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Proposed SEC Rule Concerning Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds

The Securities and Exchange Commission (the "SEC") has proposed two new rules and rule amendments under the Securities Exchange Act of 1934, as amended (the "Exchange Act"): "Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds" (the "Proposed Rule").[1] Comments on the Proposed Rule must be submitted to the SEC within 60 days of the Proposed Rule's publication in the Federal Register. This memorandum outlines the requirements of the Proposed Rule.

A. Introduction

Investors that purchase shares in open-end investment management companies ("mutual funds") often incur distribution-related costs that reduce their investment returns. Some mutual funds issue share classes that impose sales fees ("loads") on investors when they purchase the fund shares ("front-end" loads) or when they redeem fund shares ("deferred" or "back-end" loads). Under plans adopted pursuant to rule 12b-1 under the Investment Company Act of 1940, as amended (the "1940 Act"), some mutual funds also use their assets to pay distribution-related expenses ("12b-1 fees").[2]

The SEC and other regulators have begun to scrutinize the cost structure of investments in mutual funds as well as revenue sharing and directed-brokerage arrangements, which are two types of distribution arrangements that some mutual fund complexes maintain

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1 Proposed Rule: Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds, 17 CFR Parts 239, 240 and 274; Release Nos. 33-8358, 34-49148, IC-26341, File No. S7-06-04: RIN: 3235-AJ11, 3235-AJ12, 3235-AJ13, 3235-AJ14 (January 29, 2004). This memorandum does not address the Proposed Rule's requirements for disclosures related to transactions in callable preferred stock and callable debt securities.

2 *Id.* at Section IV.A.1.a.

with broker-dealers.[3] The SEC believes that broker-dealers that participate in these distribution arrangements may face conflicts of interest because the broker-dealers may have heightened financial incentives to sell particular funds or share classes.[4]

In response to what the SEC perceives as inadequate disclosure about investment costs, revenue sharing and directed-brokerage arrangements, the SEC issued this Proposed Rule that, if adopted, would require increased disclosure to customers.

B. Current Law

Rule 10b-10 requires broker-dealers to give or send written notice disclosing to customers certain information before completion of a transaction. Along with information about loads, that information includes "the source and amount of any other remuneration received or to be received [from a third-party] by the broker in connection with the transaction.[5] Broker-dealers can comply with this rule by delivering to customers a mutual fund prospectus with adequate disclosure.[6]

Prior to a SEC settlement on November 17, 2003,[7] the SEC and one court had decided that delivery of the fund's prospectus to the customer, at or before completion of the transaction, was sufficient disclosure if the prospectus gave adequate information with respect to the revenue sharing arrangements.[8] Moreover, the SEC and the one court had taken the

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3 For purposes of this memorandum, references to the term "broker-dealer" includes reference to a "municipal securities dealer."

4 Proposed Rule at Section IV.A.1.b.

5 Rule 10b-10(a)(2)(i)(D), promulgated under the Exchange Act.

6 *Id.*

7 SEC Administrative Proceedings File No. 3-11335; Securities Act of 1933 Release No. 8339, Securities Exchange Act Release No. 48789 (November 17, 2003).

8 Press v. Quick & Reilly, Inc., 218 F.3d 121, 126-129 (2d Cir. 2000) (the court found it was bound and therefore adopted the SEC position that "the general disclosures made by the fund prospectuses and SAIs are sufficient to satisfy the broker-dealers' duty under Rule 10b-10 to disclose third party remuneration"). See SEC *Amicus* Brief at 24. In arriving at that conclusion, the SEC interpreted the

position that if sufficient information was contained in the fund's prospectus, the broker-dealer was not required to repeat this disclosure in the confirmation statements.[9] In light of the Proposed Rule however, it now appears that the SEC believes many fund prospectuses do not provide adequate information.

