares, unless the name of the member receiving the special compensation and the details of the arrangements are disclosed in the prospectus.\(^{67}\) The NASD has indicated that this disclosure can appear in a fund’s SAI rather than in the prospectus.\(^{68}\) Taking into account the disclosure requirements set forth in Form N-1A and inferred from NASD rules, the compensation disclosure requirements can be summarized as follows:

- **Sales Load Disclosure.** The form requires disclosure in the fund’s prospectus of sales loads, including deferred sales loads, applied to purchases of a fund’s shares.\(^{69}\) Information is required to be presented in the fee table, as well as in a separate table showing sales loads only. The form also requires the prospectus to explain how the sales loads are calculated and when they are imposed.\(^{70}\) The prospectus also must disclose any arrangements resulting in breakpoints in, or elimination of, sales loads, such as letters of intent, accumulation plans, dividend reinvestment plans, withdrawal plans, exchange privileges, employee benefit plans and redemption reinvestment plans.\(^{71}\)

- **Distribution and Service Fee Disclosure.** The form requires the prospectus to include the amount of distribution and/or service (12b-1) fees in the fee table.\(^{72}\) The fee table also must include under an appropriate caption or subcaption of “other expenses,” the amount of any distribution or similar expenses deducted from fund assets other than pursuant to a Rule 12b-1 plan. The form also requires the prospectus to provide narrative information about
any Rule 12b-1 plan adopted by the fund, including disclosure that the fund has adopted a plan allowing the fund to pay distribution fees for the sale and distribution of its shares and that, because these fees are paid out of fund assets on an ongoing basis, over time these fees will increase the cost of an investment and may cost more than paying other types of charges.73 If the 12b-1 plan covers service fees, as defined in NASD rules, the disclosure can be revised accordingly.74 The form also requires disclosure in the SAI concerning the 12b-1 plan, noting its material aspects and any agreements relating to the implementation of the plan. This disclosure is to provide a list of the principal types of activities for which payments are or will be made, including the dollar amount and the manner in which amounts paid by the fund under the plan during the prior fiscal year were spent on advertising, printing, and mailing of prospectuses to persons other than current shareholders; compensation to underwriters; compensation to sales personnel; and interest, carrying, or other financing charges.75 This disclosure must also indicate whether the plan reimburses the distributor only for expenses incurred or compensates the distributor regardless of its expenses.76 It also must disclose the amount of any unreimbursed expenses incurred under the plan in a prior year and carried over to future years, in dollars and as a percentage of fund net assets of the last day of the preceding year.77 The form requires disclosure of the anticipated benefits to the fund that may result from the plan.78 Finally, the form requires additional disclosure if the fund participates in any joint distribution activities or if interested persons or directors of the fund have a financial interest in the operation of the plan or related agreements.79

- **Dealer Reallowance.** The form requires disclosure in a fund’s SAI of the portion of the front-end sales load reallowed to dealers ("dealer reallowance") as a percentage of the offering price of the fund’s shares.80

- **Special Cash Compensation Arrangements.** NASD rules effectively require disclosure of any special cash compensation arrangement that is not made available on the same terms to all members who distribute the mutual fund’s securities. This disclosure must provide the name of the member participating in the special cash arrangement and the details of the arrangement.81

As noted above, this disclosure can appear in the prospectus or SAI.

- **Underwriting Commissions.** The form requires disclosure in a fund’s SAI of the aggregate dollar amount of underwriting commissions paid and the amount retained by the principal underwriter for each of the preceding three fiscal years.82 It also requires information in the SAI concerning net underwriting discounts and commissions received during the preceding fiscal year, presented in a table.83

- **Compensation on Redemptions and Repurchases.** The form requires disclosure in Part C of the fund’s registration statement of compensation on redemptions and repurchases, brokerage commissions, and other compensation received by each principal underwriter who is not an affiliated person of the fund, or an affiliate of an affiliated person of the fund during the preceding fiscal year.84

- **Brokerage Commissions.** The form requires disclosure in a fund’s SAI if a fund will consider the receipt of products or services other than brokerage or research services in selecting brokers.85 The form requires disclosure in Part C of a fund’s registration statement of brokerage commissions and other compensation received by each principal underwriter who is not an affiliated person of the fund, or an affiliate of an affiliated person of the fund during the preceding fiscal year.86

- **Other Compensation.** The form requires disclosure in the SAI of any other payments made during the preceding year to underwriters and dealers, showing for each, the name and address, the amount paid, the basis for determining the amount, the circumstances surrounding the payments, and the consideration received by the fund.87

Although there appear to be no documented studies of confirmation practices, anecdotal information suggests that most selling firms have relied on prospectus and SAI disclosure to satisfy their confirmation rule disclosure obligations with regard to the compensation they receive for mutual fund sales. In other words, confirmations for their mutual fund sales appear not to have disclosed compensation received by selling firms, whether with regard to dealer concessions or other fees or compensation received.
Reliance on prospectus disclosure to satisfy the confirmation rule’s compensation disclosure obligations has come under scrutiny more than once. In 1994, the director of the SEC division responsible for broker-dealer regulation sent a letter to the Investment Company Institute stating the division’s view that commissions for investment company transactions should be disclosed on confirmations and announcing its intent to withdraw the 1979 letter. The SEC staff, however, took no further action to withdraw the letter, and later explained that the staff was persuaded by the investment company industry at the time that prospectus disclosure provided more accurate information.

