



**Testimony**

**of**

**Mary L. Schapiro**

**NASD Vice Chairman and President  
Regulatory Policy and Oversight**

**Before the**

**United States Senate  
Committee on  
Banking, Housing, and Urban Affairs**

**Hearing to Review  
Current Investigations and Regulatory Actions  
Regarding the Mutual Fund Industry:  
The Regulatory Landscape**

**March 10, 2004**

Mr. Chairman and Members of the Committee: NASD would like to thank the committee for the invitation to submit this written statement for the record.

## **NASD**

NASD is the world's preeminent private sector securities regulator, established in 1939 under authority granted by the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934. We regulate every broker-dealer in the United States that conducts a securities business with the public—nearly 5,200 securities firms that operate more than 92,000 branch offices and employ more than 663,000 registered representatives.

Our rules comprehensively regulate every aspect of the brokerage business, and NASD examines broker-dealers for compliance with NASD rules, MSRB rules, and the federal securities laws—and we discipline those who fail to comply. Last year, 2003, NASD filed a record number of new enforcement actions (1,410) and barred or suspended more individuals (827) from the securities industry than ever before. Our market integrity and investor protection responsibilities include examination, rule writing, professional training, licensing and registration, dispute resolution, and investor education. NASD monitors all trading on the NASDAQ Stock Market—more than 70 million orders, quotes, and trades per day. NASD has a nationwide staff of more than 2,000 and is governed by a Board of Governors, more than half of whom are unaffiliated with the securities industry.

### **NASD Oversight of Mutual Fund Sales**

Millions of Americans invest in mutual funds each year. NASD is deeply disturbed by recent revelations of a wide range of abuses that undermine the confidence of mutual fund investors and the integrity of the industry. Portfolio managers have traded ahead of mutual fund investors, released portfolio information differentially and selectively, and made deals with preferred customers to permit market timing and late trading. NASD does not have jurisdiction or authority over mutual funds or their advisers. Nevertheless, we do regulate broker-dealers who sell mutual funds, including mutual fund underwriters. Broker-dealer participation in illegal or unethical sales practices in the sale of mutual fund shares is a matter of immediate concern to NASD.

NASD reviews mutual fund advertisements, whether they appear in a magazine or newspaper, radio or television commercial. We vigorously enforce our suitability rule and our prohibition against compensation arrangements that create unacceptable conflicts of interest in the sale of mutual fund shares.

During 2003 and 2004, NASD brought more than 80 enforcement actions for violations concerning the sale of mutual funds and pooled investment products. Violations in these cases included suitability of the mutual fund share classes that brokers recommended, sales practices, improper disclosures, and compensation arrangements between the funds and brokers. These actions bring to more than 200 the number of cases NASD has taken in the investment company area since 2000. In addition, and most recently, NASD has brought enforcement actions dealing with market timing and the

improper failure of a broker-dealer to waive certain sales charges, and 15 cases involving the failure to deliver breakpoint discounts on shares with front-end load sales charges.

### **NASD Oversight of Mutual Fund Advertising**

NASD requires that all advertisements and other sales material issued by broker-dealers be fair, balanced, and not misleading. Every mutual fund advertisement distributed through the media and every mutual fund sales brochure issued by a broker-dealer must be filed with NASD. We review these advertisements and sales pieces to ensure that they comply with the highest standards of fair and balanced disclosure. This undertaking is significant: In 2003, NASD reviewed over 80,000 investment company sales pieces.

When a broker-dealer's mutual fund sales material fails to meet applicable standards, NASD staff directs the firm either to revise the material to meet applicable standards or to stop using the material entirely. NASD also brings enforcement actions against broker-dealers that violate our advertising rules.

One of the most important issues that NASD has addressed in our administration of the advertising rules concerns the manner in which mutual funds advertise their past performance. Too often, mutual fund advertisements stress their impressive past performance by the advertised fund, without providing balanced disclosure concerning the fees and expenses that investors incur when they purchase and own shares of the fund. Yet these fees and expenses can have a significant impact on the long-term future performance of a mutual fund investment an investor makes today.

In December, NASD proposed to amend our advertising rules to require that every advertisement that promotes a mutual fund's performance *also* presents the fund's fees and expenses in a prominent text box, not in a footnote. This would include the fund's maximum front-end and back-end sales load, if any, and the fund's ongoing expense ratio, including any 12b-1 fees. The proposal also would require that the text box contain the standardized 1-, 5-, and 10-year total return performance required by the SEC.

This proposal, which NASD filed with the SEC earlier this week, would help investors compare mutual funds and would make the costs of purchasing and owning mutual funds more apparent. NASD looks forward to working with the SEC staff on this proposal and to its prompt adoption and implementation.

