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HEARING OFFICER DISMISSES SEC ENFORCEMENT PROCEEDING ALLEGING FRAUD IN CONNECTION WITH SALES OF CLASS B SHARES

[18545] February 15, 2005 TO: CHIEF COMPLIANCE OFFICER COMMITTEE No. 13-05 COMPLIANCE ADVISORY COMMITTEE No. 12-05 SEC RULES COMMITTEE No. 15-05 SMALL FUNDS COMMITTEE No. 4-05 RE: HEARING OFFICER DISMISSES SEC ENFORCEMENT PROCEEDING ALLEGING FRAUD IN CONNECTION WITH SALES OF CLASS B SHARES After twenty-two days of hearings, an administrative law judge ("ALJ") recently dismissed all charges brought by the Securities and Exchange Commission against a broker- dealer, its president, three of its registered representatives, and an investment adviser for selling investors class B mutual fund shares instead of class A shares.1 As discussed in more detail below, the SEC generally alleged that the Respondents' failure to disclose material facts in connection with their sale of the class B shares violated the antifraud provisions of the federal securities laws. The ALJ found otherwise and dismissed the action in its entirety. THE SEC'S ALLEGATIONS The SEC alleged that the Respondents violated the antifraud provisions of the Securities Exchange Act of 1934, the Securities Act of 1933, and the Investment Advisers Act of 1940 by failing to make certain disclosures in connection with their sale to investors of class B shares in amounts exceeding $250,000 between July 1998 and December 2000. In particular, the Commission alleged that the Respondents committed fraud by failing to disclose to these investors that class A shares outperform class B shares and that the Respondents would receive higher commissions for selling class B shares instead of class A shares. The Commission also alleged that the registered representatives violated their fiduciary obligation towards their brokerage customers. In the Commission's view, this fiduciary duty stemmed from the fact that the Respondents exercise de facto control over the accounts of their customers because such customers were not especially financially sophisticated and routinely followed the representatives' advice. With respect to the broker-dealer and its president, the Commission alleged that they failed to reasonably supervise the registered representatives with a view towards detecting and preventing violations of the securities laws. 1 See In Re IFG Network Securities, Inc., William Kissinger, Kissinger Advisory, Inc., Bert Miller, Glenn Wilkinson, and David Ledbetter, Initial Decision, SEC Admin. Proc. File No. 3-11179 (Feb. 10, 2005), which is available on the SEC's website at: http://www.sec.gov/litigation/aljdec/id273cff.pdf. 2 Based upon these violations, the SEC sought bars, civil penalties, disgorgement, and an order to cease and desist against each of the Respondents. THE RESPONDENTS' DEFENSE The Respondents did not dispute the SEC's allegation that they failed to inform their clients that class A shares would outperform class B shares. Instead, they argued and produced