In 1997, several class-action lawsuits were filed against a number of broker-dealers, alleging that the defendant broker-dealers committed securities fraud by failing to disclose 1) their receipt of 12b-1 fees from money market funds in which they invested their customers’ money, 2) their receipt of revenue sharing payments from the funds’ investment advisers, and 3) the conflicts of interest engendered thereby. At issue was the sufficiency of the prospectus and SAI disclosure of compensation received by the broker-dealers. When the lower court dismissed the actions, the plaintiffs appealed to the circuit court, which requested the SEC to submit an amicus brief. The SEC complied with the court’s request, submitting a brief generally endorsing the practice of relying on prospectus disclosure. The court deferred to the SEC’s analysis, ruling in 2000 that no confirmation rule violation occurred. Nonetheless, the court expressed some skepticism “that the disclosures in the prospectuses and [statements of additional information], i.e., general statements that payments were made by the funds and their advisers to broker-dealers for their assistance, would actually alert an investor that his broker-dealer received such payments.”

In an apparent reversal of position, the SEC took enforcement action in late 2003 against a selling firm, claiming that customary fund prospectus and SAI disclosure was insufficient to satisfy the selling firm’s obligations to disclose the compensation it received from its “preferred partner” funds. In the SEC’s view, the fund prospectuses and SAIs, while containing some disclosures concerning payments to their selling firms, did not adequately disclose this particular selling firm’s preferred partner program as such, nor did they provide “sufficient facts about the programs for investors to appreciate the dimension of the conflicts of interest inherent in them.” The SEC cited the omission of information about the extra payments made “for enhanced sales and marketing [and] . . . the various marketing advantages provided through the programs.” The SEC asserted that these omissions constituted violations not only of the confirmation rule, but also of Section 17(a)(2) of the 1933 Act, which prohibits any person from obtaining money or property by means of an untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. As part of the settlement, the selling firm agreed to an undertaking to provide customers purchasing mutual funds a disclosure statement concerning compensation received by the firm and its sales representatives in connection with the sale of mutual fund securities under its preferred partner program.

Recent Rulemaking Initiatives. In September 2003, the NASD requested comment on a proposal to require point-of-sale disclosure by selling firms of revenue sharing arrangements, in which a mutual fund adviser or offeror agrees to pay cash compensation not otherwise disclosed in the prospectus fee table, such as “shelf-space” payments. In January 2004, the SEC proposed the adoption of two new rules under the 1934 Act that would mandate a point-of-sale compensation disclosure document, as well as a new confirmation document, for mutual fund sales. The SEC’s proposed rules would require broker-dealers to provide certain specified disclosures to customers at “point of sale” on a form document titled a “Schedule 15D.” The particular disclosures would differ depending on whether the particular fund security being offered at point of sale offered a front-end load or back-end load. In general, the schedule would show the sales load, expressed as a dollar amount in relation to the proposed investment amount or, if not known, a hypothetical $10,000 investment; the portion of the load to be received by the selling firm; an estimate of any asset-based distribution or services fees to be received by the selling firm from the fund during the first year; and an indication of whether the selling firm receives revenue sharing payments or portfolio brokerage commissions, and whether it pays higher compensation (i.e., differential compensation) to its sales representatives for proprietary securities or for securities with a back-end load. The companion confirmation document under the SEC’s proposed rules would provide similar information, as well as numerical estimates for revenue sharing and portfolio brokerage commission payments. In addition, the confirmation document would be required to show what each payment represents as a percentage of the investment, along with the industry norms (such as range and medium) for such compensation.
Differential Compensation for Sales Representatives

As discussed above, a practice some selling firms employ is paying their sales representatives higher cash compensation for sales of proprietary and “partnered funds.” This practice is sometimes referred to as “differential compensation.” Differential cash compensation is not prohibited currently under applicable rules and regulations, but it has been identified as a practice that creates conflicts of interest triggering considerations under antifraud standards and supervisory requirements.

Tully Committee and Tully Report. Current views on differential compensation can be traced back to a report issued in April 1995 (the “Tully Report”), by a committee formed by Arthur Levitt, then Chairman of the SEC, and headed by Daniel Tully, then chairman of the board of Merrill Lynch (hence, the name, the “Tully Committee”). The Tully Committee was given three mandates: 1) to review industry compensation practices for sales representatives and branch managers; 2) to identify actual and perceived conflicts of interest for both sales representatives and managers; and 3) to identify the “best practices” used in the industry to eliminate, reduce, or mitigate these conflicts. Among other things, the Tully Committee was directed to consider contests and incentives that stimulate sales of particular or proprietary products or undisclosed bonuses for sales representatives who change firms. Chairman Levitt announced the formation of the Tully Committee shortly after the issuance of the Rogue Broker Report.

The Tully Report primarily focused on the commission-based compensation system, which the committee criticized as one that “inevitably leads to conflicts of interest among the parties involved.” However the report recognized that the system was “too deeply rooted to accommodate radical alteration in the near-term.” Instead, the report advocated adopting practices that best align the interests of investor, the firm, and the registered person. Using this principle as its benchmark, the committee applied it to a number of industry compensation practices, including commission versus fee-based compensation models, sales contests, differential compensation, undisclosed bonuses, and higher commission payouts paid to transferring registered persons. The report identified what the Tully Committee viewed as “best practices” with regard to compensation arrangements that would prevent or minimize “conflicts of interest.” In particular, the report offered the following:

- Paying identical commissions to registered persons for proprietary and non-proprietary products within the same product family and for principal and agency transactions;
- Paying for client assets in an account, regardless of account activity;
- “No contest” policies and/or permitting contests based only on broad measures;
- Paying only regular and not enhanced commissions to transferring registered persons;
- Deferring a portion of registered person compensation for several years, and linkage of payment to a clean compliance record;
- Using stock option or stock purchase plans in overall compensation programs;
- Eliminating of up-front bonuses;
- Paying up-front bonuses in the form of forgivable loans over a period of five years; and
- Linking registered person compensation to customer satisfaction.

The Tully Report also expressed the view that investor knowledge of compensation practices “may lead to better decision-making by clients.”

