

**MEMO# 25185**

May 12, 2011

# **FINRA Seeks to Adopt Amendments to Cash Compensation and Revenue Sharing Disclosure Rules**

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TO: BROKER/DEALER ADVISORY COMMITTEE No. 24-11  
CLOSED-END INVESTMENT COMPANY MEMBERS No. 36-11  
ETF ADVISORY COMMITTEE No. 31-11  
SEC RULES MEMBERS No. 54-11  
SMALL FUNDS MEMBERS No. 35-11 RE: FINRA SEEKS TO ADOPT AMENDMENTS TO CASH  
COMPENSATION AND REVENUE SHARING DISCLOSURE RULES

The Financial Industry Regulatory Authority (FINRA) is seeking to adopt amendments to NASD Rule 2830, its rule governing broker-dealers' activities in connection with the sale and distribution of investment company securities. [\[1\]](#) The amendments would change the current rule in four ways, most notably by requiring broker-dealers to make new disclosures to investors regarding the receipt of cash compensation (including revenue sharing). The rule would also be renamed FINRA Rule 2341 in FINRA's consolidated rulebook.

The SEC has published FINRA's proposal for comment, with a very short comment period. Comments must be submitted to the SEC by May 31, 2011.

## **Background**

The current proposal seeks to complete a multi-year rulemaking process. In June 2009, FINRA published the proposal for comment. [\[2\]](#) The 2009 proposal was substantially similar to an NASD proposal from 2003. [\[3\]](#) At each stage, the Institute has commented. [\[4\]](#) We have expressed longstanding support for enhanced disclosure to help investors assess and evaluate a broker's recommendations, but we have urged regulators to avoid an investment company-specific approach that might create incentives for brokers to recommend other investment products not subject to the same regulatory burdens. In our 2009 comment letter, we urged FINRA to eliminate the requirement for detailed disclosure of cash compensation arrangements in fund prospectuses, and instead require broker-dealers to provide the information. We also have strongly supported the use of the Internet to provide much of the required disclosure.

# Summary of Significant Amendments

In connection with the distribution and sale of investment company securities, NASD Rule 2830 limits the sales charges broker-dealers may receive, prohibits directed brokerage arrangements, limits the payment and receipt of cash and non-cash compensation, sets conditions on discounts to dealers, and addresses other issues such as broker-dealers' purchases and sales of investment company securities as principal.

Proposed FINRA Rule 2341 would revise the provisions of NASD Rule 2830 in four areas. First, Rule 2341 would require a broker-dealer to make new disclosures to investors regarding its receipt of or its entering into an arrangement to receive, cash compensation. Second, Rule 2341 would make a minor change to the recordkeeping requirements for non-cash compensation. Third, Rule 2341 would eliminate a condition regarding discounted sales of investment company securities to dealers. Fourth, Rule 2341 would codify past FINRA staff interpretations regarding the purchases and sales of exchange-traded funds ("ETFs"). Each of these is described in more detail below.

## Proposed Changes to the Cash Compensation Provisions

Among other things, NASD Rule 2830(l)(4) currently prohibits broker-dealers from accepting cash compensation from an "offeror" (generally an investment company and its affiliates) unless the compensation is described in the fund's current prospectus. If a broker-dealer enters into a "special cash compensation" arrangement with an offeror, and the offeror does not make the arrangement available on the same terms to all broker-dealers that sell the fund's shares, the broker-dealer's name and the details of the arrangement must be disclosed in the prospectus.

The new rule would modify the disclosure requirements for cash compensation arrangements. As proposed, it would no longer require disclosure of cash compensation arrangements in an investment company's prospectus or SAI. Instead, if within the previous calendar year a broker-dealer received, or entered into an arrangement to receive, from an offeror any cash compensation other than sales charges and service fees disclosed in the prospectus fee tables of investment companies sold by the broker-dealer ("additional cash compensation"), the broker-dealer would have to make certain disclosures:

- First, the broker-dealer would have to prominently disclose that it has received, or has entered into an arrangement to receive, cash compensation from investment companies and their affiliates, in addition to the sales charges and service fees disclosed in the prospectus fee table. In this context, "cash compensation" would include fees received from an offeror in return for services provided to the offeror, such as sub-administrative and sub-transfer agency fees.
- Second, the broker-dealer would have to prominently disclose that this additional cash compensation may influence the selection of investment company securities that the broker-dealer and its associated persons offer or recommend to investors.
- Third, the broker-dealer would have to provide a prominent reference (or in the case of electronically delivered documents, a hyperlink) to a web page or toll-free telephone number where the investor could obtain additional information concerning these arrangements. The additional information on the web site must include a narrative description of the additional cash compensation received from offerors and any services provided for that additional cash compensation, a narrative description of any preferred list of investment companies to be recommended to customers that the

broker-dealer has adopted as a result of the receipt of additional cash compensation (if applicable), and the names of the offerors that have paid the additional cash compensation.

