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Report of the
Joint NASD/Industry
Task Force on
Breakpoints



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In a letter to NASD Chairman and Chief Executive Officer Robert R. Glauber, dated January 15, 2003, former Securities and Exchange Commission ("SEC") Chairman Harvey L. Pitt requested that NASD, joined by the Securities Industry Association ("SIA") and the Investment Company Institute ("ICI"), convene a task force to recommend 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. Chairman Pitt's letter set into motion an industry response to this problem, first uncovered by NASD's routine examination program. Prior to the formation of the Joint NASD/Industry Task Force on Breakpoints (the "Task Force"), NASD, in light of its examination findings, issued *Special Notice to Members 02-85* (the "NtM"), dated December 23, 2002,¹ which reminded broker/dealers of their obligation to apply correctly breakpoint discounts to front-end sales load mutual fund transactions. In sum, the NtM states that broker/dealers must: (a) understand the breakpoint discounts offered by mutual funds; (b) ascertain the information that should be recorded on their own books and records to allow them to provide all available discounts, such as qualifying prior or prospective transactions of a particular customer; (c) apprise each customer of the discount opportunities and inquire about other qualifying holdings that might entitle the customer to receive a discount;² and (d) correctly process the transaction so that the customer receives the applicable discount. On the same date, the SEC staff issued a letter stressing the importance of the NtM and of NASD members' attention to it.³

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- 1 *NASD Special Notice to Members 02-85* (December 2002), available at <http://www.nasdr.com/pdf-text/0285ntm.pdf>.
 - 2 As explained more fully below, at pp. 2-5, mutual funds generally allow investors to obtain breakpoint discounts based upon letters of intent, whereby the investor agrees to purchase a specified amount of shares within a specified period (usually 13 months), or through rights of accumulation, whereby an investor may aggregate his other holdings, as well as the holdings of certain related parties, toward the threshold investment level necessary to achieve a breakpoint.
 - 3 Letter to NASD Member Firm Executive Representatives from Annette L. Nazareth, Director, Division of Market Regulation, SEC, and Paul F. Roye, Director, Division of Investment Management, SEC, dated December 23, 2002, available at http://www.nasdr.com/pdf-text/ntm0285_letter.pdf.

Concurrently with the issuance of the NtM and the SEC staff's letter, the staffs of NASD, the SEC, and the New York Stock Exchange ("NYSE") conducted further examinations of broker/dealers to assess their ability to deliver breakpoint discounts. The findings of those examinations were memorialized in the *Joint SEC/NASD/NYSE Report of Examinations of Broker/Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds* (the "Joint Report"), which was published on March 11, 2003.⁴ Most of the 43 broker/dealers examined in this joint sweep failed to provide the appropriate breakpoint discount to customers in a significant number of cases. The group of firms examined in the sweep did not provide breakpoints in about 1/3 of the breakpoint-eligible transactions analyzed, and the average dollar amount of the discount not provided was \$364. The Joint Report, however, notes that most breakpoint problems did not appear to be intentional failures to charge correct sales loads.

The Task Force has met formally on three occasions prior to the issuance of this report, with subgroups and individual members of the Task Force consulting frequently between meetings. The members of the Task Force represent clearing broker/dealers, introducing and self-clearing broker/dealers, mutual fund service providers, transfer agents, a depository and clearing corporation, academia, legal experts, the SIA, ICI, NYSE, and NASD.

The Challenge of Delivering Breakpoint Discounts

Mutual funds sometimes offer multiple classes of shares of the same fund. The share classes are distinguished by different types of sales charges or by different classes of investors to whom the shares are offered, or both. Investors who buy Class A shares of mutual funds generally pay front-end sales load charges, which are deducted from the purchase price and paid to the underwriters and broker/dealers that distribute and sell the fund to investors. For example, if the front-end sales load for a Class A share is 5.75% and Class A fund shares are purchased at a cost of \$1,000, then \$57.50 is paid to (and divided among) the underwriters and dealers and \$942.50 is invested in the mutual fund.

4 Joint SEC/NASD/NYSE Report of Examinations of Broker/Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds, NASD, NYSE, and SEC Office of Compliance Inspections and Examinations (March 2003), available at http://www.nasdr.com/pdf-text/bp_joint_exam.pdf.

