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BROKER-DEALERS SETTLE WITH SEC AND NASD RELATING TO MUTUAL FUND SALES PRACTICES

 [18722] April 4, 2005 TO: BROKER/DEALER ADVISORY COMMITTEE No. 10-05 BROKER/DEALER ASSOCIATE MEMBERS No. 5-05 CHIEF COMPLIANCE OFFICER COMMITTEE No. 32-05 COMPLIANCE ADVISORY COMMITTEE No. 28-05 SEC RULES MEMBERS No. 45-05 SMALL FUNDS MEMBERS No. 29-05 RE: BROKER-DEALERS SETTLE WITH SEC AND NASD RELATING TO MUTUAL FUND SALES PRACTICES The Securities and Exchange Commission has issued an order making findings and imposing a civil money penalty and compliance reforms in an administrative proceeding against a registered broker-dealer for failing to provide customers with important information relating to their purchases of mutual fund shares.1 The broker-dealer consented to the entry of the SEC Order without admitting or denying the SEC's findings. In an investigation coordinated with the SEC, NASD announced the settlement of charges against the broker-dealer and two other broker-dealers relating to the improper sales of Class B and C shares of mutual funds.2 The settlements are summarized below. I. SEC Order A. Findings According to the SEC Order, from at least January 2002 to July 2003, the broker-dealer failed to disclose adequately certain material facts to its customers in the offer and sale of mutual fund shares. The SEC Order states that the broker-dealer failed to fully disclose to its 1 See In the Matter of Citigroup Global Markets, Inc., SEC Release Nos. 33-8557 and 34-51415, Admin. Proc. File No. 3- 11869 (March 23, 2005) ("SEC Order"). The SEC Order also censures and imposes a cease and desist order on the broker-dealer. Copies of the SEC Order and accompanying press release are available at http://www.sec.gov/news/press/2005-39.htm. The press release notes that the case against Citigroup arises out of a broader investigation into mutual fund sales practices. 2 See In re American Express Financial Advisors Inc., NASD Letter of Acceptance, Waiver and Consent (March 23, 2005); In re Chase Investment Services Corporation, NASD Letter of Acceptance, Waiver and Consent (March 23, 2005); In re Citigroup Global Markets, Inc., NASD Letter of Acceptance, Waiver and Consent (March 23, 2005) (collectively, "AWCs"). Copies of the AWCs are attached. 2 customers material information regarding its revenue sharing program under which approximately 75 mutual fund complexes made revenue sharing payments to the broker-dealer in exchange for access to or "shelf space" within the broker-dealer's retail brokerage network. The SEC Order further states that the broker-dealer offered and sold only the funds of those mutual fund complexes that participated in the program. The broker-dealer also provided additional benefits to the mutual fund complexes that made higher revenue sharing payments. These benefits included increased access to

branch offices, greater agenda space at sales meetings, and visibility in the broker-dealer's in-house publications and broadcasts. The SEC Order finds that this practice created a conflict of interest that the broker-dealer failed to adequately disclose to its customers. The SEC Order also finds disclosure failures relating to the broker-dealer's sale of Class B shares of mutual funds in amounts aggregating $50,000 or greater. According to the SEC Order, the broker-dealer recommended and sold Class B shares of mutual funds to certain customers who, depending on the amount of the investment and the holding period, generally would have obtained a higher overall rate of return had they purchased Class A shares instead. The SEC Order states that these customers could have benefited had they purchased Class A shares because they could have qualified for breakpoints beginning at the $50,000 level. As a result of the customers' purchases of Class B shares, the broker-dealer received greater commissions than it would have earned had it sold Class A shares of the same mutual funds. According to the SEC Order, the broker-dealer's financial consultants, when recommending and selling Class B shares of mutual fund shares to customers, did not adequately disclose that (i) such shares were subject to higher annual fees that could have a negative impact on the customers' investment return, or (ii) once breakpoints become available beginning at the $50,000 level, an equal investment in Class A shares could yield a higher return. As a result of the conduct generally described above, the SEC Order finds that the broker-dealer willfully violated: • Section 17(a)(2) of the Securities Act of 1933 by making materially misleading statements or omissions in the offer and sale of securities; and • Rule 10b-10 under the Securities Exchange Act of 1934 for failing to disclose the source and amount of any remuneration received from third parties in connection with a securities transaction. B. Undertakings The broker-dealer has agreed to the following undertakings: • Website Disclosure – The broker-dealer will place and maintain on its website disclosures regarding its revenue sharing program. • Independent Consultant – The broker-dealer will retain an Independent Consultant, who is not unacceptable to the SEC staff, to conduct a comprehensive review of (i) the completeness of the disclosures regarding the broker-dealer's revenue sharing program and the differences in mutual fund share classes; and (ii) the policies and procedures relating to the broker-dealer's 3 recommendations to its customers of mutual funds in its revenue sharing program and of different class shares of mutual funds. The broker-dealer will require the Independent Consultant to provide an initial report to the broker- dealer and to the SEC staff within 150 days from the date of entry of the SEC Order. A final report will be required within 270 days from the date of entry of the SEC Order. The reports will address, among other things, the adequacy, procedures, and completeness of the conversion offer described below. • Conversion Offer – The broker-dealer will provide to the Independent Consultant a list of customers who purchased $50,000 or greater of Class B shares between January 1, 2002 and the date of entry of the SEC Order. The broker-dealer will offer affected customers the option of converting their Class B shares into Class A shares in such a manner that each customer is placed in the same financial position, based on actual fund performance, in which such customer would have been had the customer purchased Class A shares instead of Class B shares. C. Civil Penalties The broker dealer will pay a civil money penalty of $20 million. II. AWCs A. Findings As part of a larger, ongoing investigation into mutual fund sales practices, NASD announced settlements with three broker-dealers involving allegations of suitability and supervisory violations relating to mutual fund sales practices between January 2002 and July 2003. The cases against the three broker-dealers involve their recommendations and sales of Class B and/or Class C shares of mutual funds. According to the AWCs, the firms made recommendations and sales of mutual funds to their customers without considering or adequately disclosing, on a consistent basis, that an equal investment in Class A shares would generally have been more economically advantageous for their customers by providing a higher overall rate of return. In particular,

