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SEC AND NASD SETTLE PROCEEDINGS AGAINST A BROKER-DEALER RELATING TO PREFERENTIAL TREATMENT OF FUNDS AND SALES OF CLASS B SHARES

[16797] November 20, 2003 TO: COMPLIANCE ADVISORY COMMITTEE No. 101-03 BOARD OF GOVERNORS No. 64-03 SEC RULES MEMBERS No. 160-03 SMALL FUNDS COMMITTEE No. 30-03 RE: SEC AND NASD SETTLE PROCEEDINGS AGAINST A BROKER-DEALER RELATING TO PREFERENTIAL TREATMENT OF FUNDS AND SALES OF CLASS B SHARES The Securities and Exchange Commission and the NASD have settled enforcement proceedings involving a broker-dealer's conduct relating to the sale of mutual fund shares.1 The broker-dealer neither admitted nor denied the allegations in these proceedings. The SEC's proceeding was based upon the broker-dealer's failure to disclose to mutual fund customers certain material facts in two distinct areas. The first area related to the broker-dealer's sale of Class B shares of its proprietary mutual funds. In particular, the SEC found that the broker-dealer failed adequately to disclose at the point of sale in connection with its recommendation of Class B shares in amounts in excess of $100,000 that such shares were subject to higher annual fees and that those fees could have a negative impact on the customer's investment return. The second area, which was also the basis for the NASD's action, involved the broker-dealer's failure to disclose to investors that it was providing certain mutual funds preferential treatment in return for compensation paid by those funds to the broker-dealer or its registered representatives. According to the SEC and the NASD, beginning on January 1, 2000, the broker-dealer established marketing programs through which the broker-dealer collected from the participating mutual fund complexes amounts in excess of standard sales loads and Rule 12b-1 trail payments.2 (Sixteen of the 115 mutual funds marketed by the broker-dealer, including 2 funds affiliated with the broker-dealer, participated in the program.) Periodically, the broker-dealer calculated the payments owed based on sales figures and billed those amounts to the participants in the program. Certain of the payments made by the participating funds were in the form of directed brokerage. In return for these payments, the participants received a number of marketing benefits.3 1 For the Commission's action, see In the Matter of Morgan Stanley DW Inc., SEC Admin. Proc. Rel. No. 33-8339 (Nov. 17, 2003) (the "SEC's Order"). A copy of the SEC's Order is available on the SEC's website at http://www.sec.gov/litigation/admin/33-8339.htm. For the NASD's action, see NASD Letter of Acceptance, Waiver and Consent Re: Morgan Stanley DW, Inc., (No. CAF03006). Information regarding the NASD's action can be found on its website at: http://www.nasdr.com/news/pr2003/release_03_051.html. 2 These programs were the Asset Retention Program and the Partners Program. 2 In its proceeding, the SEC found that the

broker-dealer willfully violated Section 17(a)(2) of the Securities Act of 1933 and Rule 10b-10 under the Securities Exchange Act of 1934 by: (1) failing to disclose the source and amount of remuneration received from third parties in connection with a securities transaction;4 and (2) with respect to single transaction purchases of $100,000 or greater, failing to adequately disclose to customers at the point of sale the greater costs associated with Class B shares and the potential greater returns associated with Class A shares. The SEC censured the broker- dealer, ordered it to comply with an undertaking set forth in the SEC's Order, and fined it $50 million, which consists of disgorgement plus prejudgment interest of $25 million and a civil monetary penalty of $25 million.5 The entirety of this $50 million is to be placed in a "Fair Fund" for distribution to customers who purchased shares from January 1, 2000 to the present of the "preferred" funds that participated in the broker-dealer's Asset Retention/Partners Program. In the NASD's proceeding, which only involved the broker-dealer's conduct relating to the Asset Retention/Partners Program, the NASD found such conduct to violate NASD Conduct Rule 2830(k)6 and censured the broker-dealer. The NASD did not impose any monetary penalties on the broker-dealer in light of the sanctions imposed in the SEC's proceeding. Tamara K. Salmon Senior Associate Counsel 3 These benefits included: having the mutual fund complexes placed on a "preferred list," which the broker-dealer's representatives were to look to first in making mutual fund recommendations; having more prominence on the representatives' workstations; being eligible to participate in the broker-dealer's 401(k) programs and to offer offshore fund products to the broker-dealer's customers; the payment of additional incentive compensation to the representatives who sold funds on the preferred list and their branch managers; access to the representatives' training and customer seminars; inclusion in representative events; and ability to participate in programs broadcast over the broker-dealer's internal communication systems. 4 The SEC's Order at ¶ 25 also notes that: Although the Asset Retention Program and Partners funds' prospectuses and SAIs contain various disclosures concerning payments to the broker-dealers distributing their funds, none adequately disclose the preferred programs as such, nor do most provide sufficient facts about the preferred programs for investors to appreciate the dimension of the conflicts of interest inherent in them. For example, none of the prospectuses specifically discloses that [the broker-dealer] receives payments from the fund complexes, that the fund complexes send portfolio brokerage commissions to [the broker-dealer] in exchange for enhanced sales and marketing, nor do they describe for investors the various marketing advantages provided through the programs. 5 These undertakings include: (1) placing on the broker-dealer's website disclosure regarding the Partners Program; (2) providing customers with a disclosure document that will disclose, among other things, specific information concerning the Partners Program and the difference in fees and expenses connected with the purchase of different mutual fund share classes; (3) for those customers who bought certain Class B shares in amounts of $100,000 or more, offering to convert those customers' Class B shares to Class A shares; (4) retaining an independent consultant to conduct a review of, and to provide recommendations concerning, the broker-dealer's disclosures, policies and procedures and its plan to offer to convert Class B shares to Class A shares; and (5) adopting the recommendations of the independent consultant. 6 Rule 2830(k) prohibits a member from: favoring or disfavoring the sale or distribution of mutual funds on the basis of brokerage or other remuneration; conditioning brokerage commissions paid to the member upon the member's sale or promise of sales of shares of a mutual fund; or providing incentives or additional compensation for the sale of specific mutual funds based upon the amount of brokerage commissions received or expected from any source or recommending specific mutual funds based on brokerage commissions.