

MEMO# 18705

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NASD TASK FORCE ISSUES REPORT RECOMMENDING ENHANCED POINT OF SALE DISCLOSURE AND 12B-1 REFORMS

[18705] March 28, 2005 TO: SEC RULES MEMBERS No. 43-05 EQUITY MARKETS ADVISORY COMMITTEE No. 18-05 CLOSED-END INVESTMENT COMPANY MEMBERS No. 18-05 BOARD OF GOVERNORS No. 14-05 COMPLIANCE ADVISORY COMMITTEE No. 25-05 CHIEF COMPLIANCE OFFICER COMMITTEE No. 29-05 INVESTMENT ADVISER MEMBERS No. 6-05 RE: NASD TASK FORCE ISSUES REPORT RECOMMENDING ENHANCED POINT OF SALE DISCLOSURE AND 12b-1 REFORMS Last year, the NASD formed the Mutual Fund Task Force to provide guidance to the Securities and Exchange Commission on issues relating to soft dollars, mutual fund portfolio transaction costs, and distribution arrangements. The Task Force's work was divided into two phases. The results of the first phase, which focused on portfolio transaction costs, including soft dollar issues, were published in a report provided to the SEC in November 2004.¹ The results of the second phase, which focused on distribution issues, including point of sale disclosure and Rule 12b-1 issues, are contained in a report published by the NASD.² While the Task Force's Report is briefly summarized below, overall the Task Force concluded that the most important change the Commission should consider relating to distribution is to make the costs and potential conflicts associated with the distribution of mutual funds more visible to the retail investor. The Task Force's Report includes recommendations to implement this conclusion. REQUIRED DELIVERY OF A "PROFILE PLUS" DISCLOSURE DOCUMENT The Task Force recommends that the Commission require broker-dealers to make available to investors at the point of sale a "Profile Plus" document. This document, a sample of which is attached, would be short, easy to understand, and describe the material features of a fund as well as the broker-dealer's revenue sharing and differential compensation ¹ See Institute Memorandum to SEC Rules Members No. 164-04, Equity Markets Advisory Committee No. 46-04, Closed-End Investment Company Members No. 74-04, Board of Governors No. 76-04, Compliance Advisory Committee No. 111-04, Chief Compliance Officer Committee No. 26-04, and Investment Adviser Members No. 24-04 [18195], dated November 18, 2004, which summarized the Task Force's 2004 report. ² See Report of the Mutual Fund Task Force: Mutual Fund Distribution (March 24, 2005) (the "Report"). It would include fee and expense and conflict of interest information similar to that proposed by the Commission in its pending point of sale/confirmation disclosure proposal. Unlike the Commission's proposal, however, it would include summary information about the fund's investment strategies, risks, and other significant features. The Task Force recommends that broker-dealers be required to provide this disclosure to investors via their website at the point of sale. It urges the Commission to issue interpretive guidance providing that an investor's access to the Profile Plus via the Internet would constitute delivery for purposes

