

MEMO# 16566

September 22, 2003

NASD CASH COMPENSATION DISCLOSURE PROPOSAL

[16566] September 22, 2003 TO: BOARD OF GOVERNORS No. 49-03 CLOSED-END INVESTMENT COMPANY MEMBERS No. 74-03 SEC RULES MEMBERS No. 126-03 UNIT INVESTMENT TRUST MEMBERS No. 30-03 RE: NASD CASH COMPENSATION DISCLOSURE PROPOSAL NASD has issued proposed amendments to Rule 2830 that would require point-of-sale disclosure of revenue sharing and differential cash compensation arrangements relating to the sale of investment company securities.¹ The proposal is summarized below. The proposal would require disclosure concerning two types of compensation arrangements that, according to the NTM, present investor protection concerns. These are (1) revenue sharing arrangements, in which an offeror agrees to pay an NASD member cash compensation not otherwise disclosed in the prospectus fee table, and (2) differential cash compensation arrangements which, the NTM states, typically occur when an NASD member provides higher payouts to its registered representatives for the sale of certain investment company products, such as the member's proprietary funds. The NTM notes that these compensation arrangements can create conflicts of interest, and that disclosure of the arrangements would enable investors to evaluate whether a registered representative's particular product recommendation was inappropriately influenced by these arrangements. The NTM indicates that "Congress and the SEC also are considering the adequacy of disclosure regarding mutual fund fees and broker-dealer compensation for fund sales, and Congress may enact legislation or the SEC may issue separate proposals addressing these matters." According to the NTM, any enhanced disclosure required by Congressional or SEC action would be complementary to NASD's proposal. The proposal would amend the definition of "cash compensation" in Rule 2830 to expressly include gross dealer concessions as well as any cash payment received as a condition for inclusion of an investment company on a preferred or select sales list, in any other sales 1 NASD Notice to Members 03-54 (September 2003) ("NTM"). The NTM is available on NASD's website at <http://www.nasdr.com/pdf-text/0354ntm.pdf>. 2 program, or as an expense reimbursement.² In addition, the proposal would add definitions of "differential cash compensation" and "gross dealer concessions" to Rule 2830. Under the proposal, any NASD member that has, within the previous 12 months, received cash compensation (other than sales charges or service fees disclosed in the prospectus fee table), or that uses differential cash compensation policies in compensating associated persons, would have to disclose: (1) that information about an investment company's fees and expenses may be found in its prospectus and that the company's policies regarding selection of brokers (including soft dollar practices) may be found in the statement of additional information (SAI); (2) if applicable, (i) that the member receives cash payments from an offeror, other than sales charges (including 12b-1 fees) or service fees disclosed in the prospectus fee table, (ii) the nature of any such payments received in the last 12 months, and (iii) the name of each

offeror that made such a payment, listed in descending order based upon the amount of compensation received; (3) if applicable, (i) that an associated person receives different rates of compensation for different investment company products that may provide an incentive to offer specific products to the customer, (ii) a description of the arrangements, and (iii) the names of any investment companies favored by these arrangements;³ and (4) a web page or toll-free telephone number that a customer may use to obtain updated information about revenue sharing and differential cash compensation arrangements. The required disclosures would have to be updated semi-annually and would have to be made in writing to the customer at the following times: (1) when the customer establishes an account with the NASD member or the member's clearing broker; (2) if no account is established, at the time that the customer first purchases shares of an investment company; or (3) for accounts existing when the rule amendments become effective, the later of (a) 90 days after the effective date or (b) the time the customer first purchases investment company shares after the effective date. ² According to the NTM, the definition would not include directed brokerage. The NTM reminds NASD members that Rule 2830(k), which generally prohibits a member from directly or indirectly seeking brokerage commissions as a condition to the sale or distribution of investment company securities, would continue to apply even after adoption of the proposed amendments. ³ The NTM states that this disclosure requirement would not apply to arrangements under which different associated persons receive different payout ratios, so long as an individual associated person receives the same payout ratio for all funds that he or she sells. It also would not apply to differences in total compensation received by the associated person, such as for the sale of an investment company that provides a higher gross dealer concession to the member, provided that the payout ratios are the same for all funds that the associated person sells. ³ The proposal would retain NASD's current cash compensation prospectus disclosure requirements, but with some modifications. According to the NTM, the modifications are intended to clarify a member's obligation not to accept any sales charges or service fees that are not described in a fund's prospectus. In addition, if a special sales charge or service fee arrangement is made available to some, but not all, members who distribute a fund's securities (e.g., an offeror pays a higher percentage of a fund's sales charges to one member than it pays to other members), the details of the arrangement must be described in the fund's prospectus.⁴ The NTM seeks comment on a number of issues including, for example, whether NASD should require prospectus (rather than SAI) disclosure of special cash compensation arrangements, whether money market funds should be excluded from the differential cash compensation provision, and whether NASD should pursue any of various alternative approaches to disclosure of revenue sharing and differential cash compensation arrangements. Comments on the proposal must be filed with NASD by October 17th. Frances M. Stadler Deputy Senior Counsel ⁴ The NTM notes that NASD has interpreted Rule 2830(l)(4) to allow this disclosure to be made in the fund's SAI.