### **Compensation Arrangements between Brokers and Funds**

NASD recognizes that compensation arrangements between mutual funds and brokers can inappropriately influence the investment recommendations that brokers make to their retail customers. Accordingly, NASD has taken a number of steps, both in terms of rulemaking and enforcement of existing rules, to help ensure that investors are protected from misleading practices.

### *Non-cash Compensation*

NASD prohibits most forms of non-cash compensation, such as luxury cruises, trips and lavish entertainment, for the sale of mutual fund shares. These compensation arrangements present a conflict of interest for sales personnel and interfere with the ability of regulated firms to supervise their sales forces. In September 2003, NASD sanctioned Morgan Stanley DW Inc. and fined the firm \$2 million for sponsoring sales contests that awarded meals, trips, concert tickets, and other prizes to sales representatives that met certain sales targets and favored Morgan Stanley proprietary funds. NASD also charged Morgan Stanley and the head of its retail sales division with supervisory violations, because Morgan Stanley failed to have any supervisory systems or procedures in place to detect and prevent this widespread misconduct.

### *Directed Brokerage Compensation*

NASD rules have long addressed the possibility that a mutual fund may direct its portfolio brokerage to a broker-dealer in exchange for the broker-dealer's commitment to feature or promote the sale of the fund's shares. Such an arrangement presents a potential conflict of interest for the investment adviser to the mutual fund, who must execute the fund's portfolio transactions; it also presents a conflict for the broker-dealer, who may recommend fund shares to its customers in order to reap brokerage commissions from the fund. NASD prohibits any broker-dealer from accepting brokerage commissions from a mutual fund as a condition to favoring the sale of the fund's shares. Exchanging prominent placement of a fund or family of funds on a firm's Web site or in the firm's marketing material or placing a fund on a "featured" or "preferred" list of funds in exchange for brokerage commissions from the fund may be misleading to investors and is a violation of NASD rules.

In November 2003, NASD and the SEC sanctioned and fined Morgan Stanley \$50 million for violations of this rule due to its use of directed brokerage arrangements to promote sales of its proprietary funds. In return for brokerage commissions and other payments, Morgan Stanley gave 16 of 115 mutual fund families it sold preferential treatment, including placement on a "preferred list" of funds that financial advisers were to look to first in making recommendations of fund products; higher visibility on Morgan Stanley's sales systems and workstations; eligibility to participate in the firm's 401(k) programs and to offer offshore fund products to Morgan Stanley customers; better access to its sales force and branch managers; and payment of special sales incentives to Morgan Stanley financial advisers.

NASD recently proposed to expand these directed brokerage prohibitions. Under our proposal, a broker-dealer would be prohibited from selling shares of any mutual fund that even considers its fund sales as a factor in selecting a broker-dealer to execute its trades. The SEC has proposed a similar amendment to its Rule 12b-1.

## *Revenue Sharing and Differential Compensation*

In September 2003, NASD proposed new rules to address “revenue sharing” and “differential compensation” arrangements. Frequently, mutual funds seek to improve the sales of their shares by paying for “shelf space” at a broker-dealer. This practice, commonly known as “revenue sharing,” can take a variety of forms, including sharing of advisory fees, direct cash payments, and reimbursing brokers for their sales and training-related expenses. Our rule proposal would require every broker-dealer to disclose to its customers whether the firm accepts revenue sharing payments from funds. The broker-dealer would have to list the funds in order based on the amount of revenue sharing received. Broker-dealers also would have to periodically update the list of funds that pay revenue sharing to the firm and make the list available through a Web site, toll-free telephone number, or customer mailings.

In addition, some broker-dealers may pay “differential compensation” to their sales force. Under these arrangements, a broker-dealer may pay its sales representatives higher compensation for the sale of certain funds, such as a firm’s proprietary fund family or funds that pay revenue sharing to be included on a preferred list. Our proposal would require broker-dealers to disclose these differential compensation arrangements to their customers and to name the funds that benefit from these arrangements.

The SEC recently issued its own proposal that would require brokers to make similar disclosures regarding revenue sharing and differential cash compensation at the point of sale and as part of a customer’s sales confirmation statement. We are reviewing this proposal and we will work with the SEC both on its proposal and on how best to proceed with our own rule proposal.