C. Overview of Proposed Rule

The Proposed Rule seeks to give investors better access to information about costs and distribution arrangements by requiring broker-dealers to make additional disclosures "at the point of sale" and in transaction confirmations.[10] The new confirmation rules, under Proposed Rule 15c2-2, would require broker-dealers to provide customers with information about distribution-related costs. The new point of sale disclosure rule, under Proposed Rule 15c2-3, would require broker-dealers to provide disclosure to customers about costs and conflicts of interest before the customer makes the decision to purchase mutual fund securities. And finally, the Proposed Rule would amend Form N-l A, the registration form used by mutual funds to register under the 1940 Act, and require fund prospectuses to improve disclosures regarding sales loads and revenue sharing arrangements.)[11]

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rule 10b-10 Adopting Release as establishing the general principle that "delivery of a prospectus containing sufficient disclosure can satisfy a broker-dealer's obligations under Rule 10b-10." Recognizing that "there is no precise standard as to how much disclosure the Rule currently requires," the SEC went on to note that the staffs 1979 letter, with its "precise amount" standard for prospectus disclosure of loads and related fees, did not apply to third-party remuneration because precision was not necessary to inform customers about conflicts of interest. Proposed Rule at Section IV.A.2.

9 Press v. Quick & Reilly, Inc., 218 F.3d at 129 (the court stated, "although we are skeptical that the disclosures in the prospectuses and SAIs, *i.e.*, general statements that payments were made by the funds and their advisers to broker-dealers for their assistance, would actually alert an investor that *his* broker-dealer received such payments, we cannot say that the SEC's determination that Rule 10b-10 may be satisfied by these types of disclosures is plainly erroneous." (emphasis added)

10 Proposed Rule at Section I.

11 *Id.*

D. **Proposed Rule 15c2-2**

Proposed Rule 15c2-2 would retain much of the disclosure framework of rule 10b-10.[12] The disclosure requirements of Proposed Rule 15c2-2 would apply to transactions by broker-dealers on behalf of customers in "covered securities." The term "covered security" would be defined as:[13]

- any security issued by an "open-end company," as defined by section 5(a)(1) of the 1940 Act, that is not traded on a national securities exchange;
- any security issued by a "unit investment trust," ("UIT") as that term is defined by Section 4(2) of the 1940 Act, other than an exchange-traded fund that is traded on a national securities exchange or facility of a national securities association, or a UIT that is the subject of a secondary market transaction; and
- any "municipal fund security."

A. Proposed Schedule 15C

The Proposed Rule would require broker-dealers to disclose a range of costs and conflicts of interest information in a manner that is "consistent with [Proposed] Schedule 15C" under the Exchange Act.[14] Proposed Schedule 15C supplements current requirements for confirmation statements and would provide a standardized format for disclosing quantitative information.

B. General Disclosures

The Proposed Rule would require disclosure of the following information to customers in confirmation statements:[15]

- the date of the transaction, the issuer and class of the covered security;
- the net asset value ("NAV") of the shares or units and, if different, their public offering price;

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[12] *Id.* at Section IV.B.1. The SEC notes that the confirmation disclosure requirements are not determinative of, and do not exhaust, a broker-dealer's disclosure obligations under the antifraud provisions of the federal securities laws. Proposed Rule at Section IV.B.1.a.

[13] Proposed Rule at Section IV.B.l.b.

[14] *Id.* at Section IV.B.1.c.

[15] *Id.* at Sections IV.B.1.d.(i), (ii)(a) and (ii)(b).

- the number of shares of a covered security purchased or sold;
- the total dollar amount paid or received in the transaction;
- the net amount of the investment bought or sold in the transaction, which would be equal to the number of shares or units bought or sold multiplied by the NAV of those shares or units;
- any commission, markup or other remuneration the broker-dealer will receive from the customer in connection with the transaction;[16]
- the amount of any deferred sales loads incurred by the customer;[17]
- when applicable, the fact that a broker-dealer is not a member of the Securities Investor Protection Corporation ("SIPC"), or that the broker-dealer clearing or carrying the customer account is not a member of SIPC;
- the amount of any sales load that the customer has incurred or will incur at the time of purchase, expressed in dollars and as a percentage of the net amount invested, together with information about the potential relevance of breakpoint discounts;
- the availability of breakpoints as reflected in Proposed Schedule 15C with regard to a different class of the covered security, including a statement of the sales load that the customer would have incurred at the time of sale if the transaction had been in that different class of the covered security;
- the potential amount of deferred sales loads;[18]
- any asset-based sales charges and service fees paid in connection with the customer's purchase of covered securities;[19] and
- any dealer concession that the broker-dealer earns in connection with the transaction, expressed in dollars and as a percentage of the net amount invested.[20]

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[16] Rule 10b-10(a)(2)(i)(B) already requires disclosure of remuneration from customers. This remuneration is distinct from dealer concessions and other types of sales fees that a broker-dealer may receive from the fund or its primary distributor. Remuneration from customers also is distinct from any sales load that the customer may pay in connection with a transaction. Both of those would be disclosed separately. Proposed Rule at Section IV.B.1.d.

