



Morgan Lewis

C O U N S E L O R S   A T   L A W

# Mutual Funds Update - Revenue Sharing and Internal Compensation Issues

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# Conflicts in Fund Sales

- **Breakpoint & related refund issues**
  - NTMs 02-85 & 03-47
- **Sales contests**
  - Recent cases
- **Shelf space disclosure**
  - Proposed amendments to Rule 2830 (NTM 03-54)
    - Comments due 10-17
  - Forthcoming SEC guidance on 10b-10 disclosure of third party remuneration
- **Brokerage for fund sales**
  - Forthcoming SEC release on 12b-1 accounting

# Revenue Sharing - Background

- Revenue sharing raises two major category of issues
  - Rule 12b-1 issues for mutual funds and their advisers
  - Disclosure issues for broker-dealers

# Rule 12b1- Issues

- Issue is whether revenue sharing payments involve an indirect use of fund assets to finance distribution
  - A fund would be viewed as indirectly financing distribution if any allowance were made in the adviser's advisory fee to finance distribution
  - Revenue sharing would not involve an indirect use of fund assets for distribution if the adviser makes revenue sharing payments from the profits of its advisory fee that are "legitimate" and "not excessive"

# Broker Disclosure Issues

- **Broker disclosure issues are the most problematical**
  - Disclosure requirements in this area are unclear
  - Tension between regulatory concerns & common industry practice
- **Disclosure issues apply primarily to brokers**
  - Funds are not required to disclose revenue sharing arrangements
  - Broker are required by Rule 10b-10 to disclose their receipt of revenue-sharing payments
  - NASD Rule 2830 bars broker-dealers - including both fund distributors and selling broker-dealers - from entering into "special cash compensation arrangements" unless specific information regarding the arrangements is disclosed in the applicable fund's prospectus or SAI

# Confirmation Disclosure

- A broker is required to disclose in writing, before the completion of a trade, that it will receive compensation from a third party and the source & amount of such compensation
- For revenue sharing payments, a broker may satisfy its disclosure obligations by delivering a copy of the fund's prospectus if the prospectus contains adequate disclosures
  - SEC has taken the stance that general disclosure of revenue sharing may suffice if the disclosure conveys the dimensions of the conflict
  - The SEC is now revisiting this stance
- Because many brokers lack systems to print revenue sharing disclosures on confirms, many brokers rely on prospectus disclosure to satisfy these obligations

# Special Cash Compensation

- NASD Rule 2830(1)(4) bars a broker from
  - Accepting cash compensation from a fund's adviser unless the fund's prospectus or SAI describes the compensation
  - Entering into a "special cash compensation arrangement" not available on the same terms to all brokers that distribute a fund's shares unless the prospectus or SAI discloses the broker's name and the details of the arrangement
- But what is it?
  - "Special cash compensation arrangements" is vague and prone to differing interpretations
  - Applicability of NASD Rule 2830(1)(4) to revenue sharing arrangements has been unclear
  - Until recently, the NASD had not policed the rule

# Special Cash Compensation

- NASD Enforcement actions
  - Pilgrim Distributors Corp.
  - Distributor, Inc.

# Proposed Rule 2830 Amendments

- Requires that members disclose revenue sharing arrangements and differential cash compensation arrangements
  - Disclose where to find info on fund fees & expenses and brokerage practices
  - Disclose if the firm receives cash payments (other than sales charges & service fees disclosed in the prospectus)
    - And list the offerors that made the payments in descending order based on compensation received

# Proposed Rule 2830 Amendments

- Disclose if an associated person receives different rates of compensation based on which funds are purchased, the nature of the arrangements, and the names of funds favored
- Give this information to customers:
  - At account opening or, if no account is established, when the customer first purchases funds
  - For current customers, later of 90 days or on next fund purchase
  - Semi-annually, by posting on website or by mailing hard copy

# How it Fits Together, or Not

The background is a dark blue gradient. A faint, light blue world map is visible, centered behind the text. In the top-left and bottom-right corners, there are wireframe globe graphics consisting of intersecting lines representing latitude and longitude.