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A legal update from Dechert's Financial Services Group

NYSE Outlines Mutual Fund and Variable Annuity Sales "Best Practices"

Introduction

The New York Stock Exchange ("NYSE" or the "Exchange") has issued an Information Memorandum[1] outlining disclosure and sales practices requirements for mutual fund and variable annuities. The Memorandum also reminds NYSE members[2] of their disclosure obligations under NYSE and SEC Rules.

Directed Brokerage

The Memorandum reminds members promoting or selling mutual funds ("Selling Brokers") that their obligations under Exchange Rules 401 and 476(a)(6) parallel those imposed on mutual funds by amended Rule 12b-1 (the "Rule") under the Investment Company Act of 1940 (the "Act").[3]

Under the Rule, a mutual fund may use a Selling Broker as an Executing Broker only if, among other things, the fund or its adviser has implemented policies and procedures reasonably designed to prevent the persons responsible for selecting the fund's Executing

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1 Information Memo Number 05-54 (Aug. 11, 2005) (the "Memorandum" or "Memo").

2 As used herein, the term "member" includes member organizations.

3 At its open meeting on August 18, 2004, the Securities and Exchange Commission (the "SEC" or "Commission") voted unanimously to adopt amendments to Rule 12b-1. The amendments prohibit registered open-end management investment companies ("funds") from compensating broker-dealers for promoting or selling fund shares by directing brokerage transactions to that broker ("directed brokerage"). The amendments also prohibit arrangements whereby broker-dealers are indirectly compensated through "step out" or other arrangements in which the seller receives a portion of a brokerage commission. Release No. IC-26591 ("SEC Adopting Release"). *See Dechert OnPoint*: *SEC Adopts Amendments on Directed Brokerage and Portfolio Management Disclosure*, Sept. 2004, Issue 27. Similarly, on December 20, 2004, the SEC approved amendments to NASD Rule 2830(k) providing, among other things, that an NASD member firm may not sell the shares of, or act as an underwriter for, a fund that follows a policy of considering sales of shares of the fund as a factor in selecting broker-dealers to execute portfolio transactions. *Notice to Members 05-04* ("NTM 05-04") at 2; *see also Dechert OnPoint*: *SEC Adopts Amendments on Directed Brokerage and Portfolio Management Disclosure*, Sept. 2004, Issue 27 ("DOP Sept. 2004"); NASD Charges American Funds Distributors, Inc. with Arranging $100 Million in Directed Brokerage Commissions for Top Sellers of American Funds, News Release, February 16, 2005; NASD Charges 15 Firms with Directed Brokerage Violations, Imposes Fines Totaling More than $34 Million, News Release, June 8, 2005.

Brokers from taking into account the promotion or sale of fund shares.[4]

An NYSE member or member organization that acts as Selling Broker for a fund should not execute portfolio transactions for that fund unless the member confirms that the fund has implemented the policies required by Rule 12b-1(h)(2)(ii) and ensures that the fund uses reasonable criteria in the selection of its Selling Brokers. Even where a fund has proper procedures in place, a Selling Broker should not execute portfolio transactions for a fund if it knows or has reason to believe that the fund took the Selling Broker's sales efforts into account when selecting it as Executing Broker.[5]

The Memo states that to prevent remuneration prohibited by Rule 12b-1, a Selling Broker should implement reasonably designed policies and procedures. The procedures should, at a minimum, designate personnel with supervisory authority to conduct periodic reviews to identify any correlation between fund sales and directed brokerage commissions that might suggest violations of Rule 12b-1.[6]

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4 *See* Rule 12b-1(h), which provides:

