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NYSE GUIDANCE ON DISCLOSURES AND SALES PRACTICES CONCERNING MUTUAL FUNDS AND VARIABLE ANNUITIES

 [19192] September 26, 2005 TO: COMPLIANCE MEMBERS No. 17-05 SEC RULES MEMBERS No. 106-05 VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 11-05 RE: NYSE GUIDANCE ON DISCLOSURES AND SALES PRACTICES CONCERNING MUTUAL FUNDS AND VARIABLE ANNUITIES The New York Stock Exchange recently issued an Information Memorandum that clarifies disclosure and sales practice requirements concerning mutual funds and variable annuities and reminds NYSE members of their disclosure obligations under NYSE and Securities and Exchange Commission rules. 1 The Memorandum addresses directed brokerage, revenue sharing, and disclosures and suitability related to variable annuities. It is summarized below. Directed Brokerage The Memorandum references recent changes to Rule 12b-1 under the Investment Company Act of 1940 that prohibit certain directed brokerage practices. It reminds NYSE members and member organizations that a fund may use a broker-dealer that promotes or sells fund shares ("selling broker") to execute portfolio transactions for the fund only if, among other things, the fund or its adviser has implemented policies and procedures reasonably designed to prevent the persons responsible for selecting broker-dealers to execute the fund's portfolio transactions ("executing brokers") from taking into account the promotion or sale of fund shares. The Memorandum states that in keeping with this requirement, and as a matter of best practices, a selling broker should not execute fund portfolio transactions unless it: (1) confirms that the fund has implemented the policies and procedures required by Rule 12b-1; and (2) ensures that the fund uses reasonable criteria in selecting executing brokers. Furthermore, a selling broker should not execute fund portfolio transactions if it knows or has reason to believe that the fund took its selling efforts into account when selecting it as an executing broker. 1 NYSE Information Memorandum No. 05-54 (Aug. 11, 2005) ("Memorandum"), available at http://apps.nyse.com/commdata/PubInfoMemos.nsf/AllPublishedInfoMemosNyseCom/85256FCB005E19E885257 05800712FC6/$FILE/Microsoft%20Word%20-%20Document%20in%2005-54.pdf. 2 According to the Memorandum, as a matter of best practices, selling brokers should implement written policies and procedures reasonably designed to prevent remuneration prohibited by Rule 12b-1. At a minimum, these 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 that might suggest informal arrangements in violation of the rule. The Memorandum also reminds selling brokers of their obligation to ensure that mutual

fund customers “receive full disclosure of all potential conflicts of interest concerning the transaction, including but not limited to” how the fund selects selling brokers to be executing brokers. It states that, as demonstrated by recent disciplinary actions and reflected in the SEC’s point of sale disclosure proposal, a member that is a selling broker for a fund should disclose to its customers that it receives payments as an executing broker for the fund. Revenue Sharing The Memorandum describes certain types of revenue sharing arrangements and discusses recent disciplinary actions in this area. It states that the NYSE’s rules and the federal securities laws require members and member organizations to ensure full and adequate disclosure to customers of revenue sharing arrangements. According to the Memorandum, such disclosure “should prominently and completely describe, in plain language comprehensible to investors, the existence, substance, and scope of the member’s or member organization’s revenue sharing arrangements, including all facts necessary to ensure that the customer understands the full nature and extent of any conflict of interest that might affect the transaction.” In addition, the disclosure “should be delivered to the customer – as opposed to merely accessible upon request – at the time of the transaction.” The Memorandum notes broker-dealers’ past practice of relying upon disclosure in a fund’s prospectus or statement of additional information rather than directly disclosing revenue sharing arrangements to their customers. It states that as a matter of best practices, a member or member organization should directly disclose its receipt of revenue sharing to its customers. A member or member organization that chooses to rely on third-party disclosure will retain the responsibility for ensuring that its customers have received sufficient information about the conflicts of interest. It should have in place policies and procedures designed to evaluate third- party disclosures and, in instances where third-party disclosures do not suffice, should ensure that there are sufficient disclosures of all conflicts of interest directly to customers. The Memorandum points out that revenue sharing arrangements are not limited to mutual funds and that the obligations set forth in the Memorandum apply with full force to revenue sharing arrangements involving variable annuities and other investment products. Disclosures and Suitability Related to Variable Annuities The Memorandum states that the marketing of variable annuity products to retail customers entails heightened disclosure obligations because these products present unique suitability concerns, due to their containing both securities and insurance features. According to the Memorandum, a registered representative: 3 • Should not recommend an annuity product to a customer without fully disclosing – and ascertaining that the customer fully understands – the fee structure, including potential surrender charges and tax penalties arising from early liquidation; • Should have thorough knowledge of all material specifications of the product, including the death benefit, fees and expenses, sub-account choices, special features, withdrawal privileges, and tax treatment; • Should, as a good business practice, give the customer the applicable current prospectus at the time of the recommendation, to the extent practicable, but in no event later than the date of sale; • Should disclose to a customer that under normal circumstances, a variable annuity would not be appropriate as a short-term investment; and • Should ascertain, and disclose to a customer, among other things, the consequences and effects of the customer’s age, income and cash flow needs, net worth (including liquid net worth), present and reasonably projected tax status, investment objectives and experience, and risk tolerance. The Memorandum advises that customers should be able to hold a variable annuity product against all foreseeable cash needs at least until the expiration of surrender charges, and notes that the real benefits of the tax-deferral feature may not be realized until even later. Finally, the Memorandum discusses switching concerns, and states that in the event that an annuity sale involves an exchange or replacement of variable annuities, reasonable review by a supervisory employee would include, but not be limited to, a review and analysis to determine the economic justification

for the switch. Among other things, registered representatives and their supervisors should determine whether any proposed new policy changes the treatment of withdrawals in computing death benefits. The Memorandum recommends that a member or member organization that does not have its own exchange or replacement analysis document use an existing form provided by the applicable state insurance commission or regulatory agency. Frances M. Stadler Deputy Senior Counsel

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