Regulator Response to the Tully Report. The SEC did not take immediate action to adopt any of the “best practices” recommended by the report, relying instead upon public pressure to encourage firms to adopt the practices voluntarily. In finalizing its non-cash rules, discussed above, the NASD incorporated the Tully Report’s recommendation to prohibit differential compensation in the criteria for incentive non-cash compensation programs. However, while the NASD has sought comment on a number of proposals, discussed below, that would implement the report’s recommendations for differential cash compensation, the NASD too has not yet adopted any rules regulating differential cash compensation. Nonetheless, it appears that the Tully Committee’s list of practices that do not “align” the interests of investor, firm, and registered person generally are viewed by securities regulators as practices calling for enhanced scrutiny under a selling firm’s supervisory and compliance program. For example, during a call-in “online suitability workshop” in 2001, two NASD assistant general counsels made the following observation in a question-and-answer dialogue:

[Question:] [F]rom a practical standpoint, is a recommended transaction viewed differently if the broker had extra incentive to recommend the security in question?
A broker, for instance, may earn higher-than-usual commissions, gifts, or prizes for selling securities that the firm is promoting or in which the firm has a large inventory. These types of incentives are not prohibited by the NASD’s rules, but as a practical matter they are often scrutinized because they compromise the suitability rule’s essential requirement that the broker match the customer’s investment needs with the most appropriate investment product. In short, these types of incentives raise red flags for regulators.

This dialogue suggests that, under current sales practice rules for member firms, selling firms should ensure that they have in place appropriate supervisory controls and mechanisms to ensure that compensation incentives do not result in inappropriate securities transactions.

**NASD Proposals to Regulate Incentive and Differential Compensation.** After the issuance of the Tully Report, the NASD initiated a number of efforts to implement the report’s recommendations relating to differential compensation, particularly in regard to mutual funds and variable contracts. In the mutual fund context, the term “differential compensation” has been used primarily to refer to the practice of offering sales representatives a higher percentage of a selling firm’s gross dealer concession (“GDC”) for the sale of proprietary funds than for the sale of the same dollar amount of comparable non-proprietary funds. The first attempt by the NASD to regulate differential compensation appeared in an SEC release in July 1996, publishing for public comment an NASD proposed rule change that would have prohibited cash incentive compensation arrangements for investment company securities and variable contract sales unless they complied with total production and equal weighting requirements. This rule change was part of the NASD non-cash compensation rulemaking initiative resulting in the non-cash rules discussed above. This proposal did not directly prohibit differential compensation per se, but would have prohibited the use of differential compensation in the context of cash incentive arrangements. The rule filing was never approved by the SEC: the SEC received many critical comment letters on the published rule filing, particularly in regard to the cash incentive compensation provisions, and requested the NASD to reconsider the rule filing in light of the comments received. The final version of the non-cash rules adopted by the NASD in 1998 limited the prohibition on differential compensation to non-cash incentive compensation arrangements.

Even though the NASD abandoned the rule change prohibiting incentive cash differential compensation in 1996, it continued to focus on the issues created by differential arrangements. In August 1997, the NASD again requested comment on various compensation practices, including differential compensation practices. In particular, it requested comment on the best means of regulating such practices. In this regard, the NASD outlined several different approaches, ranging from mandatory disclosure of all cash compensation arrangements, substantive requirements such as limiting or prohibiting payments of differential compensation, or a policy recognition that arrangements creating conflicts of interest are “fundamentally a sales-practice issue.” With regard to differential compensation, the NASD suggested an approach of prohibiting differential compensation for sales representatives with regard to different share classes in the same fund.

Two years later, in October 1999, the NASD solicited comment on a rule proposal that would have prohibited the payment of differential cash compensation as between proprietary and non-proprietary mutual funds, “single security sales contests,” and accelerated payouts. In proposing the rule, the NASD cited the Tully Report’s conclusions that differential compensation arrangements “can create conflicts of interest by encouraging representatives to recommend proprietary products to maximize their commissions, rather than to best meet their customers’ needs.” The NASD also specifically requested comment on whether it should adopt a rule requiring oral or written disclosure of the difference in compensation as an alternative to prohibiting the practice. In this regard, the NASD observed that:

[such an] approach would be consistent with the NASD’s long-standing practice of not substantively regulating internal compensation arrangements of member firms and their registered representatives and instead permitting investors to evaluate whether a registered representative’s particular product recommendation was influenced by such arrangements.

The notice solicited comment on the mechanisms for giving, and documenting the giving, of such disclosure. No further action was taken by the NASD in response to industry comments on this notice.

**Recent Proposals.** As noted above, in 2003, the NASD requested comment on a proposal to require point-of-sale disclosure by selling firms in connection with mutual fund sales. Among other things, the NASD's
Proposed point-of-sale disclosure document required information about differential cash compensation payments, pursuant to which registered persons receive higher payouts for the sale of certain investment company products, such as the member’s proprietary funds. In this regard, the NASD explained that the disclosure should cover arrangements in which a registered person would not have to pay a ticket charge for a proprietary fund transaction, but would be required to do so for a nonproprietary fund transaction. Also as noted above, in January 2004, the SEC proposed its own version of a point-of-sale disclosure document, along with a new confirmation rule for mutual fund transactions that would require disclosure of sales representative differential compensation arrangements, among other things.119

Compensation for B Share Sales

When first introduced, mutual funds had a simple pricing structure for sales compensation: sales compensation was financed through a front-end sales charge deducted from purchase payments before investment in the fund. During the 1980s, the mutual fund industry developed alternate ways of pricing sales charges and financing sales compensation. For example, the fund industry introduced the practice of deferring the deduction of a sales charge until redemption of the shares (“deferred” or “back-end” charge), rather than at the front-end.120 The industry also made use of 12b-1 plans, allowed since the adoption of Rule 12b-1 in 1980, for the financing of sales compensation through the deduction of asset-based charges.121 Other innovations included the hub-and-spoke structure and multi-class structure, both of which effectively allowed funds to offer different purchase options to investors.122