Mutual funds typically offer discounts to the front-end sales load assessed on Class A shares at certain pre-determined levels of investment, which are called “breakpoints.” The extent of the discount is based on the size of the investor’s investment in the mutual fund. For example, breakpoint discounts may begin at dollar levels of \$25,000 (or, more typically, at \$50,000) and continue at \$100,000, \$250,000, \$500,000 and \$1,000,000. At each higher level of investment, the discount increases (and, thus, the rate of the sales load charge decreases). For example, the sales charge for a representative fund family is 5.75% for purchases up to \$49,999, 4.5% for purchases \$50,000 to \$99,999, 3.5% for purchases \$100,000 to \$249,999, 2.5% for purchases \$250,000 to \$499,999, and 2% for purchases \$500,000 to \$999,999. In many cases, transactions at or over the \$1,000,000 breakpoint are not charged a sales load.

An investor can become entitled to a breakpoint discount to the front-end sales charge in a number of ways. First, an investor is entitled to a breakpoint discount if his purchase is equal to or exceeds the specified “breakpoint” threshold. Second, mutual funds generally allow investors to count future purchases toward achieving a breakpoint if they execute a letter of intent that obligates them to purchase a specified amount of fund shares in the same fund or fund family within a defined period of time. Similarly, mutual funds generally grant investors “rights of accumulation,” which allow investors to aggregate their own prior purchases and the holdings of certain related parties toward achieving the breakpoint investment thresholds (including reaching investment thresholds necessary to satisfy letters of intent).⁵

5 Most mutual fund families use the net asset value (“NAV”) of the investor’s mutual fund holdings to determine whether an investor’s aggregate purchases meet a breakpoint at which a discount is available. However, some fund families allow existing investor holdings to be valued using a method referred to as the “public offering price” (“POP”), in which an investor’s holdings in the fund are grossed up over and above NAV to take into account the maximum load chargeable for the particular fund.

Further, some mutual funds allow investors to use the greater of market (NAV/POP) or historical cost. During a period in which market values have increased, the NAV of the investor’s holdings or POP is likely to be greater than historical cost. However, in a down market, the historical cost, or what the investor actually paid for the mutual funds at the time of purchase, may exceed the NAV and POP. Thus, in a down market, an investor who initially spent \$40,000 to buy 100 shares of a mutual fund may find that the current

Mutual fund families began to offer these breakpoint discounts to make their funds more attractive to investors. Over time, funds expanded the rights of accumulation offered by expanding the categories of accounts that could be linked or aggregated for the purpose of obtaining breakpoint discounts. Mutual funds view their aggregation rules as important competitive features of their products. Accordingly, these rights of accumulation can vary from fund family to fund family, and many fund families define the related parties that can aggregate their holdings to determine breakpoint discount eligibility differently. For instance, one fund family may allow parents to link their accounts with a “minor child,” while another fund family may allow parents to link their accounts with any child residing at home.

Although the examination sweep revealed that broker/dealers did not always give breakpoint discounts on purchases that were entitled to a discount as a result of the size of the current purchase or the existence of a letter of intent,⁶ the Task Force has concluded that there are no serious systems or operational challenges to delivering breakpoint discounts on such transactions. In such situations, the broker/dealer executing the transaction possesses all the information necessary to provide a discount. Thus, firms should be able to track the limited information necessary to charge the correct sales load in those instances. Accordingly, the Task Force did not formulate recommendations for changes with respect to these types of purchases. The Task Force nonetheless notes that firms should take care to charge the appropriate sales load in these types of transactions.

NAV of his investment is only \$35,000. If the mutual fund allows investors to obtain breakpoint discounts based only upon NAV, this investor would need to buy additional shares worth \$15,000 to obtain a discount based upon the \$50,000 breakpoint. In contrast, if the mutual fund allows its investors to base their eligibility for breakpoint discounts upon historical costs, this investor would only need to buy additional shares worth \$10,000 to obtain the discount offered at the \$50,000 breakpoint.