[17] Proposed Rule at Section IV.B.1.d.

[18] This would not apply if the shares have a deferred sales load of no more than one percent that expires no later than one year after purchase, when no other sales load would be incurred. In addition, the SEC notes that broker-dealers would rarely, if ever, know in advance when an investor may redeem those shares, and therefore would generally not be able to disclose the specific amount of a deferred sales load. Proposed Rule at Section IV.B.l.d.ii.a.

[19] "*Asset-based sales charges*" would be defined as all asset-based charges incurred in connection with the distribution of a covered security, paid by the issuer or paid out of assets of covered securities owned by the issuer. "*Asset-based service fee*" would be defined as all asset-based amounts paid for personal service or the maintenance of shareholder accounts by the issuer or paid out of assets of covered securities owned by the issuer. These terms would encompass rule l2b-1 fees and any similar types of distribution or service fees incurred by issuers. Proposed Rule at Section IV.B.l.d.ii.b.

C. Revenue Sharing and Directed Brokerage Arrangements

The Proposed Rule would also require disclosure regarding information related to revenue sharing payments and portfolio securities transaction commissions received by the broker-dealer.[21] Specifically, the Proposed Rule would require disclosure of information about "revenue sharing payments from persons within the fund complex" and "commissions, including riskless principal compensation, associated with portfolio securities transactions on behalf of the issuer of the covered security, or other covered securities within the fund complex."[22] Because the SEC believes revenue sharing and portfolio brokerage arrangements may be linked to a firm's success in distributing securities, the information

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[20] "*Dealer concession*" would be defined as fees that the broker-dealer will earn at the time of the sale, in connection with the transaction, from the issuer of the covered security, an agent of the issuer, the primary distributor, or any other broker-dealer. That amount would be distinct from the commission that the broker-dealer may receive directly from the customer, as well as any load that the investor may pay to the fund's principal underwriter. Proposed Rule at Section IV.B.1.d.ii.b.

[21] Proposed Rule at Section IV.B.I.d.ii.c. The SEC notes that NASD rule 2830(k)(1) bars broker-dealers from favoring the distribution of funds that pay portfolio brokerage commissions. The SEC also notes that the proposal to require broker-dealers to disclose information about receipt of portfolio brokerage commissions in no way should be read to condone favoring distribution of funds that pay portfolio brokerage commissions, and would not prevent a broker-dealer from being held liable for violating that NASD rule. Moreover, the SEC notes that a mutual fund that uses brokerage commissions to promote the distribution of another mutual fund may also be in violation of the 1940 Act. Proposed Rule at Section IV.B.1.d.ii.c.

[22] "*Revenue sharing*" would be defined as any arrangement or understanding by which a person within a fund complex, other than the issuer of the covered security, pays a broker-dealer, or any associated person of the broker-dealer, apart from dealer concessions or other sales fees that would be otherwise be disclosed. The proposed definition of revenue sharing excludes payments made by the issuer of the covered security, because the SEC believes those other payments, such as payments for transfer agent services, do not raise the same conflict of interest concerns that are the subject of this Proposed Rule. "*Portfolio securities transaction*" would be defined as any transaction involving securities owned by the issuer of a covered security, or owned by any other issuer within the same fund complex. The required disclosure of commissions associated with portfolio transactions would include disclosure of commissions received by a broker-dealer as part of a "soft dollar" arrangement. "*Fund complex*" would be defined to include the issuer of the covered security. Proposed Rule at Section IV.B.1.d.ii.c.

would be disclosed on the basis of the sales on behalf of the fund complex, rather than on a fund-by-fund basis.[23]

For both revenue sharing and portfolio brokerage commissions, a broker-dealer would be required to disclose information about amounts directly or indirectly earned from the fund complex by the broker-dealer, any associated person that is a broker-dealer[24] and any other associated person, if the covered security is not a proprietary covered security.[25] The Proposed Rule would require that these amounts be disclosed as a percentage of the total NAV represented by such broker-dealer's total sales of covered securities (as measured by cumulative NAV) on behalf of the fund complex over the four most recent calendar quarters, updated each calendar quarter.[26] The required disclosure also would set forth the total dollar amount of revenue sharing or portfolio brokerage commissions that the broker-dealer may expect to receive in connection with the transaction, calculated by multiplying that percentage by the net amount invested in the transaction.[27]

Finally, to the extent that the broker-dealer has entered into a revenue sharing arrangement or understanding that would result in a specific amount of remuneration in connection with purchases of the covered security, the broker-dealer would have to disclose that expected remuneration as a percentage of the net amount invested in the covered

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23 Proposed Rule at Section IV.B.l.d.ii.c.

