

MEMO# 18411

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BROKER-DEALER SETTLES SEC, NASD AND NYSE ENFORCEMENT ACTIONS RELATING TO REVENUE SHARING

[18411] January 13, 2005 TO: BOARD OF GOVERNORS No. 3-05 CHIEF COMPLIANCE OFFICER COMMITTEE No. 2-05 COMPLIANCE ADVISORY COMMITTEE No. 3-05 PRIMARY CONTACTS - MEMBER COMPLEX No. 2-05 SEC RULES MEMBERS No. 7-05 SMALL FUNDS MEMBERS No. 3-05 RE: BROKER-DEALER SETTLES SEC, NASD AND NYSE ENFORCEMENT ACTIONS RELATING TO REVENUE SHARING The Securities and Exchange Commission issued an order making findings and imposing disgorgement, civil money penalties, and disclosure reforms in an administrative proceeding against a registered broker-dealer that allegedly failed to make adequate disclosures regarding revenue sharing payments it received from certain mutual fund families.¹ The NASD and the New York Stock Exchange also announced settlements with the Respondent, which involve similar charges as well as allegations relating to the failure to establish supervisory procedures addressing late trading, the firm's retention of e-mail communications and, in the NASD settlement, directed brokerage.² The Respondent consented to the three settlements, which are summarized below, without admitting or denying the regulators' findings. 1 See In the Matter of Edward D. Jones & Co., L.P., SEC Release Nos. 33-8520 and 34-50910, Admin. Proc. File No. 3-11780 (Dec. 22, 2004) ("SEC Order"). The SEC Order also censures the Respondent and imposes a cease and desist order. Copies of the SEC Order and accompanying press release ("Press Release") are available at <http://www.sec.gov/litigation/admin/33-8520.htm> and <http://www.sec.gov/news/press/2004-177.htm>, respectively. 2 Copies of the NASD settlement and accompanying press release are available on the NASD's website at http://www.nasd.com/stellent/groups/enforcement/documents/enforcement/nasdw_012838.pdf and http://www.nasd.com/stellent/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_012839&ssSourceNodeID=1108, respectively. A copy of the NYSE settlement is available on the NYSE's website at <http://www.nyse.com/pdfs/04-194.pdf>. 2 I. SEC Order A. Findings³ According to the SEC Order, in the 1980s, the Respondent designated as "recommended" certain mutual fund families with which it had selling agreements. The SEC Order states that certain of the recommended fund families with which the Respondent had long-standing relationships later agreed to the Respondent's request for revenue sharing payments. It further states that the Respondent presently designates seven mutual fund families as "Preferred Mutual Fund Families" ("Preferred Families"). Of the approximately 240 fund families with which the Respondent has selling agreements, according to the SEC Order, only the Preferred Families make revenue sharing payments to the Respondent. The SEC Order states that the Respondent encouraged its investment representatives to consider revenue sharing in making mutual fund recommendations to their customers. It

also states that an investment representative's sales and customer holdings of funds from the Preferred Families were used in determining the representative's profitability to the firm, and that his or her profitability in turn affected whether the representative was considered for limited partner status and for bonuses during the year. According to the SEC Order, the Respondent exclusively promoted the Preferred Families on its public website, stating that the Preferred Families share the Respondent's commitment to service, long-term investment objectives, and long-term performance. The SEC Order finds that the Respondent did not disclose on the website the Preferred Families' revenue sharing payments, or the dimensions of the potential financial conflict they created, nor were these disclosures made orally to customers or included in any written document prepared by the firm. The SEC Order notes that Respondents claimed to rely on disclosure regarding revenue sharing in prospectuses and Statements of Additional Information for the Preferred Families' funds. It finds, however, that many of these documents did not disclose adequate information about the source and amount of the revenue sharing payments to the Respondent and the dimensions of the resulting potential conflicts of interest. The SEC Order makes similar findings with respect to the Respondent's sale of 529 college savings plans, including that the Respondent: (1) promoted only the 529 plans of the Preferred Families (two of which make additional revenue sharing payments to the Respondent for 529 plan sales) despite having selling agreements with other mutual fund companies to sell their 529 plans; and (2) failed to disclose the Respondent's material financial incentives to favor the sale of certain Preferred Families' 529 plans. As a result of the conduct generally described above, the SEC Order finds that the Respondent willfully violated Section 17(a)(2) of the Securities Act, which prohibits material misstatements and omissions in the offer and sale of securities; and Rule 10b-10 under the Securities Exchange Act, which requires a broker-dealer to provide a customer, at or before completion of a securities transaction, with written notification regarding the source and amount of any remuneration that the broker-dealer will receive in connection with the transaction. With respect to Respondent's sales of 529 college savings plans, the SEC Order 3 The factual allegations and findings of violation in the SEC Order are generally incorporated into the NASD and NYSE settlements. 3 finds that Respondent willfully violated Section 15B(c)(1) of the Exchange Act by acting in contravention of Municipal Securities Rulemaking Board ("MSRB") Rule G-15, which imposes a disclosure obligation similar to that of Rule 10b-10 with respect to any municipal securities transaction. B. Terms of the SEC Order4 In determining to accept the settlement offer, the SEC considered that the Respondent will not accept reimbursement or indemnification from any source, including from an insurance policy, with regard to payment of the penalties imposed by the SEC Order. Pursuant to the SEC Order, the Respondent will pay \$37.5 million in disgorgement and \$37.5 million in civil money penalties. It also will comply with the following undertakings: Required Disclosures; Related Policies and Procedures • Website Disclosures – Within 15 days of entry of the SEC Order, Respondent will maintain on its public website certain information regarding its Preferred Mutual Fund Family program, including: (1) the existence of the program; (2) the identity of the participating mutual fund families; (3) the amount, in basis points or dollars, of revenue sharing payments that the Respondent receives from each of the participating fund families; (4) the total amount, in dollars, of revenue sharing payments that the Respondent receives annually, beginning with the amount received in 2004 as of the date of the SEC Order and updated each year thereafter; (5) the source of such payments (fund assets, adviser, etc.); (6) a statement that the firm's investment representatives and equity owners may benefit financially from the revenue sharing payments received by the firm; and (7) a statement that the Respondent does not receive revenue sharing payments from any non-preferred mutual fund families. The Respondent is required to provide this information on both the mutual fund and college savings program sections of its website. • Disclosures to