> Notwithstanding any other provisions of this section, a company may not:
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> ****
>
> (2) Direct its portfolio securities transactions to a broker or dealer that promotes or sells shares issued by the company, unless the company (or its investment adviser):
>
> i. Is in compliance with the provisions of paragraph (h)(1) of this section with respect to that broker or dealer; and
>
> ii. Has implemented, and the company's board of directors (including a majority of directors who are not interested persons of the company) has approved, policies and procedures reasonably designed to prevent:
>
> A. The persons responsible for selecting brokers and dealers to effect the company's portfolio securities transactions from taking into account the brokers' and dealers' promotion or sale of shares issued by the company or any other registered investment company; and
>
> B. The company, and any investment adviser and principal underwriter of the company, from entering into any agreement (whether oral or written) or other understanding under which the company directs, or is expected to direct, portfolio securities transactions, or any remuneration described in paragraph (h)(1)(ii) of this section, to a broker (including a government securities broker) or dealer (including a municipal securities dealer or a government securities dealer) in consideration for the promotion or sale of shares issued by the company or any other registered investment company.

5 This conforms with recent action by other regulators. For example, the NASD recently amended its rules to prohibit a member from selling shares of, or acting as underwriter for, an investment company that the member knows or has reason to know engages in directing brokerage in consideration of the promotion or sale of shares issued by the investment company or any other registered investment company. *See* NASD Rule 2830(k)(2), NASD Notice to Members 05-04 at 3, and DOP Sept. 2004 at 2.

6 The SEC Adopting Release notes that:

> Rule 12b-1(h)(2) permits a fund to use its selling broker to execute transactions in portfolio securities only if the fund or its adviser has implemented policies and procedures designed to ensure that its selection of selling brokers for portfolio securities transactions is not influenced by considerations about the sale of fund shares. These procedures must be approved by the fund's board of directors, including a majority of the independent directors, and must be reasonably designed to prevent: (i) the persons responsible for selecting broker-dealers to effect transactions in fund portfolio securities transactions (*e.g.*, trading desk personnel) from taking into account, in making those decisions, broker-dealers' promotional or sales efforts, and (ii) the fund, its adviser and principal underwriter from entering into any agreement or other understanding under which the fund directs brokerage transactions or revenue generated by those transactions to a broker-dealer to pay for distribution of the fund shares. These procedures must be designed to prevent funds from entering into informal arrangements to direct portfolio securities transactions to a particular broker.
>
> The procedures should be incorporated into each fund's compliance policies and procedures, which each fund is required to adopt by our rule 38a-1. Fund chief compliance officers should assure themselves that the required procedures are in place as well as any others that they believe are reasonably necessary to prevent violation of the prohibition against directing brokerage for sales of fund shares. Compliance officers of broker-distributed funds should monitor the operation of the policies and procedures, and should consider periodic testing of brokerage allocations to determine whether there is a

The Memorandum also notes that:

> [A] member or member organization that sells or promotes the sale of mutual fund shares has an obligation to ensure that its customers receive full disclosure of all potential conflicts of interest concerning the transaction, including but not limited to the fund's practices for selecting Selling Brokers to be Executing Brokers. As demonstrated by recent disciplinary actions[7] and reflected in the SEC's proposed rule concerning point of sale disclosure requirements for certain securities transactions, a member or member organization that is a Selling Broker for a fund should disclose to its customers that it receives payments as an Executing Broker from the fund.

The Memorandum cites the SEC's proposed confirmation and point of sale disclosure requirements for the proposition that a Selling Broker should make disclosure to its customers if it receives payments as an executing broker.[8] While the Memorandum does not explain its use of the term "all *potential* conflicts of interest"[9] and does not use a materiality test,[10] the SEC does state that the reason for its changes in point of sale disclosure requirements is to "improve investor access to material information about investments in open-end management investment company securities..."[11]

Revenue Sharing

The Memo states that revenue sharing refers to the practice of broker-dealers being rewarded for the promotion and sale of shares of certain mutual fund shares by way of pre-arranged financial incentives.