In the late 1980s, the NASD took steps to address compensation arrangements that had evolved in conjunction with the proliferation of mutual fund purchase options.123 In 1992, the NASD amended its rules to establish new limits, which remain in effect today, for the different sales charge structures that had been introduced.124 The sales charge limits differentiate among three types of investment company charge structures: investment companies without an “asset-based sales charge,” investment companies with an “asset-based sales charge,” and funds of funds.125 For purposes of these limits, NASD rules define the term “asset-based sales charge” as a sales charge deducted from the net assets of a fund, not including a service fee.126 “Service fee” in turn is defined as a payment by an investment company for personal service and/or the maintenance of shareholder accounts.127 NASD rules impose a 25 basis point cap on service fees; any asset-based fees in excess of 25 basis points for service must be treated as a sales charge.128 NASD rule limits on sales charges envision a reduction in sales charges for rights of accumulation and quantity discounts (“breakpoints”) in the case of shares offered without an asset-based sales charge.129 NASD rule limits on sales charges for investment company shares with asset-based sales charges do not envision any reduction in sales charges for rights of accumulation or quantity discounts.130

Since typically only those shares labeled “Class A” have been offered without an asset-based sales charge, breakpoint discounts historically have been offered only with “A” shares. Class shares typically labeled Class “B” or Class “C” ordinarily bear an asset-based sales charge that does not subject them to NASD sales charge limits imposing a breakpoint or other volume discounts on their sales charges. Because of this difference, over time, sales expenses associated with large purchases of Class B shares can be expected to be higher than those associated with the same purchase of Class A shares.131 More importantly, the sales commissions received by selling firms and shared with sales representatives are likely to be higher on a commensurate scale. Thus, compensation for Class B shares presents essentially the same issue as the preferred payment and differential compensation arrangements discussed above.

Regulator Concern and Enforcement Actions. During the early 2000s, the securities regulators expressed concern about the higher cumulative sales charge expenses associated with large purchases of B shares compared to the reduced front-end sales charge applicable to the same size purchase of A shares, due to the effect of breakpoints.132 Both the SEC and NASD have published investor brochures, and the SEC installed an interactive tool on its website to assist investors in calculating mutual fund costs.133 Both regulators have brought a number of enforcement actions in recent years against selling firms and their sales representatives, alleging violations of various rules in connection with sales of Class B shares. SEC actions generally have been based on violations of Rule 10b-5,134 whereas NASD actions generally have been based on its suitability rule.135 In 2003, the SEC announced the settlement of an enforcement action against a selling firm relating to the selling firm’s sales of Class B shares. In that action, the SEC claimed that the differential in sales compensation between B shares and A shares in the case of large purchases, resulting from the absence of breakpoints on B shares, created a con-
flict of interest that should have been disclosed to avoid a violation of Section 17(a)(2) of the 1933 Act.136

Recent SEC Rulemaking Initiatives and Industry Developments. The SEC has published several proposals to address disclosure issues associated with Class B shares. In December 2003, the SEC proposed amendments to the Form N-1A registration statement to require enhanced disclosure of breakpoint opportunities.137 The proposed amendments would require a mutual fund prospectus to include disclosure concerning any arrangements resulting in breakpoints in sales charges and to provide a brief summary of shareholder eligibility requirements.138 The SEC’s proposed point-of-sale and confirmation disclosure documents for mutual funds, discussed above, would include disclosure and information about Class B shares and the potentially higher sales costs associated with their purchase.139 Press reports in January 2004 suggested that several fund complexes had taken steps to reduce their ceilings on shareholder investments in Class B shares to $100,000.140 Finally, the SEC’s proposed ban on directed brokerage arrangements, discussed below, also appears to call for reconsideration of the NASD sales charge limits, a call which if pursued, could have significant consequences for the pricing and design of Class B shares.141

DIRECTED BROKERAGE ARRANGEMENTS

The third compensation practice mentioned above is “directed brokerage,” i.e., the use of brokerage commissions on fund portfolio trades as a form of sales compensation. Through the years, one of the more controversial compensation practices for mutual fund sales has been the allocation of mutual fund portfolio brokerage commissions to selling firms. Under these allocation arrangements, a selling firm may receive additional compensation through the commissions received for executing portfolio trade orders placed by the funds with the selling firm, or from a portion of the commission on the execution of the order by another broker-dealer firm instructed by the firm portfolio manager to “step out” a portion of the commission to the designated selling firm.142 While directed brokerage arrangements raise issues under a number of regulatory provisions, the following paragraphs focus on the NASD’s “Anti-Reciprocal Rule.”143

In 1973, the NASD adopted the so-called “Anti-Reciprocal Rule,” originally as an interpretation.144 As first adopted, the Anti-Reciprocal Rule prohibited member firms from seeking orders for the execution of fund portfolio trades on the basis of their sales of fund shares. The rule also prohibited members acting as principal underwriters from participating or influencing the fund in considering sales of fund shares as a qualifying or disqualifying factor in the selection of a firm to execute a transaction for the fund’s portfolio.145 The Anti-Reciprocal Rule was adopted at the behest of the SEC, which had requested the NASD to direct its members to discontinue the use of reciprocal portfolio brokerage for the sale of fund shares.146

In 1980, reflecting a seismic change in SEC views, the SEC adopted Rule 12b-1 under the 1940 Act.147 Rule 12b-1, for the first time, permitted a mutual fund to bear expenses associated with the distribution of its shares, provided that the rule’s conditions were met. Rule 12b-1 contemplates the adoption of a plan by the fund’s board of directors for the financing of any activity primarily intended to result in the sale of shares issued by the company.148 Rule 12b-1 thus provided a vehicle for the permissible use of fund assets, such as portfolio trade commissions, to finance distribution expenses.

