

MEMO# 15751

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JOINT SEC, NASD AND NYSE REPORT ON EXAMINATIONS OF BROKER-DEALERS REGARDING MUTUAL FUND SALES CHARGE BREAKPOINTS

[15751] March 13, 2003 TO: BOARD OF GOVERNORS No. 12-03 BROKER/DEALER ADVISORY COMMITTEE No. 11-03 COMPLIANCE ADVISORY COMMITTEE No. 21-03 SEC RULES MEMBERS No. 31-03 TRANSFER AGENT ADVISORY COMMITTEE No. 29-03 RE: JOINT SEC, NASD AND NYSE REPORT ON EXAMINATIONS OF BROKER-DEALERS REGARDING MUTUAL FUND SALES CHARGE BREAKPOINTS On March 11, the Securities and Exchange Commission, National Association of Securities Dealers, Inc. and the New York Stock Exchange issued a joint report on examinations of broker-dealers regarding discounts on front-end sales charges on mutual funds ("Report").¹ The Report summarizes the results of an examination sweep conducted by examiners from the Commission's Office of Compliance Inspections and Examinations, NASD and NYSE from November 2002 to January 2003, of 43 registered broker-dealers that sell mutual funds with a front-end load in order to determine whether investors are receiving the benefit of available discounts on front-end sales charges in mutual fund transactions.²

I. Background The examination sweep was one part of a multi-faceted action plan launched by the Commission, NASD and NYSE in light of concerns that broker-dealers may not be uniformly applying appropriate sales charges and providing breakpoint opportunities to investors. Other actions taken as part of the plan included (1) requiring all broker-dealers conducting a public business to review the adequacy of policies and procedures in this area, make necessary changes, and report information concerning their mutual fund business,³ and (2) the formation of a working group by the NASD, the Securities Industry Association and the ICI to recommend

¹ The Report is available at www.sec.gov/news/studies/breakpointrep.htm. ² An appendix to the Report provides a summary of the responses to a recent NASD survey that gathered statistical information about sales of mutual funds by NASD members. ³ The Report indicates that most of the firms that sell mutual funds with front-end loads responded that they have conducted a review of the adequacy of the firms' policies and procedures related to breakpoints and that they had adequate procedures in place regarding breakpoints and that they were in compliance with their own policies and procedures and NASD rules relating to breakpoints. A small number of firms indicated that they were either not in compliance with their own breakpoint policies and procedures or not in compliance with NASD rules regarding breakpoints, or did not respond to the question. The Report states that regulators will follow up with these firms. **2 ways in which the mutual fund and broker-dealer industries can prevent breakpoint problems in the future, and improve systems and disclosure.**

II. Summary of Findings The findings in the Report are based on limited samples of

transactions at each of the 43 broker-dealers examined.⁴ In summary, the findings included the following:

- Nearly one in three transactions that appeared to be eligible for a breakpoint discount or sales charge waiver did not receive one.⁵
- Most of the firms examined, in some instances, did not provide customers with breakpoint discounts for which they appear to have been eligible.
- The average discount not provided was \$364 per transaction.
- The most frequent causes of not providing a breakpoint discount were not linking a customer's ownership of different funds in the same mutual fund family, not linking shares owned in a fund or fund family in all of a customer's accounts at the firm, and not linking shares owned in the same fund or fund family by persons related to the customer (e.g., spouse, children) in accounts at the firm. Many of the problems do not appear to be intentional failures to charge correct loads.
- Breakpoint issues were found in all types and sizes of firms, but were less frequent in firms that complete purchases of funds by sending paper applications directly to the fund's transfer agent.
- While most firms had written supervisory procedures addressing breakpoints, they often were not comprehensive.
- Most firms indicated that they rely on registered representatives to ensure that a breakpoint discount is received.
- Many firms can improve their compliance and supervisory systems and controls with respect to disclosing breakpoint opportunities and obtaining information from customers about related accounts, creating exception reports to identify breakpoint issues, and enhancing supervision and training.

Most firms that sell front-end load mutual funds to investors report that they are undertaking significant reviews of their supervisory practices in this regard and a number of them have already implemented changes.

⁴ Examiners sought to include transactions in the sample that were most likely to be eligible for a discount. As a result, these findings were not based on a random sample.

⁵ In particular, of the more than 9,000 transactions reviewed, examiners identified 5,515 transactions that appeared to be eligible for a reduced sales charge. Of those, examiners found 1,757 transactions that did not receive a breakpoint discount or appear to have incurred other unnecessary sales charges.

3 III. Conclusion and Remedial Actions

The Report concluded that the examination results warrant that broker-dealers who sell fund shares that offer breakpoint discounts review and improve their practices to ensure that customers receive appropriate breakpoint discounts. The Report states that the limited nature of the examination sweep does not allow regulators to determine the full extent of the breakpoint issue industry-wide. Accordingly, broker-dealers engaged in front-end load mutual fund transactions will be immediately required by the NASD to conduct an assessment of a sample of their front-end load mutual fund sales transactions in order to provide the firm and regulators with an indication of whether the firm has provided appropriate discounts to customers. The NASD, in consultation with the SEC, will develop a standard methodology to be utilized for the sample that will be designed to provide a representative sample of the firm's transactions and opportunities for a breakpoint. Firms will be required to submit the results of the sample analysis to the NASD within a specified deadline. Following receipt of each firm's sample review, additional actions will be taken based on the results of each sample review, which may include requiring firms to contact customers and/or conducting a larger review of transactions over a longer period of time. Firms will also be required to refund to customers any amounts that are found to have been overcharged. Regulators will also consider disciplinary or enforcement actions. Furthermore, all broker-dealers that sell front-end load mutual funds are obligated to review past transactions to ensure that customers have been charged appropriate sales charges.

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should not be considered a substitute for, legal advice.