Recently, the Exchange and other regulators have brought disciplinary actions against member organizations for failing to adequately disclose revenue sharing arrangements with mutual fund families when recommending funds from those families to customers.[12] In one case, the member organization consented to findings that it had violated Section 17(a)(2) of the Securities Act of 1933,[13] Rule 10b-10 under the Securities Exchange Act of 1934,[14] and NYSE Rules 401 and 476(a)(6).[15]

According to the Memorandum, Exchange rules and the federal securities laws require members to ensure that revenue sharing arrangements are fully and adequately disclosed to customers. Such disclosure should

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significant correlation between sales and the direction of brokerage that may suggest the existence of informal arrangements in violation of the rule (footnotes omitted).

7 The Memorandum cites *Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds*, Investment Company Act of 1940 Release No. 26341 (Jan. 29, 2004), which refers to *In the Matter of Morgan Stanley DW*, Securities Exchange Act of 1934 Release No. 48789 (Nov. 17, 2003).

8 Memorandum at 2. *See also Dechert OnPoint: SEC Proposes New Confirmation and Point of Sale Disclosures*, No. 6 (Feb. 20, 2004).

9 The Memorandum states in its section on Revenue Sharing, discussed *supra*, that "a potential conflict of interest arises between a member or member organization and its customers when the member or member organization accepts revenue sharing payments from mutual funds without providing full and adequate disclosure of such payments to its retail customers."

10 The Memorandum states in relation to Revenue Sharing disclosure, discussed *supra*, that a member disclosing Revenue Sharing arrangements should disclose "all facts necessary to ensure that the customer understands the full nature and extent of any conflict of interest that might affect the transaction."

11 Investment Company of 1940 Release No. 26341 (Jan. 29, 2004).

12 The Memorandum cites Edward D. Jones & Co. L.P., HPD-4-194 (Dec. 22, 2004).

13 Section 17(a)(2) of the Securities Act provides in pertinent part that it is unlawful for any person in the offer or sale of any securities to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

14 Rule 10b-10 provides in pertinent part that it is "unlawful for any broker or dealer to effect for or with an account of a customer any transaction in, or to induce the purchase or sale by such customer of, any security ... unless such broker or dealer, at or before completion of such transaction, gives or sends to such customer written notification disclosing ... the source and amount of any other remuneration received or to be received by the broker in connection with the transaction."

15 Exchange Rule 401 requires adherence to good business practices. Exchange Rule 476(a)(6) relates to conduct inconsistent with just and equitable principles of trade.

prominently and completely describe in plain language the existence, substance, and scope of the member'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.[16] The disclosure must be delivered to the customer at the time of the transaction, instead of merely being made available to the customer. The NYSE is recommending a point of sale document, while the SEC has thus far declined to institute such a requirement.[17]

According to the Memorandum, member reliance on disclosure contained in third party materials such as fund prospectuses no longer conforms with NYSE best practices. If a member chooses to continue relying on third party disclosures, it will retain responsibility for ensuring that customers have received sufficient information about relevant conflicts of interest. A member organization should also have in place policies and procedures to evaluate whether third party disclosures are adequate and prominently displayed. Where third party disclosures do not suffice, the member should ensure sufficient disclosures are made directly to customers.

Third party disclosure usually does not include an explanation of the differing incentives that a broker-dealer or its associated person receives for selling one product instead of another. It is therefore unlikely in most cases that relying on third party disclosures will suffice to escape the possibility of regulatory enforcement activity.

Variable Annuities

Variable Annuity Suitability and Disclosure

According to the Memo, variable annuity marketing entails heightened disclosure obligations because of those products' unique suitability concerns. A registered representative should not recommend an annuity product to a customer without fully disclosing, and ascertaining that the customer fully understands, the annuity's fee structure, including surrender charges and tax penalties for early liquidation.

Before recommending a variable annuity product, a registered representative should have a thorough knowledge of all material specifications of a product, including death benefit, fees and expenses, sub account choices, special features, withdrawal privileges, and tax treatment. To ensure the customer understands these features, good business practices require that the customer at least be given a current prospectus as close as practicable to the time of recommendation, but in no case later than the date of sale.

