The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 20085

June 5, 2006

NYSE Information Memos on Mutual Fund Directed Brokerage and Revenue Sharing Arrangements and Variable Annuities

 [20085] June 5, 2006 TO: SEC RULES MEMBERS No. 48-06 COMPLIANCE MEMBERS No. 26-06 CHIEF COMPLIANCE OFFICER COMMITTEE No. 7-06 OPERATIONS MEMBERS No. 14-06 BROKER/DEALER ADVISORY COMMITTEE No. 18-06 RE: NYSE INFORMATION MEMOS ON MUTUAL FUND DIRECTED BROKERAGE AND REVENUE SHARING ARRANGEMENTS AND VARIABLE ANNUITIES In August 2005, the New York Stock Exchange issued Information Memo No. 05-54 to clarify, under rules of the NYSE and SEC, its members' disclosure and sales practice requirements relating to mutual fund directed brokerage and revenue sharing arrangements and the sale of variable annuities.1 On June 1, 2006, the NYSE issued an additional Information Memo to clarify some of the issues raised in IM 05-54.2 While the NYSE's Information Memoranda apply only to NYSE members, as discussed in more detail below, in some instances the NYSE expects its members to obtain written representations from the funds for which they act as both a selling and executing broker. Accordingly, the NYSE's Information Memoranda are briefly summarized below. I. IM 05-54: DISCLOSURE AND SALES PRACTICES CONCERNING MUTUAL FUNDS AND VARIABLE ANNUITIES 1 See Information Memo No. 05-54, NYSE (Aug. 11, 2005) ("IM 05-54"). A copy of IM 05-54 is available on the NYSE's website at: http://apps.nyse.com/commdata/PubInfoMemos.nsf/0/85256FCB005E19E88525705800712FC6/$FILE/ Microsoft%20Word%20-%20Document%20in%2005-54.pdf. 2 See Information Memo No. 06-38, NYSE (June 1, 2006) ("IM 06-38"). A copy of IM 06-38 is available on the NYSE's website at: http://apps.nyse.com/commdata/PubInfoMemos.nsf/0/85256FCB005E19E88525718000539A1F/$FILE/ Microsoft%20Word%20-%20Document%20in%2006-38.pdf. 2 A. Directed Brokerage IM 05-54 discusses the SEC's September 2004 amendments to Rule 12b-1 under the Investment Company Act that prohibit mutual funds from directly or indirectly compensating selling brokers through directed brokerage. It notes that, pursuant to NYSE Rules 401 and 476(a)(6), NYSE members that act as selling brokers for mutual funds have parallel obligations to those imposed on funds under Rule 12b-1. Accordingly, an NYSE member acting as a selling broker should not execute mutual fund portfolio transactions unless the broker both confirms that the fund has implemented policies and procedures as required by Rule 12b-1 and ensures that the fund uses reasonable criteria in the selection of its selling brokers. A member that either knows or has reason to believe that a fund took

the member's selling efforts into account when selecting it to be an executing broker should not execute portfolio transactions. An NYSE member's policies and procedures relating to compliance with Rule 12b-1should, at a minimum, designate personnel with appropriate supervisory authority to conduct periodic reviews to identify any correlation between fund sales and directed brokerage commissions that might suggest informal arrangements in violation of Rule 12b-1. Citing the SEC's September 2004 release, IM 05-54 notes that "[t]he SEC has suggested that this would be an advisable undertaking for mutual fund compliance officers." In addition to ensuring compliance with Rule 12b-1, IM 05-54 notes that an NYSE member that acts as both a selling and an executing broker for a mutual fund should disclose this fact to its customers. B. Revenue Sharing IM 05-54 notes that the NYSE and other regulators have brought enforcement proceedings against NYSE members for failing to adequately disclose to customer revenue sharing ("shelf space") payments from a select group of fund families recommended to customers. It reminds members that the NYSE's rules and federal securities laws require them to ensure that revenue sharing arrangements are fully and adequately disclosed to customers. Pursuant to this obligation, a member should disclose whether the registered representative recommending a particular fund will receive a greater commission for selling that fund than for selling other funds. Also, the customer should be informed in the event the fund pays the member a certain percentage of gross fund sales. These disclosures should be delivered to the customer – as opposed to merely accessible upon request – at the time of the transaction. IM 05-54 notes that, in the past, NYSE members had relied upon third-party disclosures in mutual fund prospectuses and SAIs to communicate this information to customers. According to the NYSE, however, "[a]s a matter of best practices, a member or member organization should directly disclose its receipt of revenue sharing to its customers." If, however, the member chooses to rely on a third-party's disclosures, the member retains the responsibility for ensuring that customers have received sufficient information about the conflicts of interest. Also, the member should have in place policies and procedures designed to evaluate whether the third-party's disclosures are adequate and prominently disclosed. 3 C. Disclosures and Suitability Relating to Variable Annuities IM 05-54 also addresses issues relating to the sale of variable annuities. In particular, it reminds members of their disclosure obligations as well as the various factors they should consider in determining whether a variable annuity recommended to a customer is suitable for that customer. It also cautions members against engaging in "switching." II. IM 06-38: DIRECTED BROKERAGE ARRANGEMENTS IM 06-38 was issued by the NYSE to provide further guidance and clarification to members relating to the discussion in IM 05-54 of directed brokerage arrangements. It reminds members of their responsibility, when acting as both a selling and executing broker for a mutual fund, to be diligent, pursuant to NYSE Rules 401 and 476(a)(c), not to accept directed brokerage. As a matter of best practices, IM 06-38 suggests that members fulfill this responsibility by: Performing reasonable due diligence of the fund – According to IM 06-38, a member acting as a selling and executing broker "should obtain a written representation from the fund, in a selling agreement or separate document, as appropriate, that the mutual fund company has reasonable policies and procedures in place to ensure that no formal or informal directed brokerage arrangements will arise." The broker should also obtain a written representation from the fund that the fund "uses reasonable criteria in the selection of its [s]elling [b]rokers;" Implementing policies and procedures that strictly prohibit the member from receiving directed brokerage – In the view of the NYSE, the member's policies and procedures should designate personnel with appropriate supervisory authority to conduct periodic reviews to identify any correlation between fund sales and directed brokerage commissions suggestive of informal arrangements in violation of Rule 12b-1; Educating marketing and sales staff regarding the prohibitions of Rule 12b-1 – IM 06-38 suggests that this education could be

incorporated into the member’s Firm Element of its required continuing education program; and Conducting internal reviews – In the event the member either receives information about a potential directed brokerage arrangement or discovers a potential arrangement through a correlation review or other surveillance, the member should promptly cause an internal review to be conducted. If the review yields evidence of directed brokerage, the member should inform its management as well as the fund’s chief compliance officer or other appropriate supervisory employee. The member should also determine whether it should notify regulatory authorities. Tamara K. Salmon Senior Associate Counsel

---