24 "*Associated Person*" is defined in Sections 3(a)(18) and 3(a)(32) of the Exchange Act.

25 "*Proprietary covered security*" would be defined as any covered security as to which the broker-dealer is an affiliated person, as defined by Section 2(a)(3) of the 1940 Act, of the issuer, or is an associated person of the issuer' s investment adviser or principal underwriter, or, in the case of a covered security that is an interest in a UIT, is an associated person of a sponsor, depositor or trustee of the covered security. Proposed Rule at Section IV.B.1.d.ii.c.

26 Firms would have 30 days to update the information following the end of the calendar quarter. Proposed Rule at Section IV.B.1.d.ii.c.

27 Proposed Rule at Section IV.B.l.d.ii.c.

securities, and would have to disclose the total dollar amount of remuneration it may expect to receive in connection with the transaction.[28]

D. Differential Compensation Structure

The Proposed Rule would require disclosure of whether a broker-dealer pays "differential compensation" to associated persons related to purchases of two specific types of securities: covered securities that carry a deferred sales load[29] and shares of proprietary covered securities that are issued by an affiliate of the broker-dealer.[30] "Differential compensation" would be defined differently depending on the securities transaction at issue.[31] If a customer

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[28] Amounts received by affiliates that are not broker-dealers would not be included with respect to transactions involving proprietary covered securities, to avoid requiring disclosure of management fees and other payments between funds and investment advisers and any other service providers that are associated with the broker-dealer. Proposed Rule at Section IV.B.1.d.ii.c.

[29] This would not include shares with a deferred load of no more than one percent that expires no later than one year after purchase, when no other sales load would be incurred. Proposed Rule at Section IV.B.1d.ii.d.

[30] Proposed Rule at Section IV.B.l.d.ii.d.

[31] For customer purchases of a class of covered security associated with a deferred sales load, "*differential compensation*" would be defined as any form of higher compensation (including total commissions, reimbursement or avoidance of charges or expenses, or other cash or non-cash compensation) that a broker-dealer can be expected to pay to any associated person in connection with the sale of a stated dollar amount of that class of covered security over the next year, based on its current practices and assuming no change in the shares' NAV if applicable, compared with the compensation that the associated person would have been paid over the next year in connection with the sale of the same dollar amount of another class of the same security that is associated with a front-end sales load. For customer purchases of proprietary covered securities, the Proposed Rule would define "*differential compensation*" as any practice by which a broker-dealer pays an associated person a higher percentage of the firm's gross dealer concession in connection with selling a proprietary covered security than the percentage of the gross dealer concession that the firm would pay in connection with selling the same dollar amount of any non-proprietary covered security offered by the firm, and any other practices of a broker-dealer that causes an associated person to earn a higher rate of compensation in connection with selling a proprietary covered security, such as additional cash compensation or the imposition, allocation, or waiver of expenses, overhead costs, or ticket charges. "*Gross dealer concession*" would be defined as the total amount of any discounts, concessions, fees, service fees, commissions, or asset-based sales charges received by the broker-dealer from the issuer in connection with the sale and distribution of a covered security, other than

purchased a proprietary covered security that carries a deferred sales load, both disclosures would be required. The Proposed Rule would provide for "affirmative", "negative" or "not applicable" disclosure about differential compensation.

The broker-dealer would have to disclose the existence of differential compensation related to securities with a deferred sales loads whenever any associated person is paid more to sell a security that has a deferred load.[32] The Proposed Rule only relates to remuneration expected to be paid in the next year when identifying the presence or absence of differential compensation, because the SEC believes short-term compensation reflects the associated person's most immediate financial incentive and because of the difficulty of estimating the near-term value of later revenues. The Proposed Rule would not require broker-dealers to identify all instances in which an associated person has a higher financial stake to sell the shares of one fund than another.[33]

E. Periodic Disclosure Alternative

The Proposed Rule would permit broker-dealers to disclose the required information periodically, rather than transaction-by-transaction, in certain limited circumstances involving transactions in a "covered securities plan" or in no-load open-end money market funds.[34] This provision is based on the periodic disclosure requirements of rule

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portfolio brokerage commissions for transactions effected on behalf of the issuer. Proposed Rule at Section IV.B.I.d.ii.d.