of the federal securities laws. According to the Report, use of the Internet to deliver this disclosure to investors has several advantages over paper or oral delivery of the same information, including the fact that it could include hyperlinks to a mutual fund's prospectus. The Report recognizes that, notwithstanding the Commission's adoption of Rule 498 under the Securities Act of 1933, which enabled funds to use a summary or "profile" prospectus, few funds did so. According to the Report, this is because of concerns that use of a profile prospectus would expose funds to "unforeseen liability." To address similar concerns with the use of the Profile Plus, the Task Force recommends that the Commission mandate its use. In the view of the Task Force, mandatory use of the Profile Plus coupled with hyperlinks in it to the full fund prospectus should alleviate the liability concerns that arose in connection with the voluntary use of the profile prospectus. The Task Force additionally recommends that, contemporaneously with recommending a particular fund, registered representatives of broker-dealers be required by the Commission either to refer investors to the Profile Plus on the broker-dealer's website or e-mail a link to it to an investor. For those investors who may not have access to the Internet or who elect not to receive disclosure via the Internet, the Task Force recommends that broker-dealers be required to offer their customers the option to receive the Profile Plus disclosure in hard copy via mail or hand-delivery. The Task Force Report also discusses the Commission's November 2004 proposal relating to "access equals delivery." Under this proposal, which is intended to modernize the registration, communications, and offering processes under the Securities Act of 1933, investors are presumed to have access to the Internet and issuers and intermediaries could satisfy their delivery requirements by posting their required documents on a website. As proposed by the Commission, however, the proposal would not apply to registered investment companies. To resolve any additional liability concerns with use of the Profile Plus, the Task Force urges the Commission to apply an "access equals delivery" approach for mutual fund prospectuses. The Task Force additionally urges the Commission "to carefully delineate the respective responsibilities" of funds and broker-dealers for information appearing in the Profile Plus. The Report notes the importance of fund management companies and broker-dealers working with the NASD to develop common industry practices for the prompt delivery of information for inclusion in the Profile Plus, as well as the need for broker-dealers to be able to rely in good faith on information in the Profile Plus that is provided by a fund management company. To ensure the consistency of information provided to investors, the Task Force recommends that the Commission require other regulated intermediaries – such as banks, investment advisers, and retirement plan sponsors – to provide investors the Profile Plus at the point of sale. Towards this end, the Task Force recommends that the Commission work with 3 other agencies, such as the Department of Labor, to ensure that all intermediaries provide point of sale information to assist investors in making informed investment decisions.

RECOMMENDATIONS RELATING TO 12B-1 PLANS According to the Task Force Report, "the substantive regulatory scheme for mutual fund distribution payments is fundamentally sound, and improved disclosure at the point of sale is the most important change the Commission should consider." On the issue of whether Rule 12b-1 fees should be deducted at the shareholder account level, the Task Force Report concludes that making all fund fees and expenses transparent at the point of sale accomplishes the same objective. Moreover, this approach would eliminate the costly system changes necessary to deduct such fees at the shareholder account level. With respect to Rule 12b-1, the Task Force recommends that:

- The Commission review the provisions of the rule, particularly its procedural requirements, with a view towards modernizing such requirements;
- In lieu of making quarterly findings regarding whether a Rule 12b-1 plan benefits investors, a fund's board should make an annual determination that focuses on specific concerns, such as whether the plan should continue for a fund closed to new investors; and
- The reference in the

prospectus to Rule 12b-1 fees should instead refer to “Distribution and Shareholding Servicing Fees” so that investors could better understand the purpose of these fees. CLASS B SHARES The Task Force Report notes that Class B shares have been the subject of recent regulatory scrutiny. To address concerns with Class B shares, the Report recommends that the Commission:

- Impose limits on the length of time before a Class B share converts to a Class A share in order to avoid investors being charged the higher 12b-1 fee after the fund has recouped its up-front distribution costs;
- Provide guidance on when a closed fund may no longer charge distribution-related 12b-1 fees in order to distinguish the appropriate charging of such fees by a fund from the inappropriate; and
- Consider possible limitations on the size of cumulative Class B sales and guidance concerning the mutual fund sponsor’s responsibility to police this limitation.

UNIFIED FEE FUNDS The Task Force also recommends that a unified fee investment company (UFIC) be permitted as an option under mutual fund regulation. As described in the Report, a UFIC would be a new type of investment company structure under which all fund expenses would be paid out of a single fee, with no separate sales charges or redemption fees. This single fee, which would be prominently disclosed to investors on the cover of the prospectus, could facilitate cost comparisons among funds, thereby increasing competition and placing 4 downward pressure on fee levels. A UFIC fee that is “unconscionable or grossly excessive” would be prohibited. • • • • • A copy of the Task Force’s Report and the Task Force’s recommended Profile Plus document is attached.

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