The shift in SEC views called into question the NASD’s Anti-Reciprocal Rule. The NASD then commenced an undertaking to revise its Anti-Reciprocal Rule to accommodate distribution practices permitted under Rule 12b-1.149 In 1981, the Anti-Reciprocal Rule’s prohibitions were relaxed in the case of funds following a disclosed policy of considering sales of their shares as a factor in the selection of broker-dealers to execute portfolio transactions, subject to best execution.150 In approving this rule change, the SEC referenced Rule 12b-1 which had been adopted in 1980, noting that, since Rule 12b-1 allowed funds to bear expenses associated with the distribution of their shares, it then is “not inappropriate for [funds] to seek to promote the sale of their shares through the placement of brokerage without the incurring of any additional expense.”151

Since the 1981 amendments, the Anti-Reciprocal Rule has prohibited member firms from engaging in a number of identified practices, including:

• favoring or disfavoring the sale or distribution of investment company shares on the basis of brokerage commissions;
• demanding, requiring, or soliciting a promise for brokerage commissions as a condition to the sale or distribution of investment company shares;
• offering or promising another member brokerage commissions from any source as a condition to the sale or distribution of shares of an investment company;

38 COMPENSATION PRACTICES FOR RETAIL SALES OF MUTUAL FUNDS
requesting or arranging for the direction to a member firm of a specific amount or percentage of brokerage commissions conditioned upon that member's sales or promise of sales of an investment company's securities;

- circulating any information regarding the amount or level of brokerage commissions received by the member firm from any investment company or covered account to anyone other than management personnel who are required to have access to the information in the overall management of the firm's business;
- sponsoring a campaign or sales effort financed by brokerage commissions.\textsuperscript{152}

In addition, with regard to arrangements that a selling firm may offer its sales personnel and branch managers, the Anti-Reciprocal Rule prohibits a member firm from:

- providing any incentive or additional compensation for the sale of shares of specific investment companies based on the amount of brokerage commissions received or expected from any source, including investment company or covered accounts;
- identifying specific investment companies to sales personnel as "recommended," "selected," or "preferred," on the basis of brokerage commissions;
- sharing with them brokerage commissions from investment company portfolio transactions; and
- using investment company sales as a factor in negotiating the price of, or amount of brokerage commissions to be paid on, a portfolio transaction for an investment company, whether the transaction is executed in the over-the-counter market or elsewhere.\textsuperscript{153}

Importantly, the rule clarifies that its prohibitions are not intended to prohibit the execution of portfolio transactions by member firms who sell the investment company's securities, or from selling shares of an investment company that follows a disclosed policy of considering investment company sales as a factor in the selection of broker-dealers to execute portfolio transactions, subject to best execution, or from compensating sales personnel and managers based on total sales of investment company securities attributable to such persons, provided that the compensation is not designed to favor or disfavor sales of shares of particular investment companies on a basis prohibited by the Anti-Reciprocal Rule.

In 1984, the NASD issued guidance on the Anti-Reciprocal Rule, emphasizing that the 1981 rule change was not intended to result in an extensive alteration in the regulatory framework. The guidance emphasized that the rule continued to prohibit a number of practices, whether or not disclosed, such as conditioning the sale of fund shares on the payment of brokerage commissions; directing a specific amount or percentage of brokerage commissions on the basis of sales or promises of sales of fund shares; or allowing registered representatives, branch managers, or other sales personnel to share in fund brokerage commissions on the basis of sales of fund shares.\textsuperscript{154} The guidance also offered several examples of practices prohibited by the Anti-Reciprocal Rule, such as a request, offer, or agreement for the placement of portfolio trades to finance part or all of a selling firm's sales contest or for the fund to be placed on a selling firm's preferred list.\textsuperscript{155}

From time to time after 1984, brokerage allocation practices have sparked scrutiny.\textsuperscript{156} For example, questions have arisen concerning the treatment of brokerage allocation practices under Section 17(e)(1) of the 1940 Act.\textsuperscript{157} In early 2003, reports surfaced of an SEC initiative to issue guidance clarifying that, for any arrangement involving the direction of a portion of a fund's portfolio trade commissions to a non-executing firm as compensation for its sales of fund shares, such arrangement had to be conducted under a Rule 12b-1 plan.\textsuperscript{158} However, industry practices appeared relatively unchanged until an NASD administrative action against a selling firm in November 2003 for violation of the Anti-Reciprocal Rule. That action focused on the firm's practice of accepting a portion of brokerage commissions earned by an affiliate on trades placed for a fund as a means of satisfying a promise by the fund's service providers to make additional cash payments to the selling firm for distribution.\textsuperscript{159} The consent in settlement of the action indicated that the NASD viewed the firm's practices as a violation of the Anti-Reciprocal Rule's prohibitions on favoring the sale of an investment company's securities on the basis of brokerage commissions, arranging for the direction of a specific amount of brokerage commissions conditioned upon the firm's sale of investment company securities, and providing incentives to sales personnel for the sale of investment company securities based on brokerage commissions received.\textsuperscript{160}

\textbf{Proposed Ban on Directed Brokerage Arrangements.}\n
The NASD's administrative action in 2003 appeared to have a chilling effect on the industry. In December 2003, the Investment Company Institute petitioned the SEC to adopt rules prohibiting directed brokerage arrangements.\textsuperscript{161} Press reports started to surface that fund complexes had decided to discontinue directed brokerage arrangements.\textsuperscript{162}
As this article was being finalized, press reports suggested that additional regulatory investigations were underway. In February 2004, the SEC issued a release proposing an amendment to Rule 12b-1 that would have the effect of prohibiting funds from using brokerage commissions to pay for distribution. In particular, the proposed amendment would prohibit “step-out” and similar arrangements. The release refers back to the adoption of Rule 12b-1 in 1980 and related amendment to the Anti-Reciprocal Rule, noting that the changes approved at the time were “based on a view that merely factoring sales efforts into the selection of brokers, consistent with the investment adviser’s fiduciary duties to the fund, was essentially benign.” The release then observes that:

