

MEMO# 15883

April 10, 2003

NASD DISCIPLINARY ACTION CONCERNING DISCLOSURE OF SPECIAL CASH COMPENSATION ARRANGEMENTS

[15883] April 10, 2003 TO: BROKER/DEALER ADVISORY COMMITTEE No. 15-03 SEC RULES MEMBERS No. 45-03 RE: NASD DISCIPLINARY ACTION CONCERNING DISCLOSURE OF SPECIAL CASH COMPENSATION ARRANGEMENTS A mutual fund distributor ("distributor") and an affiliated broker-dealer firm ("broker-dealer") recently settled an NASD disciplinary action involving special cash compensation arrangements between the distributor and the broker-dealer. Without admitting or denying NASD's allegations, the distributor and the broker-dealer consented to the entry of findings. A copy of the NASD Letter of Acceptance, Waiver and Consent ("AWC")¹ is attached and summarized below. According to the AWC, a new family of mutual funds underwritten and distributed by the distributor became available for sale to the public in December 1998. To encourage sales of the funds, the distributor paid affiliated dealers a 1% bonus to be passed on to the brokers selling the fund shares. In addition to this bonus, the distributor entered into two special cash compensation arrangements providing for and resulting in payments to a select group of registered representatives ("select group") who had recently left another firm and become registered with the broker-dealer. The first such arrangement, which was entered into in December 1998, provided that the distributor would pay the select group an additional .5% bonus on class A shares of the funds sold at NAV. This bonus was paid on sales of fund shares from December 1998 through June 1999. Under the second arrangement, entered into in April 1999, the distributor paid the select group another .5% bonus on sales of class A shares sold at NAV, retroactive to the launch of the funds in December 1998. The AWC notes that these arrangements entitled the select group to earn 1% more than other dealers and brokers selling class A shares during the same period. The AWC indicates that neither the fund prospectus nor the related statements of additional information disclosed the special cash compensation arrangements until mid-May 1999, when disclosure was included in an SAI supplement.² The net bonus paid to the select group versus other representatives who sold fund shares during the period December 1998 1 NASD Letter of Acceptance, Waiver and Consent No. C8A0 90001 (accepted by NASD 1/10/03). 2 In addition, while a January 15, 1999 supplement to the SAI disclosed the 1% bonus payment available to affiliated dealers, the AWC states that to the extent these arrangements were offered to affiliated dealers and not other dealers during the period December 15, 1998 through January 15, 1999, detailed disclosure was required. 2 through mid-May 1999 was "significant" according to the AWC, amounting to approximately \$220,000. NASD found that the distributor and the broker-dealer violated NASD Rules 2830 and 2110 by entering into special cash compensation arrangements while failing to ensure that appropriate disclosure of these arrangements was made. NASD Rule 2830(I)(4) provides in part that: "No member

shall accept any cash compensation from an offeror unless such compensation is described in a current prospectus of the investment company. When special cash compensation arrangements are made available by an offeror to a member, which arrangements are not made available on the same terms to all members who distribute the investment company securities of the offeror, a member shall not enter into such arrangements unless the name of the member and the details of the arrangements are disclosed in the prospectus.”³ Rule 2110 requires NASD members to uphold high standards of commercial honor and just and equitable principles of trade in the conduct of their business. In settling the NASD action, the distributor was censured and fined \$125,000, and the broker-dealer was censured and fined \$25,000. Frances M. Stadler Deputy Senior Counsel Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (<http://members.ici.org>) and search for memo 15883, or call the ICI Library at (202) 326-8304 and request the attachment for memo 15883. Attachment (in .pdf format) 3 The AWC notes that SAI disclosure of cash compensation arrangements will satisfy the NASD disclosure requirements in some circumstances.

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