### **Suitability of the Fund Sales**

Many mutual funds offer different classes of the same investment portfolio. Each class provides broker-dealers and their customers with a choice of distribution fee structure. For example, Class A shares charge a “front-end” sales load when the customer purchases shares and they may impose an ongoing distribution fee, called a Rule 12b-1 fee. Class B shares do not impose a “front-end” sales load, but they do impose higher annual Rule 12b-1 fees which are assessed over the first six to eight years of their investment or until they convert into Class A shares. Class B shares normally impose a “contingent deferred sales charge” (CDSC) which a customer pays if the customer sells the shares within first six or eight years. This CDSC declines over time during that six- or eight-year period. Class C shares usually do not impose a front-end sales load, but often impose a load if a customer sells shares within a short time of purchase, usually one year. Class C shares typically impose higher Rule 12b-1 fees than Class A shares, and, unlike Class B shares, do not convert into a lower expense class following a specified holding period.

While Class A shares impose a front-end sales load, most mutual funds offer a reduced load, or “breakpoint,” for large purchases. NASD has found that some broker-dealers have recommended Class B shares in such large amounts that the customer would

have qualified for significant breakpoint discounts had the broker-dealer recommended Class A shares instead. Some broker-dealers also have recommended transactions in Class B shares that are so frequent as to cause the customer to incur CDSC charges. In both cases, the broker may receive higher compensation for the Class B recommendations. NASD has vigorously prosecuted these violations of our rules, and we are continuing our comprehensive monitoring of Class B share sales practices. Over the last two years, NASD has brought more than a dozen enforcement actions against firms and individual brokers for these types of violations. Currently, NASD has more than 50 active investigations in this area.

### **Discounts for Customers**

One area that has been a focus for NASD in recent months is reviewing whether brokers are giving their customers all the discounts and waiver of sales charge benefits to which they are entitled when buying certain funds.

#### *NAV Transfer Programs*

Some mutual fund families offer programs that essentially permit a customer to exchange shares from another fund family at the new fund's net asset value (NAV), without paying the front-end sales load. These programs permit customers to purchase Class A shares without paying a front-end sales load, if in purchasing those shares the customer used proceeds from a recent redemption of shares of another load fund. Investors who qualify for NAV transfer programs have no reasonable basis to purchase any class of shares other than Class A shares.

Last month, NASD brought the first enforcement action involving a broker-dealer's failure to obtain sales load waivers for mutual fund customers through these NAV transfer programs. NASD fined AXA Advisors, LLC \$250,000 for these failures. We also jointly fined a senior vice president of the firm \$50,000.

NASD found that the firm failed to have an adequate supervisory system in place to identify and provide customers with sales charge waivers to which they were entitled. We determined that, from February 2000 through July 2003, AXA earned more than \$700,000 in revenue on more than \$18 million invested by the customers of the firm in these two mutual fund families offering NAV transfer programs. As part of the settlement, the firm was ordered to provide full restitution to all customers who paid sales charges on purchases that were subject to these programs over a four-year time period.

NASD is initiating a broad-based review to determine whether other firms are meeting their obligations to provide sales charge waivers to their customers under similar types of programs. Examinations and investigations are underway and NASD will bring additional enforcement actions when they are warranted.

### *Breakpoints*

As previously discussed, most mutual funds offer discounts on their front-end sales charge at certain predetermined levels of investment. These discounts are called “breakpoints.” Front-end loads and breakpoints vary across fund complexes and also may vary among funds within a single fund complex. An investor usually is entitled to discounts on sales charges at investment levels of \$50,000, \$100,000, \$250,000, and \$500,000, and, typically, sales charges are eliminated at the \$1,000,000 level.

Significantly, an investor usually may aggregate purchases in one or more of his own accounts and the accounts of related parties to reach a breakpoint threshold. These rights of accumulation vary from fund family to fund family. In addition, fund families typically permit investors to sign a letter of intent, which allows them to aggregate future sales over a set time period (usually 13 months) to meet breakpoint thresholds.

During routine examinations of broker-dealers by our Philadelphia District Office, NASD discovered that several broker-dealers were selling front-end load mutual funds without properly delivering breakpoint discounts to investors. We expanded our inquiry by conducting a sweep of a large number of broker-dealers of varying sizes and business models and found the same problem. Following this NASD effort, in late 2002 the SEC and New York Stock Exchange joined us for an examination sweep of 43 firms selling front-end load mutual funds. We found that most of those firms did not give investors all the breakpoint discounts they should. Failures to give the discounts did not appear to be intentional but stemmed from a variety of operational problems, including a failure to link share classes and holdings in other funds in the same fund family and a failure to link accounts of family members. As was the case in the earlier NASD-only sweep, the problem was not confined to firms of a particular type; therefore, the problem required industry-wide analysis.