[The SEC’s] review of current practices . . . suggests that many arrangements that direct brokerage is used to reward selling brokers for distribution constitute more than mere allocation of brokerage, and are not consistent with our 1981 rationale for approving the exception to the NASD’s Anti-Reciprocal Rule. The use of multiple broker-dealers for execution, step-outs, and other arrangements . . . explicitly [quantifies] the value of the distribution component of fund brokerage commission and belie the notion that fund advisers are merely ‘considering’ the selling efforts of the broker(s) involved.164

The release points out the various conflicts created by the practice, observing that the SEC believes “that the way brokerage has been used to pay for distribution involves unmanageable conflicts of interest that may harm funds and fund shareholders.” In order to ensure that the ban is enforced, the SEC’s proposal also would require funds that use a selling firm to execute portfolio trades to adopt, and the fund’s board (including independent directors) to approve, policies and procedures reasonably designed to prevent the persons who select executing firms from taking into account their distribution efforts and to prevent the fund, its adviser, or its principal underwriter from entering into any agreement under which the fund is expected to direct brokerage commissions for distribution.165

Finally, in February 2004, the NASD submitted a rule filing to the SEC, proposing an amendment to its Anti-Reciprocal Rule to prohibit a member firm from selling fund shares if the member knows or has reason to know that the fund or certain of its affiliates have entered into an arrangement or understanding, written or oral, to direct fund portfolio transactions in exchange for the promotion of fund shares. [FN 167] The rule filing also proposed to eliminate the exception, added in 1981, that permits a member to sell shares of a fund following a disclosed policy of considering fund sales as a factor for the selection of broker-dealers to execute portfolio transactions.167

CONCLUSION

In addition to the rulemaking reforms discussed above, several bills were introduced in Congress during 2003 and 2004 relating to mutual fund sales, most of which included provisions that would prohibit or regulate revenue sharing, shelf-space payments, and directed brokerage arrangements. At the time this article was finalized, it was too soon to predict the likely structure and scope of the final reforms. Nonetheless, it appears likely that compensation arrangements, regulatory requirements, and disclosure practices for mutual fund sales will change in the near future.

ENDNOTES

The author gratefully acknowledges the assistance of Alex Nagy in the preparation of this article.

1See NASD Notice to Members 02-85, NASD Requires Immediate Member Firm Action Regarding Mutual Fund Purchases and Breakpoint Schedules (December 2002), reporting that recent examinations had uncovered instances in which investors were not charged correct sales loads. The notice directed member firms to conduct an immediate review of the adequacy of their policies and procedures to ensure that they were designed and implemented so that investors were charged the correct sales loads on mutual fund transactions. This notice led to an industry-wide review of breakpoint compliance practices, as well as Congressional hearings on the matter. The Securities and Exchange Commission (the “SEC”), NASD, Inc. (“NASD”), and New York Stock Exchange (“NYSE”) submitted a joint report to Congress in March 2003. See SEC, NASD, NYSE Release Findings of breakpoint Examination Survey: Broker-Dealers To Review Transactions, SEC Press Release, March 11, 2003, available on links at http://www.sec.gov/news/press/2003-31.htm. By the summer of 2003, states had announced investigations into mutual fund marketing and compensation practices. See, e.g., Galvin, Spitzer Announce Joint Inquiry Into Sale of Mutual Funds by Morgan Stanley (July 14, 2003) (press release available on links at http://www.state.ma.us/sec/sct/sctms/msidx.htm).


3The term “SEC” refers to the Securities and Exchange Commission.

4The term “NASD” refers to NASD, Inc., a self-regulatory organization for broker-dealers registered with the SEC under the Securities Exchange Act of 1934, as amended (the “1934 Act”).


6In this article, the term “sales representative” is used to refer to an individual associated with a registered broker-dealer admitted as an NASD member firm and registered with NASD as a representative or principal of that NASD member firm.

7Rule 18f-3 under the Investment Company Act of 1940 (the “1940 Act”) sets forth conditions for a multi-class structure.

8Payments to selling firms are generally funded through the “sales load” deducted from gross payments in the case of front-end loads. If the shares sold are subject to a back-end load or a spread load, the payments generally are made by the fund distributor or other service provider, and are funded over time through asset-based charges deducted from fund assets.

9As a general matter, the 1940 Act prohibits a mutual fund from bearing the expenses of distributing and marketing its shares to the public. Rule 12b–1, adopted under the 1940 Act in 1980, permits a mutual fund to pay for such expenses under a plan that is adopted by the fund’s board of directors in accordance with specified review and approval requirements and meets the substantive conditions of the rule. See also discussion at n. 123 below.


13Registration requirements for mutual funds are set forth in the 1940 Act; adviser registration requirements are set forth in the Investment Advisers Act of 1940; and transfer agent registration requirements are set forth in the 1934 Act.

14See NASD Conduct Rule 2830.

15The non-cash rules also address the use of cash compensation. See paragraph (b)(1) and (b)(4) of NASD Conduct Rule 2830.

16See paragraph (b)(1)(E) of NASD Conduct Rule 2830. The definition references the definition of “affiliated person” provided by Section 2(a)(3) of the 1940 Act.

17See paragraph (b)(5)(C) of NASD Conduct Rule 2830.

18See paragraph (b)(5)(E) of NASD Conduct Rule 2830.

19See paragraph (l) of NASD Conduct Rule 2830.

20See paragraph (b)(1)(D) of NASD Conduct Rule 2830.


22See NASD Notice to Members 81–8 (March 10, 1981), announcing the implementation of new rules governing the distribution of investment company securities. The rules so adopted included provisions permitting non-cash compensation only if disclosed in the fund prospectus and only if a selling firm has an option to receive a cash equivalent. These new rules also included the codification of the NASD’s “special deals” rule and revisions to its “anti-reciprocal” rule discussed later in this article.


24See NASD Conduct Rule 2820(g).

25See NASD Conduct Rule 2810.