evidence that, depending upon certain variables – such as the holding period, tax considerations, withdrawal rate, rate of return, and waiver of a contingent deferred sales load in the case of the investor's death or disability – class B shares may, in fact, outperform class A shares.2 As regards their failure to disclose to investors that they would receive greater commissions for sales of class B shares, the Respondents produced evidence that: it was not industry practice during the relevant period for brokers to disclose to customers the differential compensation they received for selling class A and B shares; there was no duty to disclosure such differential compensation during the time in question; and there was no rule or precedent that supported the existence of such a duty. The Respondents that were charged with failing to supervise produced evidence that the broker-dealer supervised its registered representatives' disclosure and sales practices by: having a "business review principal" revise all transactions for issues such as suitability, switching, and breakpoint violations;3 reviewing all exception reports; issuing information updates; conducting annual training sessions; having a compliance procedures manual; issuing Compliance Alerts; utilizing a mutual fund class disclosure form;4 monitoring and reviewing customer complaints;5 and conducting annual audits of branch offices and other offices, which 2 One of the Respondents, who had previously served as a comptroller in the Army, including for the Delta Force, testified that, when he was introduced to class B shares in 1994, he sought information on which class was appropriate at different investment levels and found no guidance from the SEC or the NASD. Accordingly, he conducted his own review and concluded, based on his calculations, which he subsequently confirmed with Morningstar Principia software, that class A shares would not outperform class B shares until a 2% breakpoint was reached at the $500,000 level. Accordingly, for an investment of $500,000 or more, he recommended class A shares; below $250,000 he recommended class B shares. 3 Transactions of concern to the "business review principal" would be referred to the compliance department, which had the authority to cancel transactions. 4 The broker-dealer encouraged, but did not require, its representatives to provide a mutual fund multiple class disclosure form to investors for trades over $250,000. This form: explained to the investor, in general terms and in plain English, the features of class A and class B shares; urged the investor to read the prospectus carefully and ask his or her representative to explain any part that was not clear; stressed that class A shares are especially advantageous for investors who can invest enough to reach a reduced commission breakpoint and noted that, for this reason, many funds will not accept a class B investment over $500,000; and, contained a block, which the customer signed, that listed his or her investment choices and confirmed that the investor received and reviewed the prospectus, understood all charges associated with the class of shares chosen by the investor, and had an opportunity to discuss all issues with the registered representatives. This form was developed by the broker-dealer in 1998 and used thereafter. Testimony at the hearing indicated that, during the relevant period, no other firm in the industry had a requirement that the customer sign a document similar to the form before effecting a class B trade over $250,000. 5 The broker-dealer, which effected approximately $1.5 billion in mutual fund sales during the relevant period, had ten or fewer complaints per year related to mutual funds. None of these complaints concerned the adequacy of disclosure with respect to the relative performance of class A and B shares at the $250,000 level. 3 included reviewing customer files. Also, the broker-dealer maintained a "mutual fund coordinator" to answer representatives' questions about mutual funds. The Respondents also argued, in their defense, that if there is a need for greater disclosure concerning class B shares, new requirements should be adopted prospectively by the Commission through rulemaking, rather than imposed retroactively through an enforcement proceeding. THE ALJ'S FINDINGS The ALJ first considered the SEC's allegation that the Respondents committed fraud by failing to disclose to investors that class A shares outperform class B

shares. Based upon the totality of the evidence, the ALJ found that “it is unproven that [class] A shares always outperform [class] B shares at the $250,000 level.” As such, the ALJ concluded “that none of the registered representatives violated the antifraud provisions in regard to disclosure about the relative performance of A and B shares.” The ALJ next considered whether the Respondents committed fraud by failing to disclose to investors that the representatives would receive higher commissions for selling class B shares at the $250,000 level. In considering this issue, the ALJ found that there was no duty of disclosure during the relevant period; nor was there any specific case precedent or rule that required such disclosure of broker-dealers. The ALJ noted that the SEC has proposed a rule to require such disclosure.6 According to the ALJ, if such rule is adopted, the Respondents will have “fair notice” of their duty to disclosure differential compensation; if it is not adopted, “a fortiori registered representatives’ past nondisclosure cannot, in fairness, be a violation of the antifraud provisions.” As such, for the ALJ “to decide whether or not [the Respondents’] nondisclosure was fraud would be to usurp the Commission’s policy and rulemaking function.” On the issue of whether the Respondents owed their customers a fiduciary duty based upon the Respondents’ de facto control of the customers’ account, the ALJ disagreed with the SEC’s allegation. According to the ALJ, the “fact that a customer follows the advice of his broker does not in itself establish control.” Moreover, with respect to the customers in question, the ALJ found that each “had sufficient education and cognitive skills to ask questions and to study and understand mutual fund prospectuses had he or she made the effort.” The ALJ concluded that none of the Respondents who were registered representatives had de facto control of the customer accounts at issue and, accordingly, none had a fiduciary obligation. As such, the SEC failed to prove any violation by the Respondents of a fiduciary duty. Finally, on the SEC’s allegation of a failure to supervise by the broker-dealer and its president, the ALJ concluded that, “[s]ince the alleged violations of the three registered representatives are unproved, it must be concluded that the failure to supervise charge [against the broker-dealer and its president] is also unproved.” 6 See SEC Release Nos. 330-8358, 34-49148, IC-26341 (File No. S7-06-04) Proposed Rule: Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds (Jan. 29, 2004). 4 Based upon the above findings, the ALJ issued an Order dismissing the Commission’s administrative proceeding in its entirety. Tamara K. Salmon Senior Associate Counsel