A registered representative should disclose that under normal circumstances, a variable annuity would not be appropriate as a short-term investment. The availability and suitability of other options for a tax-sheltered account, such as 401(k) or Roth IRAs, should be fully disclosed to the customer. A customer for whom a variable annuity is recommended should be told 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, investment experience, and risk tolerance.[18]

The Memo also focuses attention on the liquidity constraints of variable annuities with regard to both disclosure and suitability. It states that: "a registered representative should disclose to a customer that under normal circumstances, a variable annuity would not be appropriate as a short-term investment." It also notes that a registered representative should "ascertain, pursuant to Rule 405, and should disclose to a

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16 The Memorandum also states that "revenue sharing arrangements, although commonly associated with mutual funds, are not limited to them, and such arrangements have been identified in the sale of other investment products, such as variable annuities. The disclosure obligations set forth above apply with full force to revenue sharing arrangements involving variable annuities and other investment products.

17 However, the SEC has stated that, regardless of whether disclosure is specifically required by confirmation rules, the failure to disclose relevant information about revenue sharing arrangements may violate the antifraud provisions of the federal securities laws. *See Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds*, Investment Company Act of 1940 Release No. 26341, 69 F.R. 27 at 6440.

18 Collection of this information is required under Exchange Rule 405, which sets forth general due diligence obligations to which members and member organizations must adhere in the opening of accounts and sales of securities. The Memorandum reminds members that, under Exchange Act Rule 17a-3(a)(17), broker-dealers must make much of that due diligence information part of their books and records.

customer, among other things, the consequences and effects" of factors such as age, net worth, and risk tolerance.[19]

Switching

Exchange Rule 342 requires that any switching transaction, including its economic justification, be reasonably reviewed by a supervisory employee. Any exchange of an annuity contract must, after a careful weighing of the costs and benefits, be clearly demonstrated to be in the best interests of the customer. Such an analysis should include:

- The costs of an extended surrender period versus demonstrated benefits
- Whether the new policy's features could be achieved without switching
- Whether the new policy would change the treatment of withdrawals in computing death benefits[20]
- Whether the customer or the registered representative has a history of frequent exchanges or replacements

The Exchange recommends using an exchange or replacement analysis document for collecting the required information. If a member does not have such a document of its own, it should use a form provided by the applicable state insurance commission or regulatory agency.

Conclusion

Securities regulators continue to devote considerable attention to mutual funds and variable annuities. This Memorandum is a further demonstration that the NYSE, along with other regulators,[21] continues to be concerned about sales practices and supervisory procedures. The Memorandum also suggests that the Exchange may have concerns about other types of products.

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19 Memorandum at 5. The Memorandum further notes that:

> A valuable assessment exercise for registered representatives is to present the customer with a circumstance where a sum of money is needed at some point during the surrender charge period. If the customer's only source of liquidity would be the variable annuity, the product may not be an appropriate recommendation, due to backend sales charges which can last for as long as seven to nine years. Customers should be able to hold a variable annuity product against all foreseeable cash needs at least until the expiration of the surrender charges, and the real benefits of the tax-deferral feature may not be realized until even later. *Id*.

Note 9 also discusses the supervisory and record keeping responsibilities associated with this process.

20 According to the Memorandum, many older policies reduce the death benefit on a dollar-for-dollar basis, while newer policies tend to reduce the death benefit by an amount proportional to the withdrawal. Such different treatment can have a material effect on death benefits.

21 *See also* Rel. 34-52046A and Rel. 34-52191, File No. SR-NASD-2004-183 (The NASD has proposed a new rule relating to sales practice standards and supervisory requirements for transactions in deferred variable annuities, which would prescribe special suitability standards and requirements for principal review and approval, supervision and training, all tailored specifically for these products.)

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