#### **◆ Assessing and Correcting Past Performance**

NASD required all broker-dealers that conducted more than a minimal amount of automated front-end load, Class A share business in 2001 or 2002 to complete an assessment of their breakpoint compliance. The assessment used a statistical sampling technique, developed in conjunction with an outside expert, to enable us to assess the universe of transactions in that time period. Approximately 625 firms completed the assessment. The assessments showed that most firms did not uniformly deliver appropriate breakpoint discounts to customers. Overall, discounts were not delivered in about one of five eligible transactions. The average amount overcharged per transaction was \$243, and ranged up to \$10,000. We estimated that at least \$86 million was owed to investors for 2001 and 2002 alone.

In August 2003 NASD notified broker-dealers that they were required to make appropriate refunds, plus interest, owed to their customers. In November, NASD directed almost 450 broker-dealers to notify customers who purchased Class A mutual fund shares since January 1, 1999, that they may be due refunds as a result of the firms' failure to

provide breakpoint discounts. NASD directed firms to contact investors, through an NASD-drafted letter and claim form, to assure uniform treatment of investors. In addition, we supplemented that system of notification with an unprecedented NASD national advertising campaign to assure that investors were informed of their rights. We also directed about 175 of the securities firms with poor records of providing breakpoint discounts to complete a comprehensive review of transactions since the beginning of 2001 for possible missed discount opportunities.

In February 2004, the SEC and NASD announced enforcement actions against a number of firms for failure to deliver mutual fund breakpoint discounts during 2001 and 2002. The SEC and NASD each brought cases against a group of seven firms, and NASD separately brought actions against an additional eight firms. The 15 firms agreed to compensate customers for the overcharges, pay fines in an amount equal to their projected overcharges that total over \$21.5 million, and undertake other corrective measures.

### ◆ **Correcting the Problem**

At the request of the SEC, NASD, working with the Securities Industry Association and the Investment Company Institute, also led a task force on breakpoints, which included representatives from the broker-dealer and mutual fund industries, as well as academia and regulators. The Joint NASD/Industry Task Force on breakpoints was charged with recommending industry-wide changes to address errors and missed opportunities to provide discounts in the calculation of sales loads charged on the purchase of mutual fund shares that carry a front-end sales load.

The Task Force issued its report in July 2003, making recommendations that affect virtually every level of the mutual fund distribution chain, including broker-dealers that sell mutual funds, the mutual funds, and the transfer agents that administer mutual fund accounts. The Task Force made a series of recommendations for modification of the systems used by broker-dealers and mutual funds to process mutual fund transactions; additional steps by mutual funds to ensure that investors are aware of breakpoint discounts; enhancement of broker-dealer procedures to gather the necessary information from investors; and enhanced industry and investor education. The industry immediately began to implement the report's recommendations. Many of the recommendations are fully implemented and others are nearing completion. In addition, NASD, the NYSE, and the SEC will rigorously examine firms to ensure that they are meeting their responsibility to deliver breakpoint discounts.

### **Late Trading and Market Timing**

NASD is extremely concerned about the recent revelations of illegal late trading and market timing arrangements. On September 5, 2003, we reminded broker-dealers that they would violate NASD rules if they knowingly or recklessly effect mutual fund transactions that constitute impermissible "late trading" or facilitate market-timing or other transactions in collusion with a mutual fund that is contrary to a representation in the fund's prospectus.

## *Investigations*

In September 2003, NASD sought information regarding these practices from 160 broker-dealers. Our review indicates that a number of those examined clearly received and entered mutual fund orders after U.S. markets had closed for the day. Other broker-dealers were not always able to tell with clarity whether or not they had entered late trades. This imprecision indicates poor internal controls and record keeping—issues that NASD is also pursuing.

NASD has identified a number of broker-dealers that were involved in market timing. These cases have been referred to our Enforcement Department for full investigation. A number of firms have been told that the staff believes that their market timing activities were impermissible under NASD rules or applicable federal statutes. These firms appear to have facilitated customers' market timing strategies in mutual funds or variable annuities, employed staff who agreed with a mutual fund or variable annuity to market time the issuer's shares, or had an affiliate involved in some form of market timing of mutual funds or variable annuities. We expect to conclude these cases in the coming months and bring enforcement actions where warranted.

In February 2004, NASD announced the first of its market timing enforcement actions. NASD fined State Street Research Investment Services, Inc. (SSR) \$1 million for failing to prevent market timing of State Street Research mutual funds as a result of its inadequate supervisory systems. SSR also agreed to pay more than \$500,000 in restitution to the individual State Street Research mutual funds to compensate for the losses attributed to market timing activity.