Representatives of the Task Force reviewed 73 fund families' prospectuses and statements of additional information (“SAIs”) for pricing methods, and found that 33 use NAV, 25 use POP, 13 use the greater of NAV or historical costs, and 2 use the greater of POP or historical costs

- 6 Eight of the 43 firms examined in the joint sweep did not provide a discount on a single trade in which the customer was entitled to a lower sales charge as a result of investing in dollar amounts that exceeded the breakpoint level. See Joint Report at p. 17.

However, providing breakpoint discounts where investor eligibility is based upon the rights of accumulation offered by the mutual fund is a more complicated endeavor. To deliver a discount based upon a right of accumulation, the parties executing the mutual fund transaction must be able to identify all the related accounts that may be aggregated and ascertain the value of all those accounts to determine the breakpoint level that has been achieved and what resulting discount is available. The process of “linking” or “aggregating” these related accounts is challenging and is the crux of the problem faced by the mutual fund and securities industries. Likewise, valuation of the investment can be challenging for investors and broker/dealers if the mutual fund allows investors to use the historical cost, rather than the net asset value (“NAV”) of their investment or the public offering price (“POP”) method, to determine whether they are eligible for breakpoint discounts. Accordingly, the Task Force focused its efforts on developing recommendations that would facilitate the delivery of breakpoint discounts that are based upon rights of accumulation.

There are three distinct challenges to delivering breakpoint discounts that are based upon investors’ rights of accumulation. First, broker/dealers have found it difficult to access and fully understand the terms upon which mutual funds allow investors to aggregate both their holdings and the holdings of related parties to reach a breakpoint at which a discount is available. Second, broker/dealers and mutual funds must communicate to investors the terms concerning rights of accumulation and broker/dealers must obtain the necessary information from investors regarding accounts that may be linked (and, if applicable, historical costs) to ensure that all appropriate discounts are delivered.⁷ Third, and possibly most significant, is the challenge that the broker/dealer and mutual fund transfer agent must meet to effectively process investor breakpoint information once it is gathered from investors or the broker/dealer’s own records.

7 Many broker/dealers do not track the historical cost basis of transactions as part of their account statement information process. Additionally, broker/dealers would not generally have historical cost information for customer positions transferred into their firm or for positions held away from their firm that the customer may be able to link in order to receive a breakpoint discount. Thus, investors who wish to have their eligibility for breakpoint discounts measured by historical costs may need to keep personal records to demonstrate the historical costs of their investments.

Considerations and Recommendations

We discuss each challenge associated with delivering breakpoint discounts in turn and provide the Task Force recommendations for meeting those challenges. We emphasize that this report contains recommendations for change and builds upon existing obligations and processes. A variety of recommendations are discussed, and unless otherwise clear from the context, we recommend that all be adopted in combination.⁸

The Task Force appreciates that its recommendations will impact every level of the mutual fund distribution chain, and undoubtedly will impose additional costs on the financial services industry during a period of economic hardship. Nevertheless, the broker/dealer and mutual fund industries should and will take the lead in squarely addressing the operational challenges of consistently delivering breakpoint discounts. Accordingly, with only a few exceptions as stated in this report, the Task Force recommendations call for a voluntary industry response. Nonetheless, the effectiveness of some of the recommendations will be undermined if they are not adopted by virtually all industry participants. Thus, the Task Force recommends that the SEC and self-regulatory organizations (“SROs”) monitor the extent to which the industry voluntarily implements the recommendations outlined below. To the extent that the industry fails to implement these recommendations, the SEC and SROs should stand ready, where appropriate, to adopt rules that would require firms to implement them.

Finally, being charged the correct amount of a sales load is an important issue of investor protection. The Task Force notes that, as stated in the NtM, the broker/dealer and mutual fund industries have an obligation to deliver the appropriate breakpoint discounts offered to investors, and that obligation cannot be deferred pending the implementation of the Task Force’s recommendations.⁹

8 The Task Force recognizes that the broker/dealers selling front-end load mutual fund shares have a variety of business models, ranging from traditional full-service platforms to on-line brokerage firms. The manner in which a firm implements some of the recommendations, thus, may vary. A broker/dealer need not implement a particular recommendation if, through implementing other changes, it is able to deliver breakpoint discounts.