26See NASD Conduct Rule 2710. Non-cash rules were added to NASD Conduct Rules 2710 and 2810 effective January 1, 1989. In conjunction with finalizing those rules, the NASD commenced an initiative to adopt non-cash rules for mutual funds and variable contracts, an initiative that was concluded with the adoption of the non-cash rules in 1998. See NASD Notice to Members 98–75, supra n. 23. The non-cash rules included in NASD Conduct Rules 2820 and 2830 were slightly different from those in 2710 and 2810. In 2003, the NASD amended the non-cash compensation provisions in 2710 and 2810 to harmonize them with 2820 and 2830.

27See Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. to Amend Its Restrictions on Non-Cash Compensation in Connection with Corporate Financing and Direct Participation Programs, Exchange Act Release No. 34–47697 (April 18, 2003), approving amendments to non-cash
provisions in NASD Conduct Rules 2710 and 2810.

36See, e.g., NASD Interpretive Letters, Name not Public, Response Dated November 18, 1999, indexed under NASD Conduct Rule 2830, concerning the application of the rule to a non-cash compensation program for wholesalers.


38See id., Question 17.

39See id., Question 16.

40See id., Question 14.

41See id., Question 15. Recordkeeping requirements are discussed below.

42See, e.g., clauses (5)(A) and (5)(B) of paragraph (l) of NASD Conduct Rule 2830. The maximum dollar value for any small gifts is the amount fixed by the NASD Board of Governors from time to time. At the time this article was finalized, the maximum amount so fixed was $100.

43See Question 13 in Notice to Members 99-55, supra n. 29.

44See NASD Interpretive Letter, Submitted by American Funds Distributors, response dated September 9, 1999, indexed under NASD Conduct Rule 2830. Recordkeeping conditions are discussed below.

45See Question 9 in NASD Notice to Members 99-55, supra n. 29.

46See NASD Notice to Members 98-75, supra n. 23.

47See, e.g., paragraph (l)(4)(C)(iii) of NASD Conduct Rule 2830.

48See NASD Notice to Members 98-75, supra n. 23.


50See id.

51See NASD Interpretive Letter, Name not Public (response dated March 7, 2001), indexed under NASD Rules 2820 and 2830.

52See paragraph (l)(5)(D) of NASD Conduct Rule 2830.

53See NASD Notice to Members 98-75, supra n. 23.


55See Notice to Members 99-55, supra n. 29, Question 1.

56See paragraph (g) of NASD Conduct Rule 2820.

57See Notice to Members 99-55, supra n. 29, Question 6.

58See Notice to Members 99-55, supra n. 29, Question 22.

59See Rule 17a-3(a)(19) under the 1934 Act.


62Id.


64Id. The AWC Letter also entailed a sanction and fine against a senior officer of the selling firm.


67See paragraph (a)(2) of Rule 10b-10 under the 1934 Act.

68Depending on the nature of the contractual relationships among the selling firm, the fund, the fund's distributor, and the customer, the dealer concession or reallowance may functionally be deemed to be a markup or third-party remuneration.


70See Rule 10b-10(e) under the 1934 Act.


72See Brief of the Securities and Exchange Commission as Amicus Curiae, Press v. Quick & Reilly, 218 F.3d 121 (2d Cir. 2000), at 10 (citing the Rule 10b-10 Adopting Release at n. 58) (“Quick & Reilly Amicus Brief”). Rule 10b-10 permits a broker-dealer to merely state whether such remuneration has or will be received and the fact that the source and amount of such remuneration will be furnished upon written request of the customer. However, this alternative is available only if the broker-dealer is not participating in a distribution in the case of a purchase of a security, or not participating in a tender offer, in the case of a sale of a security. See Rule 10b-10(a)(2)(D)(I) under the 1934 Act. Thus, this alternative is not available for securities transactions effective in the context of a securities offering.

73See NASD Conduct Rule 2830(l)(4).

74Id.

75See Question 18 in NASD Notice to Members 99-55, Questions and Answers Relating to Non-Cash Compensation Rules (July 1999). The rule does not require prospectus disclosure of arrangements between principal underwriters of the same security or between the principal underwriter of a security and the sponsor of a unit investment trust which utilizes the security as its underlying investment. See NASD Conduct Rule 2830(l)(4).

76See Items 3 and 8 of Form N-1A.

77See Item 8 of Form N-1A.

78Id.

79See Item 3 of Form N-1A.
generally was articulated in an administrative proceeding in 1939, was based in part on Section 17(a)(2) of the 1933 Act. This theory launched the so-called “shingle theory” discussed below, also impliedly represents that it will deal fairly with the public. See generally, L. Loss, Securities Regulation, vol. VIII, ch. 9 at 3772-98 (3rd ed. 1991). See also NASD Conduct Rule IM-2310-2.


102See Proposed Rule 15c2-2, as set forth in the 2004 Confirmation Proposal, supra n. 100.

103See, e.g., Robert T. Greene, “Differential Commissions as a Material Fact,” 34 Emory L. Journal 507 (1985), for a discussion of differential commission practices in place during the 1960s and 1970s; see also SEC v. Hasho, 784 F.Supp. 1059, 1109-10 (S.D.N.Y. 1992), in which a district court ruled that sales representatives had violated the antifraud provisions of Sections 17(a) of the 1933 Act and 10(b) of the 1934 Act for, among other things, misstating to customers that they would not earn any commissions and failing to disclose the amount of commissions earned. But see In re Michael Flanagan, et al., SEC Adm. Proc. File No. 3-9784 (Jan. 31, 2000) (judicial decisions do not recognize a legal obligation for brokers or advisers to disclose comparative non-excessive compensation or “conflicts” to clients and customers in the absence of special circumstances.)


107See.

108See.

109See discussion above under “Use of Non-Cash Compensation in Connection with Mutual Fund Sales.”