[32] This includes both salespersons or supervisors. Proposed Rule at Section IV.B.l.d.ii.d.ii.

[33] Proposed Rule 15c2-2 would not incorporate several provisions of rule 10b-10 that do not appear material to customer transactions in mutual fund shares. In particular, it would not require disclosure of whether the broker-dealer is acting in the capacity of agent or principal because those firms would act in an agency capacity for the transactions at issue. For the same reason, Proposed Rule 15c2-2 would not incorporate the rule 10b-10 disclosure standards for principal transactions or the requirements for disclosing information about the person from whom the security was purchased, payment for order flow, odd-lot differentials and several requirements specific to transactions in debt securities. Proposed Rule at Section IV.B.1.d.ii.d.ii.

[34] Proposed Rule at Section IV.B.l.d.ii.e.

10b-10(b),[35] but modified to be consistent with the Proposed Rule's disclosure standards.[36] The periodic disclosure alternative would require a broker-dealer to provide quarterly disclosure for transactions involving covered securities plans, and monthly disclosure for money market fund transactions subject to the periodic disclosure alternative.[37]

The Proposed Rule would also require a broker-dealer to provide the customer with written notification before it could take advantage of the periodic disclosure alternative. Prior to relying on the periodic disclosure alternative, the broker-dealer would be required to provide the customer with at least one written disclosure document consistent with the proposed disclosure standards at the time of each purchase of a particular security within a covered securities plan.[38]

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[35] Rule 10b-10(b), *Alternative periodic reporting*, currently permits a broker-dealer to give or send to a customer within five business days after the end of each quarterly period and after the end of each monthly period a written statement disclosing each purchase or redemption, effected for or with, and each dividend or distribution credited to or reinvested for, the account of such customer during the month; the date of such transaction; the identity, number, and price of any securities purchased or redeemed by such customer in each such transaction; the total number of shares of such securities in such customer's account; and any remuneration received or to be received by the broker or dealer in connection therewith. Such customer however must be provided with prior notification in writing disclosing the intention to send this written information in lieu of an immediate confirmation. It should be noted that this alternative is only permitted if the relevant transactions are effected pursuant to a periodic plan or an investment company plan or effected in shares of any mutual fund that holds itself out as a no-load money market fund and attempts to maintain a stable NAV. It should be noted that if the Proposed Rule is adopted, the requirements of Rule 10b-10(b) will continue to remain in effect.

[36] "*Covered securities plan*" would be defined as any plan for direct purchase or sale of a covered security pursuant to certain retirement or pension plans or other agreements or arrangements. While this definition in large part would be analogous to the rule 10b-10 definition of "investment company plan," it also would encompass arrangements for automatic reinvestment of dividends or other distributions paid by the issuer of a covered security. Proposed Rule at Section IV.B.l.d.ii.e.

[37] Proposed Rule at Section IV.B.l.d.ii.e.

[38] *Id.*

F. Comparison Range Disclosure

The Proposed Rule would require broker-dealers to provide comparison information.[39] In the case of disclosures of loads, asset-based sales charges and service fees, and dealer concessions, these comparisons would be based on the median and ranges associated with 95 percent of the transactions involving the same type of covered security. In the case of disclosures of revenue sharing and portfolio brokerage, these would be the medians and the ranges associated with 95 percent of the broker-dealers that distribute the same type of covered security. The SEC would publish, in percentage form, the medians and comparison ranges in the Federal Register and firms would have to update median and percentage range information on their confirmations within 90 days of their publication.[40]

G. Transactions Effected by Multiple Firms

Although a customer may receive a single confirmation for a transaction effected as part of an introducing-clearing arrangement, the Proposed Rule would require specific disclosure of loads, revenue sharing and portfolio brokerage commissions received by any broker-dealer that effects a transaction.[41] However, a single confirmation still would separately disclose the loads, revenue sharing and portfolio brokerage commissions earned by each firm. That may require a broker-dealer that receives loads, revenue sharing or portfolio brokerage to convey responsive information to the firm that sends out the confirmation, which may require enhancement of existing flows of information.[42] The Proposed Rule would

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39 *Id.* at Section IV.B.I.d.ii.g.

