



*NRS 19th Annual Fall Compliance Conference
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Morgan Lewis
C O U N S E L O R S A T L A W

Establishing Broker-Dealer and Rep Compensation Arrangements

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Overview

- Increased Scrutiny of Fee and Compensation Arrangements
- Mutual Funds
- Variable Products
- Differential Compensation
- Fee Based Brokerage Arrangements
- Wrap Fee Arrangements
- Adviser Referral Fees
- Other Fees
- Tips on Establishing Rep Compensation Arrangements

Increased Scrutiny

- Regulators are Taking a “Follow the Money” Approach to Fees and Compensation
- Focal Points
 - Conflicts
 - Disclosure & Transparency
 - Reasonability
 - Suitability
 - Supervision
- Issues are Most Acute at Point of Sale

Mutual Funds



Discount Issues

- B Share Issues
 - 529 Plan issues
- Breakpoint Issues
 - NTMs 02-85 & 03-47
- NAV Transfer Issues
 - NASD Investor Alert
- Institutional Funds

Compensation Issues

- Revenue Sharing/Shelf Space Payments
 - Proposed Rule 2830 amendments (NTM 03-54)
 - Proposed SEC Confirmation/Point-of-Sale Disclosure Rules
- “Special Cash Compensation”
 - NASD Enforcement Cases
- Brokerage for Fund Sales
 - New SEC Bar – December 13, 2004 Compliance Date
 - Enforcement Cases
- Cash and Non-Cash Compensation
- Sales contests

Variable Products



- NASD Concerns
 - Ads that fail to disclose charges and fees
- NASD Proposed Risk Disclosure Document
 - Surrender charges and IRS penalties
 - Sales charges
 - Fees (including mortality and administrative fees, investment advisory fees and charges for riders or special features)
- Recent NASD Enforcement Actions
- Layering of Fees

Differential Compensation



- Initial Regulatory Focus Limited
 - Proprietary Funds (1995 Tully Report)
 - Preferred or “Partner” Funds
 - Scrutiny at reps level, not firms
- Focus on Disclosure and Suitability
 - Proposed amendments to Rule 2830 (NTM 03-54)
- SEC Now Taking More Aggressive Enforcement Stances
- Emerging Issues
 - Indirect payments (*e.g.*, picking up ticket charges)
 - Differential compensation for different products and services
 - Differential compensation for referrals versus sales
 - “President’s Clubs”
 - Variable Products

Fee Based Brokerage



- **NASD NTM 03-68:**
 - “Members must have reasonable grounds for believing that a fee-based program is appropriate for a customer given the services provided, cost, and customer preferences”
 - “It generally is inconsistent with just and equitable principles to place a customer in an fee-based account that reasonably can be expected to result in a greater cost than an alternative offered by the member that provides the same services & benefits”
- **According to the NASD, members must**
 - Have reasonable grounds before opening to believe a fee based account is appropriate
 - Disclose all material components of a fee-based program (e.g., fee schedule, services provided, and that the program may cost more than paying for services separately)
- **Absent “inducement by the member,” no suitability liability will arise where**
 - Member discloses that a potentially lower cost account is available
 - Member has documented & can demonstrate the customer chose for reasons beyond cost

Fee Based Brokerage



- **Periodic Reviews & Reporting**

- Members should periodically review fee-based accounts to determine if they remain appropriate
- Members should consider whether changes have occurred in key assumptions about appropriateness of fee based arrangement
- Members also may “wish” (but are not required) to create reports that compare the asset-based fees to those that would have been generated in the same account on a commission basis
- “A retrospective finding that a customer would have been charged less in a commission-based account is not conclusive that the account is inappropriate for that customer. However, such a finding should cause the member to give careful scrutiny to those issues.”

Fee Based Brokerage - NYSE Proposal



- General Disclosures Required
 - Initial & Annual Disclosure
 - Types of fee-based programs available
 - For each,
 - Description of the services
 - Eligible assets
 - Fees
 - Conditions or restrictions
 - Summary of the account's advantages and disadvantages
- Monitoring of Accounts
 - Ongoing monitoring of transactional activity by customers in asset based fee accounts
 - Specific transactional criteria for identifying activity inconsistent with account's intended purpose
- Review and Follow-Up
 - Procedures for contacting and following-up with customers - no less frequently than every 24 months

Wrap Fee Arrangements



- Reasonable grounds to believe wrap fee arrangement is appropriate
- Disclosure that obtaining services separately may be less costly

Adviser Referral Fees

- State investment adviser rep licensing
- Compliance with SEC Rule 206(4)-3
 - Solicitor cannot be subject to a statutory disqualification
 - Some exceptions
 - Written agreement (recordkeeping)
 - Disclosure obligations
 - Separate written disclosure document
 - Form ADV Delivery
 - Client acknowledgement of receipt (recordkeeping)

Other Fees



- Firm

- Administrative charges
- Inactivity fees
- “Segment” or Management Reporting

- Reps

- Commission sharing - Teams and Un(der)registered persons
- Fees on margin positions/interest
- Rule 3040 issues

Tips on Establishing Rep Compensation Arrangements



- Assess conflict and disclosure issues
- Consider “gaming” and supervision issues
 - Focus on
 - Largest producers
 - “Richest” products
 - Exceptions to standard compensation processes and manual overrides
- Address recordkeeping rule issues – Recent recordkeeping rule amendments require
 - Record of all compensation - Cash & non-cash
 - Agreements between associated persons and firm, including oral agreements
 - If compensation is not calculated on a per trade basis, records describing method of compensation



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