The proposal also would add supplementary material that would clarify the definition of “cash compensation,” which would supersede all prior guidance with respect to that definition. The supplementary material would provide that “cash compensation” includes, among other things, revenue sharing paid in connection with the sale and distribution of investment company securities. More specifically, the supplementary material would specify that “cash compensation” includes revenue sharing payments regardless of whether they are based upon the amount of investment company assets that a broker-dealer’s customers hold, the amount of investment company securities that the broker-dealer has sold, or any other amount if the payment is related to the sale and distribution of the investment company’s securities.

### **Proposed Changes to the Non-Cash Compensation Provisions**

NASD Rule 2830(l)(3) requires broker-dealers to keep records of all compensation received by the broker-dealer or its associated persons from offerors, other than small gifts and entertainment permitted by the rule. Currently, this provision requires the records to include the nature of, and “if known,” the value of any non-cash compensation received. FINRA proposes to modify this requirement by deleting the phrase “if known,” while adding supplementary material that would clarify that a broker-dealer may estimate in good faith the value of certain compensation.

### **Proposed Changes Regarding Conditions for Discounts to Dealers**

NASD Rule 2830(c) currently prohibits investment company underwriters from selling the fund’s shares to a broker-dealer at a price other than the public offering price unless 1) the sale is in conformance with NASD Rule 2420 and 2) for certain investment company securities, a sales agreement is in place that sets forth the concessions paid to the broker-dealer. FINRA explains that the reference to Rule 2420 is based on historical concerns that are no longer valid, and proposes to eliminate it.

### **Proposed Changes Regarding Sales of Shares of ETFs**

In recent years, broker-dealers have bought and sold shares of ETFs, which are open-end management investment companies or unit investment trusts (“UITs”) that differ from traditional mutual funds and UITs, since their shares typically are traded on securities exchanges. Because ETF shares are sometimes traded at prices that differ from the fund’s current net asset value, ETFs can raise issues under both the Investment Company Act and NASD Rule 2830. For example, Section 22(d) of the Investment Company Act requires dealers to sell shares of an open-end investment company at the current public offering price described in the investment company’s prospectus (i.e., the fund’s net asset value plus any applicable sales load). Similarly, NASD Rule 2830(i) generally prohibits broker-dealers from purchasing fund shares at a price lower than the bid price next quoted by or for the issuer (for traditional mutual funds, this price is the fund’s next quoted net asset value).

To address these issues, the SEC has issued a series of exemptive orders that allow ETFs to trade on exchanges at prices that differ from the fund’s public offering price. The SEC also has proposed a rule that generally would codify the exemptive relief provided by its orders. Similarly, FINRA staff has issued letters interpreting NASD Rule 2830 that allow broker-dealers to purchase and sell shares of ETFs at prices other than the current net asset value

consistent with SEC exemptive orders. The proposal would add a new paragraph, FINRA Rule 2341(o), to codify earlier FINRA staff interpretive letters that permit the trading of ETF shares at prices other than the current net asset value consistent with applicable SEC rules or exemptive orders.

## Next Steps

The SEC will accept comments on the proposed rule until May 31, 2011.

By June 23, 2011, the SEC will either approve or disapprove of the proposed rule change, or institute proceedings to determine whether the proposed rule change should be disapproved. (The SEC may designate a later date for such action, which in any case will be on or before August 8, 2011.)

If the SEC approves the rule amendments, FINRA will then announce an implementation date. FINRA has indicated that the implementation date would be no more than 365 days following SEC approval.

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### endnotes

[1] See Release No. 34-64386 (May 3, 2011), avail. at <http://www.sec.gov/rules/sro/finra/2011/34-64386.pdf>. Additional materials are available on FINRA's site at <http://www.finra.org/Industry/Regulation/RuleFilings/2011/P123528>.

[2] See FINRA Regulatory Notice 09-34 (June 2009) and Institute Memorandum No. 23568 (June 19, 2009).

[3] See NASD Notice 03-54 (September 2003) and Institute Memorandum No. [16566](#) (September 22, 2003).

[4] See Institute Memoranda Nos. [23676](#) (August 4, 2009) and [16683](#) (October 20, 2003).