40 *Id.*

41 *Id.* at Section IV.B.l.d.ii.h.

42 There are other instances in which a broker-dealer may effect transactions in covered securities in conjunction with another broker-dealer. For example, a broker-dealer may solicit persons at their workplaces, as part of an employer-sponsored marketing arrangement, to invest in covered securities. Although the broker-dealer that solicits transactions may be paid on a transaction-basis, the customer accounts may be opened at a different firm. Proposed Rule at Section IV.B.l.d.ii.h.

require disclosure of payments to the broker-dealer soliciting the transaction, even if it does not maintain the account.[43]

H. Amendments to Rule 10b-10

Because the Proposed Rule would govern confirmation disclosure of purchases and sales of mutual fund shares, the SEC also proposes to amend rule 10b-10 to exclude those securities.[44] The SEC believes two other changes to rule 10b-10 are necessary to accommodate the addition of Proposed Rule 15c2-2. First, the SEC proposes to remove the required disclosure for when a broker-dealer is not a member of SIPC. Second, the SEC proposes to remove the periodic reporting alternative.[45] Because these two categories would be encompassed within the periodic alternative of Proposed Rule 15c2-2, the SEC proposes deleting them from the scope of rule 10b-10.[46] The SEC also proposes removing the definition of "investment company plan" from rule 10b-10 because the term will no longer be used in the rule.

E. Proposed Rule 15c2-3

Proposed Rule 15c2-3 would require broker-dealers to provide customers with specified information "at the point of sale" about "covered securities."[47] Specifically, the Proposed Rule would require broker-dealers to deliver to customers, at the point of sale, quantified information regarding distribution-related costs and the dealer concession that

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43 Proposed Rule at Section IV.B.1.d.ii.b.

44 The Proposed Rule would provide that rule 10b-10 does not extend to transactions in: (i) U.S. Savings Bonds, (ii) municipal securities, and (iii) any other security that is defined as a "covered security" by Proposed Rule 15c2-2. Proposed Rule at Section IV.B.2.

45 This alternative applies to transactions effected pursuant to a "periodic plan" or "investment company plan," or to transactions in no-load money market funds. Proposed Rule at Section IV.B.2.

46 Proposed Rule at Section IV.B.2.

47 Paragraph (f)(2) of Proposed Rule 15c2-3 would provide that the term "covered security" has the meaning set forth in rule 15c2-2. Proposed Rule at Section V.A.

would be connected with the purchase, along with qualitative information about revenue sharing, portfolio brokerage commissions and differential compensation.[48] The Proposed Rule however would not apply to transactions in which an investor sells a covered security, because the SEC believes those transactions do not raise the same special cost and conflict concerns.[49]

A. Timing

Generally, the point of sale would be immediately prior to the time that the broker-dealer accepts the order from the customer.[50] In the case of transactions in which the customer has not opened an account with the broker-dealer or the broker-dealer does not accept the order from the customer,[51] the point of sale would be the time that the broker-dealer first communicates with the customer about the covered security.[52] As such, these soliciting firms would disclose the required information at the time they recommend the security or otherwise discuss the investment.[53]

B. Information Requirements

The Proposed Rule would require a broker-dealer to deliver at the point of sale quantitative information about distribution-related costs that the investor may incur and the dealer concession that the broker-dealer may expect to receive in connection with the transaction, combined with qualitative information about practices that the SEC believes lead

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48 Proposed Rule at Section V.A.

49 The SEC notes that the point of sale disclosure requirements are not determinative of, and do not exhaust, a broker-dealer's disclosure obligations under the antifraud provisions of the federal securities laws. Proposed Rule at Section V.A.

50 "Point of sale" would be defined differently depending on the relationship between the broker-dealer and the customers that it solicits. Proposed Rule at Section V.B.