Customers – The Respondent must send the information outlined above to its current customers within 60 days of entry of the SEC Order and annually thereafter, and to new customers upon the opening of an account. In those cases where the Respondent sends confirmations directly, it must provide the same information to a customer at or before the completion of each transaction in mutual funds or 529 plans (except that the information may be sent quarterly to customers purchasing shares through a periodic plan). •

Disclosure Policies and Procedures – Within 60 days of the SEC Order, the Respondent is required to implement policies and associated procedures to: o ensure compliance with its disclosure obligations under the SEC Order, the federal securities laws, and MSRB rules; and to ensure that all statements on its 4 The NASD and NYSE settlements require the Respondent to pay disgorgement and penalties in the amounts and manner set forth in the SEC Order. The undertakings in the two settlements also mirror those in the SEC Order. 4 public website comply with the SEC Order, the federal securities laws, and the MSRB rules, and are otherwise not misleading; o conduct comprehensive reviews, on a regular basis, of all prospectuses and Statements of Additional Information issued by the Preferred Families to ensure that the Respondent is in compliance with the SEC Order, the federal securities laws, and the MSRB rules; o document the basis for its decisions to add or remove mutual fund families from its Preferred Mutual Fund Family Program; and o train its investment representatives regarding the disclosure of financial incentives that the Respondent, its investment representatives, general partners, and limited partners receive from each of the Preferred Families. Independent Consultant • Compliance Review – Within 60 days of the SEC Order, the Respondent must retain an independent consultant acceptable to the SEC staff to conduct a comprehensive review of: (1) the adequacy of the policies and procedures that the SEC Order requires the Respondent to implement; and (2) whether the Respondent’s receipt and disclosure of revenue sharing payments comply with the SEC Order, the federal securities laws, and the MSRB rules. The consultant must complete its review and provide its recommendations in a report to the Respondent and the SEC staff within 120 days of the SEC Order. The consultant also must conduct a follow-up review and submit a final report to the Respondent and the SEC staff within one year of the SEC Order. •

Distribution Plan – Within 60 days of the SEC Order, the Respondent must submit to the consultant and the SEC staff a plan pursuant to which the consultant will distribute the total disgorgement and penalties under the SEC Order. The plan must address how the money should be distributed to benefit customers who purchased shares offered by the Preferred Families through the Respondent from January 1, 1999 through the date of the SEC Order.

II. NASD Settlement The NASD settlement incorporates the factual allegations and findings of violation in the SEC Order (see Section I.A above). The NASD also found that the Respondent violated various NASD Conduct Rules by engaging in the following conduct: •

Directed Brokerage – According to the NASD settlement, from January 1999 through December 2003, the Respondent received almost \$18 million in directed brokerage from three of the Preferred Families. These payments, which were made through “step-out arrangements,” were part of the Respondent’s revenue sharing program. The NASD found that this conduct violated rules prohibiting an NASD member from conditioning its efforts to distribute a fund’s shares upon receipt of the fund’s brokerage commissions. 5 •

Failure to Establish Supervisory Procedures Addressing Late Trading – According to the NASD settlement, prior to November 2003, the Respondent allowed its investment representatives to request that fund trades entered after 4:00 pm EST be “released” and priced at that day’s net asset value, based solely on the representative’s statement that the order had been received before 4:00 pm. The NASD found that the firm failed to have adequate policies and procedures for approving released trades and for supervisory review of decisions to grant requests for released trades. • Unlawful Sales Contest – According to the NASD settlement, the Respondent held a sales contest that awarded credit only for

sales of certain preferred funds and variable annuities made during part of the contest. The NASD found that this conduct violated applicable rules requiring an NASD member to base sales contest awards on a registered representative's total sales of all mutual funds and variable contracts distributed by the firm. • Supervisory Procedures and Systems – The NASD found that the Respondent failed to reasonably supervise, or to establish supervisory procedures and systems addressing, activities relating to: the sale of Preferred Families' mutual funds and 529 plans, revenue sharing, directed brokerage, sales contests, e-mail communications, and late trading. • E-mail Retention – The NASD found that the Respondent failed to preserve and retain certain e-mail communications as required by applicable recordkeeping rules. III. NYSE Settlement The NYSE settlement incorporates the factual allegations and findings of violation in the SEC Order (see Section I.A above). The NYSE also found that the Respondent violated various rules of the Exchange by failing to supervise late trading and to preserve and maintain certain e-mail communications, as described in the NASD settlement (see Section II above). Finally, the NYSE found that the Respondent violated an Exchange rule by failing to reasonably review certain mutual fund prospectuses and Statements of Additional Information to determine if they adequately disclosed revenue sharing, directed brokerage payments, or the other incentives provided to the Respondent. Rachel H. Graham Assistant Counsel