the AWCs state that the firms did not consistently consider that large investments in Class A shares of mutual funds entitle customers to breakpoint discounts on sales charges, generally beginning at the $50,000 investment level, which are not available for investments in other share classes. The AWCs state further that the broker-dealers had inadequate supervisory and compliance policies and procedures relating to these mutual fund sales. According to the AWCs, the NASD finds that the broker-dealers violated NASD Conduct Rules 2110,3 2310,4 and 3010.5 3 NASD Conduct Rule 2110 requires that a member, in the conduct of its business, observe high standards of commercial honor and just and equitable principles of trade. 4 NASD Conduct Rule 2310 requires that, before recommending a transaction, a member firm and its registered representatives have reasonable grounds for believing, on the basis of information furnished by the customer, and after reasonable inquiry concerning the customer's investment objectives, financial situation, and needs, that the recommended transaction is suitable for the customer. 4 B. Undertakings • Conversion Offer – Each broker-dealer will create a list of customers who purchased $50,000 or more of Class B shares between January 1, 2002 and the effective date of the AWCs. (Each list, to the extent applicable, will also include those purchases of Class C shares during the relevant time which, when aggregated, total $500,000 or more and involve payment of a front-end load, or $1 million or more where no front-end load was paid). Each broker-dealer will offer affected customers the option of converting their Class B or Class C shares into Class A shares in such a manner that each customer is placed in the same financial position, based on actual fund performance, in which such customer would have been had the customer purchased Class A shares instead of Class B or C shares. • Independent Consultant – The broker-dealer involved in the SEC proceeding will retain an Independent Consultant, who is not unacceptable to NASD, to perform all of the services and tasks described above and conduct a comprehensive review of (i) the completeness of the disclosures regarding the differences in mutual fund share classes; and (ii) the policies and procedures relating to the broker-dealer's recommendations to its customers of different class shares of mutual funds. The broker-dealer will require the Independent Consultant to provide an initial report to the broker-dealer and to NASD within 150 from the effective date of the AWCs. A final report will be required within 270 days. • Independent Examiner – Each of the remaining broker-dealers will retain an Independent Examiner, who is not unacceptable to NASD, to examine the firm's performance of its obligations under the terms of the AWCs. Each broker-dealer will require the Independent Examiner to submit a written final report to the broker-dealer and NASD within 420 days following the effective date of the AWCs. C. Sanctions The broker-dealers will pay fines totaling $21.25 million.6 Jane G. Heinrichs Assistant Counsel Attachment (in .pdf format) Note: Not all recipients receive the attachments. To obtain copies of the attachments, please visit our members website (http://members.ici.org) and search for memo 18722, or call the ICI Library at (202) 326-8304 and request the attachments for memo 18722. 5 NASD Conduct Rule 3010 requires that each member establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations and with the rules of the NASD. 6 Chase Investment Services Corporation will pay a $2 million fine, Citigroup Global Markets will pay a $6.25 million fine, and American Express Financial Advisors will pay a $13 million fine.