51 For example, workplace marketing of 529 plans. Proposed Rule at Section V.B.

52 Proposed Rule at Section V.B.

53 *Id.*

to conflicts of interest in connection with the transaction.[54] The Proposed Rule specifically would require the broker-dealer to inform its customer about:[55]

- the amount of sales loads that would be incurred at the time of purchase;
- estimated asset-based sales charges and asset-based service fees paid out of fund assets in the year following the purchase if NAV remained unchanged;
- the maximum amount of any deferred sales load that would be associated with the purchase if those shares are sold within one year;[56]
- a statement about how many years a deferred sales load may be in effect; and
- the dealer concession or other sales fees it would expect to receive in connection with the transaction.[57]

The Proposed Rule would require the broker-dealer to state at the point of sale whether it receives revenue sharing or portfolio brokerage commissions from the fund complex and whether it pays differential compensation in connection with transactions in the covered security, if the covered security charges a deferred sales load or is a proprietary covered security.[58]

C. Termination of Order

The Proposed Rule would provide that an order made prior to the required disclosure must be treated as an indication of interest until after the point of sale information

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54 *Id.* at Section V.C.

55 *Id.*

56 This excludes shares with deferred loads of no more than one percent that expire no later than one year after purchase, when no other load would be incurred on that transaction. Proposed Rule at Section V.C.

57 Those amounts would be disclosed by reference to the value of the purchase, or, if that value is not reasonably estimable at the time of the disclosure, by reference to a model investment of $10,000. Proposed Rule at Section V.C.

58 The definitions of the terms "asset-based sales charge," "asset-based service fee," "dealer concession," "differential compensation," "portfolio securities transaction," "revenue sharing" and "sales load" would be the same as the definitions used in Proposed Rule 15c2-2. Proposed Rule at Section V.C.

is disclosed, and customers have received an opportunity to terminate any order following disclosure of the information.[59] It further would provide that the broker-dealer shall disclose this right to the customer at the time it discloses the required information.

D. Manner of Disclosure

The Proposed Rule would require the broker-dealer to give or send the information to the customer in writing using Proposed Schedule 15D, supplemented by oral disclosure if the point of sale occurs at an in-person meeting.[60] If the point of sale occurs through means of an oral communication other than at an in-person meeting however, then the information shall be disclosed to the customer orally at the point of sale.[61] Similar to Proposed Schedule 15C, Proposed Schedule 15D provides a standardized format for the required disclosure.[62]

E. Recordkeeping

The Proposed Rule would require broker-dealers, at the time they disclose information required by the Proposed Rule, to make records of communications and disclosure sufficient to demonstrate compliance with the delivery requirements.[63] Maintaining a copy of the disclosure document that was provided to the customer can satisfy this requirement. In the case of disclosure solely by means of oral communications, this provision

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59 Proposed Rule at Section V.D.

60 *Id.* at Section V.E.

61 *Id.*

62 The SEC has drafted the Proposed Rule to permit different mediums for disclosure. If the broker-dealer took the customer's order over the telephone, then oral disclosure over the telephone would be required. If the broker-dealer took the customer's order over the Internet, then the Internet could be used to provide the required disclosure. If the broker-dealer solicited the transaction in a seminar or meeting, then the firm would have to provide the disclosure orally and in writing.

63 The broker-dealers would have to preserve those records and for the period specified in Exchange Act rule 17a-4(b), or, in the case of records of oral communications and their disclosures, in accordance with Rule 17a-4(f) and for the period specified in Exchange Act rule 17a-4(b) with regard to similar written communications and records. Proposed Rule at Section V.F.

would require the broker-dealer to have compliance procedures in place that are adequate to demonstrate that it provided the required disclosure.[64]

F. Exceptions

The Proposed Rule would except several types of transactions. First, it would except transactions resulting from orders that a customer placed via U.S. mail, messenger delivery or a similar third-party delivery service. However, this exception is available only to broker-dealers that:[65]

- are not compensated for effecting transactions for customers that do not have accounts with that broker-dealer;
- have provided the customer, within the prior six months, with information about the maximum potential size of sales loads and asset-based sales charges and service fees associated with covered securities sold by that broker-dealer; and
- have disclosed to the customer, within the prior six months, whether the broker-dealer receives revenue sharing or portfolio brokerage commissions or pays differential compensation.

Second, the Proposed Rule would except a clearing broker-dealer or a fund's primary distributor from having to disclose information if that party did not communicate with the customer about the transaction other than to accept the customer's order, and if that party reasonably believed that another broker-dealer has delivered the information to the customer required by Proposed Rule 15c2-3.[66]

The Proposed Rule would also include an exception for transactions effected as part of a "covered securities plan" so long as the broker-dealer provides disclosure

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64 Proposed Rule at Section V.F.