110As discussed above, use of differential compensation in the context of non-cash compensation for mutual fund sales is prohibited under NASD Conduct Rule 2830(l).
111 A transcript of this workshop held June 20, 2001 is available at http://www.nasdr.com/2660_memreg.htm#transcripts.
112 The term “differential compensation” generally is not used to refer to situations in which the dollar amount of a sales representative’s compensation actually paid for the sale of shares in one fund may differ from the dollar amount paid for another similar fund, simply because of differences in the GDC for the two funds. Nor does the term refer to the situation in which a selling firm may receive a higher GDC from one product provider than another.
114 See NASD Notice to Members 97-50, NASD Regulation Requests Comment on Regulation of Payment and Receipt of Cash Compensation Incentives; Comment Period Expires October 15, 1997 (August 1997).
115 Id.
116 Id.
117 See NASD Notice to Members 99-81, NASD Regulation Requests Comment on Sales Representative Compensation Rules (October 1999).
118 See NASD Notice to Members 03-54, Compensation for the Sale of Investment Company Securities (September 2003).
119 See 2004 Confirmation Proposal, supra n. 100.
120 Rule 6c-10 under the 1940 Act provides the necessary exemptions from various 1940 Act and rule provisions for a mutual fund to offer its shares subject to a contingent deferred sales charge. Prior to the adoption of the rule in 1995, a mutual fund seeking to utilize a deferred sales charge structure had to obtain exemptive relief from the SEC. See Investment Company Act Release No. 20916 (Feb. 23, 1995).
122 For a discussion of the development of the multi-class structure, see J. Julie Jason, Mutual Fund Share Classes: Uses and Abuses, Practising Law Institute, PLI Order No. B0-01A6 (August 2002).
123 The NASD is authorized under Section 22(a) and (b) of the 1940 Act to adopt rules to regulate the amount of sales charges on mutual funds distributed by its member firms. As discussed below, in 1980, the SEC adopted Rule 12b-1, which allowed mutual funds to adopt plans providing for financing of the distribution of fund shares with fund assets. Rule 12b-1 proved to be a popular rule; by 1988, over 52% of funds then in existence had adopted a 12b-1 plan. See Investment Company Act Release No. 16431 (June 13, 1988). In 1988, the SEC proposed amendments to Rule 12b-1 to address certain practices that had developed over the intervening years, including the use of 12b-1 plans to exceed the limitation on maximum sales charges in NASD rules. Id., text accompanying nn. 57-58. When the NASD stepped forward to amend its rule to take into account 12b-1 plans, the SEC dropped its 12b-1 amendment proposal.
124 Since 1975, NASD rules have prohibited its members from offering mutual funds (as well as certain other investment companies, such as unit investment trusts and certain closed-end investment companies) if the aggregate amount of sales charges described in the prospectus is “excessive.” See NASD Notice to Members 75-68 (Nov. 19, 1975). This prohibition, which was modified in 1992, as discussed below, is currently codified as paragraph (d) of NASD Conduct Rule 2830.
125 See NASD Notice to Members 93-12, Questions and Answers About New NASD Rules Governing Investment Company Sales Charges – Article III, Sections 26(b) and (d) of the Rules of Fair Practice (February 1993).
126 See NASD Conduct Rule 2830(b)(8)(A).
127 See NASD Conduct Rule 2830(b)(9). Although the NASD rule does not explicitly reference Rule 12b-1, as a practical matter, fees characterized as “service fees” under the NASD rule are authorized under a 12b-1 plan.
128 See NASD Conduct Rule 2830(d)(4).
129 See NASD Conduct Rule 2830(d)(1).
130 See NASD Conduct Rule 2830(d)(2).
136 See In re Morgan Stanley DW Inc., Securities Act Release No. 8339 (Nov. 17, 2003). The settlement required the selling firm to offer customers who had purchased Class B shares in amounts of $100,000 or more the option of converting their shares into Class A shares on a basis as though they had purchased Class A shares originally.
138 These proposals would affect Items 7, 8, and 18 of Form N-1A.
139 See 2004 Confirmation Proposal, supra n. 100.
152 Id.
153A discussion of the issues for fund advisers and executing broker-dealers under best execution standards is beyond the scope of this article. For a discussion of best execution duties, see generally Lemke, Lins, Regulation of Investment Advisers (2003 ed.).
155 It is worth noting that the rule was developed and adopted at a time when commission rates for trades on the New York Stock Exchange were still fixed. Fixed commission rates were viewed as a factor contributing to reciprocal practices, and were examined in studies of the securities markets during the 1960s. See, e.g., “Special Report: Statement of the Securities and Exchange Commission on the Future Structure of the Securities Markets,” February 2, 1972, citing reports issued by the SEC in 1963 and 1966 on the same matter.
157 See Investment Company Act Release No. IC–11414 (October 28, 1980). In 1976, the SEC commenced a review of arrangements entailing the use of fund assets for the purpose of financing the distribution of fund shares. See Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. IC–9915 (Aug. 31, 1977). As discussed in note 145 above, the SEC had conducted several studies of this issue during the 1960s and early 1970s, each time resulting in a policy decision to enforce the 1940 Act prohibition on use of fund assets to finance distribution expenses. While the SEC held hearings in 1976 on the matter, it was another three years until the SEC proposed the adoption of a rule that would permit such a use. See Investment Company Act Release No. IC–10862 (Sept. 7, 1979).
158 See Rule 12b–1(b).
159 See NASD Notice to Members 80–7 (Mar. 6, 1980).
160 See NASD Notice to Members 84–40, Compensation With Respect to Mutual Fund Shares (July 26, 1984).
161 See National Association of Securities Dealers, Inc., Exchange Act Release No. 34–17599 (Mar. 4, 1981). As noted above, the registration statement form for mutual funds has required funds to disclose in their SAI s whether they will consider factors other than brokerage or research services in selecting brokers for the execution of portfolio trades.
162 See paragraphs (1) and (2) of NASD Conduct Rule 2830(k).
163 See paragraph (6)(B) of NASD Conduct Rule 2830(k).
164 See NASD Notice to Members 84–40 (July 26, 1984).
165 Id.

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