NASD found that, from 2001 through August 2003, SSR's inadequate supervisory system improperly permitted the customers of at least one other securities firm to buy and sell shares of SSR funds alternatively, beyond the annual limits set forth in the prospectuses. SSR's supervisory procedures and systems were not adequate to prevent and detect customers circumventing restrictions designed to limit the number of exchanges made in excess of the prospectus limits.

The SSR action highlights the need for firms to follow up on red flags. While SSR did make some efforts to prevent market timing, it did not follow through to ensure proper compliance with the measures it had put in place. Firms must respond quickly and effectively to market timing issues once they are placed on notice that such activities are occurring.

## **Omnibus Task Force**

In November 2003 SEC Chairman Donaldson requested that NASD convene a task force to determine how omnibus processing would affect SEC efforts to curb abusive market timing trading activity in mutual funds, and in particular imposition of mandatory redemption fees for short-term trading. The mechanics of regulating market timing, and

imposing redemption fees, are complicated by the fact that various broker-dealers, banks, and pension plan administrators and insurance companies use omnibus processing of mutual fund transactions, which generally does not disclose the identity of the mutual fund shareholder to the mutual fund.

Although NASD's jurisdiction extends only to the broker-dealers involved in mutual fund sales, the SEC requested our assistance in analyzing the issue and offering suggestions as to how to achieve the SEC's objectives in an omnibus environment before it moved forward with rulemaking. The Task Force consisted of 16 professionals, who represent a broad range of participants in the omnibus trading process—broker-dealers, mutual fund sponsors, third-part administrators, banks, transfer agents, and clearing corporations. We also had discussions with a number of other interested parties who, although not members of the Task Force, were identified as having expertise, including members of the insurance and actuarial communities.

In January 2004 NASD presented the SEC with a report from the Omnibus Task Force. The Omnibus Task Force report does not reach definitive conclusions regarding omnibus processing and market timing practices; rather, it provides the Commission with an analysis of the advantages and disadvantages of various avenues for removing the economic incentives for mutual fund market timing and policies when such timing occurs. The options considered and discussed range from the disclosure of information about the underlying shareholders or their accounts to delegating compliance obligations in this area on the omnibus processor. Since the issuance of the report, the SEC has proposed a mandatory redemption fee rule, which reflects the operational pragmatics and other views offered by the Task Force.

## **Investor Education**

Mutual funds have also been an ongoing focus of NASD's investor education efforts. In 2003 and 2004 NASD issued the following *Investor Alerts* on share classes, principal-protected funds, and breakpoint discounts:

[Net Asset Value Transfers: Look Before You Leap Into Another Mutual Fund](#) (2/26/2004)

[Mutual Fund Breakpoints: Are You Owed a Refund?](#) (11/03/2003)

[Class B Mutual Fund Shares: Do They Make the Grade?](#) (06/25/2003)

[Principal-Protected Funds - Security Has a Price](#) (03/27/2003)

[Mutual Fund Breakpoints: A Break Worth Taking](#) (01/14/2003)

[Understanding Mutual Fund Classes](#) (updated; 01/14/2003)

Each of these Investor Alerts educates investors about the wide variety of mutual fund fee structures that exist and urges investors to scrutinize mutual fund sales charges, fees, and expenses.

NASD research has shown that many investors are unaware of how much they pay to own mutual funds and that even small differences in fees can result in thousands of dollars of costs over time that could have been avoided. For example, nearly 80 percent of those responding to NASD's investor survey did not understand fully the meaning of "no load" funds.

To help investors make better decisions when purchasing mutual funds, we have unveiled an innovative mutual fund and exchange-traded fund expense analyzer on our Web Site. Unlike other such tools, the expense analyzer allows investors to compare the expenses of two funds or classes of funds at one time, tells the investor how the fees of a particular fund compare to industry averages, and highlights when investors should look for breakpoint discounts. To make this tool more widely available to investors, we developed a version of the expense analyzer for broker-dealer intranet and Web sites.

NASD also recently announced the creation of an Investor Education Foundation to focus our efforts on the critical area of investor education. The Foundation has been initially funded with \$10 million.

## **Conclusion**

NASD will continue its vigorous examination and enforcement focus on mutual fund advertising, the suitability of the mutual fund share classes that broker-dealers are selling, the compensation practices between the funds and broker-dealers, and the question of whether brokers are delivering to their customers the sales charge and pricing discounts to which they are entitled. And as we continue our examinations and investigations into late trading and market timing issues, we will enforce NASD rules with a full range of disciplinary options—which include stiff fines, restitution to customers, and the potential for suspension or expulsion from the industry. NASD will continue to work with other regulators to protect investors and restore investor confidence in this very important area of the securities markets.