65 *Id.* at Section V.G.

66 The clearing or distributing firm could demonstrate this "reasonable belief' if it has entered into an agreement providing for the other broker-dealer to make the required point of sale disclosures, supplemented with appropriate auditing practices. This proposed exception is intended to preclude imposing unnecessary burdens on clearing firms and on primary distributors that do not solicit transactions, when the investor can be expected to receive the required disclosure from another broker-dealer. Proposed Rule at Section V.G.

consistent with Proposed Rule 15c2-3 prior to the first purchase of any covered security as part of the plan.[67] In addition, the Proposed Rule would provide an exception for reinvestments of dividends earned. Finally, the Proposed Rule would provide an exception for transactions in which the broker-dealer exercises investment discretion.

F. Prospectus Disclosure

The SEC is proposing to amend Form N-lA in order to enhance disclosure of sales loads.[68] Currently, a fund is required to disclose maximum sales loads as a percentage of offering price in the fee table that is located in the front of the prospectus. In addition, elsewhere in the prospectus, a fund is required to include a table of front-end loads at each breakpoint, shown as a percentage of both the offering price and the net amount invested. The SEC is proposing to amend the fee table to require the maximum front-end load to be shown as a percentage of NAV rather than as a percentage of offering price.[69]

The proposed amendment would make disclosure of front-end loads in the prospectus fee table consistent with that in the confirmation required by Proposed Rule 15c2-2. The proposed amendments would also require that a deferred load based on offering price at the time of purchase be shown in the fee table as a percentage of NAV at the time of purchase. Finally, the SEC is proposing to revise the instructions to the fee table to clarify that if a fund imposes more than one type of sales load, the aggregate load should be shown in the fee table as a percentage of NAV.[70]

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67 Paragraph (f)(2) of Proposed Rule 15c2-3 provides that the term "covered securities plan" has the meaning set forth in Proposed Rule 15c2-2.

68 Proposed Rule at Section VI.

69 Proposed Rule at Section VI. For example, if an investor started with $10,000 and paid a 5% front-end load on the gross amount, the load would be $500. The net amount invested would be $9,500 ($10,000 — $500), and the load as a percentage of the net amount invested would be 5.26% ($500/$9500 x 100%). The fee table currently requires the load to be disclosed as 5%. The proposed amendment would require the load to be disclosed as 5.26%.

70 Proposed Rule at Section VI.

The SEC is also proposing to amend Form N-lA to require disclosure in the fund prospectus that would alert investors to the fact that sales loads shown in the prospectus as a percentage of the NAV or offering price may be higher or lower than the actual sales load that an investor would pay as a percentage of the net or gross amount invested. This difference is a result of rounding.[71]

Specifically, the SEC is proposing to require funds to disclose in footnotes to the fee table, if applicable, the following information about front-end and back-end loads, as well as cumulative loads where more than one type of load is imposed:[72]

- that the actual maximum load that may be paid by an investor as a percentage of the net amount invested may be higher than the maximum sales load shown as a percentage of NAV in the fee table;
- the reason for this variation; and
- the maximum sales load as a percentage of the net amount invested.

The SEC is also proposing to amend Form N-lA to require that a mutual fund include a brief disclosure in its prospectus regarding revenue sharing payments, in order to direct investors to the disclosure regarding revenue sharing that the SEC is proposing to require in the confirmation and point of sale disclosure.[73] If any person within a fund complex makes revenue sharing payments, the proposed amendment would require a fund to disclose that fact in its prospectus.[74] If any such revenue sharing payments are made, the fund would also be required to state that specific information about revenue sharing payments is included in the confirmation or periodic statement required under Proposed Rule 15c2-2 and in the disclosure provided at the point of sale required under Proposed Rule 15c2-3.[75]

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71 *Id.*

72 The SEC is also proposing to require similar footnote disclosure with respect to the table of front-end loads that is required elsewhere in the prospectus. Proposed Rule at Section VI.

73 Proposed Rule at Section VI.

74 For this purpose, "*fund complex*" and "*revenue sharing*" would have the meanings set forth in Proposed Rule 15c2-2(f)(l0) and (15). Proposed Rule at Section VI.

75 Proposed Rule at Section VI.

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If you have any questions about the Proposed Rule or would like to consider submitting a comment on any part of the Proposed Rule, please do not hesitate to contact us. This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents.

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