9 For example, today broker/dealers should have written supervisory procedures, supervisory controls, and exception reports that allow them to monitor for compliance with breakpoint commitments.

I. Accessing and Understanding Breakpoint Discounts Offered by Each Mutual Fund Family

According to the ICI, there are approximately 200 mutual fund families that have funds that charge front-end loads. As indicated above, each fund family that imposes a front-end sales load considers the breakpoint discounts it offers to be a proprietary competitive feature of that family. Accordingly, the terms upon which breakpoints are offered, particularly the account aggregation opportunities or rights of accumulation, are not standardized among funds. For example, although most funds allow parents to aggregate their holdings with the holdings of their children to achieve a breakpoint discount, the definition of “child” varies from fund family to fund family. Furthermore, some funds may offer the investor the opportunity to link to the accounts of grandparents or other further removed relatives; and some funds go so far as to allow members of certain professional organizations to claim account linkages.¹⁰ Thus, a broker/dealer that sells funds offered by multiple mutual fund families must understand the aggregation opportunities offered by each fund family in order to deliver all appropriate breakpoint discounts to its customers.

As broker/dealers increase the number of fund families whose funds they offer, fulfilling the obligation to understand the aggregation opportunities becomes an increasingly complex and burdensome task. The difficulty of this task is exacerbated by the fact that the specific rules and definitions concerning breakpoints are usually contained in a fund's statement of additional information (“SAI”),¹¹ which is not provided to prospective investors or broker/dealers as a matter of course. Moreover, the breakpoint disclosure in the SAI is often lengthy and complex.

10 During the review of the 73 fund families' prospectuses and statements of additional information (“SAI”) for linking opportunities discussed in footnote 5, Task Force representatives found that approximately 95% allow the linkage of spouse accounts, individual retirement accounts, children's accounts (under age 21), and individual trust accounts; 13% allow the aggregation of Section 529 college tuition savings plans; and less than 6% allow the linkage of variable annuities, domestic partners, grandparents, and siblings.

11 See Investment Company Act Rel. No. 23064 (effective June 1, 1998); 63 FR 13916 (March 23, 1998) (SEC action allowing mutual funds to streamline their prospectuses).

Accordingly, to ensure the accurate delivery of breakpoint discounts, the mutual fund industry must make certain that information about aggregation opportunities is publicly disseminated and easily understood by both broker/dealers and the investing public. To achieve this goal, the Task Force makes the following recommendations.

Task Force Recommendations:

- (A) **Common Definitional Standards:** The mutual fund industry should adopt common definitions of terms frequently used in defining breakpoint opportunities. Common understanding as to the terms used in describing breakpoint opportunities, however, does not mean that funds can or should conform the bases on which they offer breakpoints to investors. The Task Force does not intend to limit the ability of mutual funds to offer linkage opportunities; it is recommending only the adoption of commonly defined terms to describe linkage opportunities. For example, the mutual fund industry should agree to common definitional terms such as “spouse” (which might be defined as anyone to whom the account holder is legally married) and “minor child” (which might be defined as any child under age 21).
- (B) **Central Breakpoint Schedule and Linkage Database:** The mutual fund industry should create a central, comprehensive database of pricing methods (*e.g.*, NAV, POP, or historical costs), breakpoint schedules, and the linkage rules used to determine when a breakpoint has been reached and should make that database easily accessible to broker/dealers’ registered representatives, preferably by providing electronic access to the database from the desktops of registered representatives. Such a database would provide registered representatives with easy access to information about breakpoint opportunities at the point of sale. This would be a powerful tool for identifying opportunities to obtain breakpoint discounts and comparing breakpoint opportunities offered by different fund families.

The infrastructure for such a centralized database already exists. The National Securities Clearing Corporation (“NSCC”), a subsidiary of the Depository Trust & Clearing Corporation (“DTCC”),¹² provides a variety of automated services to the industry for mutual fund processing, settlement, and record-keeping; those services have become the industry standard for automated solutions in the mutual fund back-office support business. Among its services, NSCC operates the Mutual Fund Profile Service (“MFPS”), which is an electronic database that contains information about mutual funds. The MFPS Profile II database currently maintains breakpoint schedules that delineate the sales charges applicable at various dollar levels for a limited number of mutual funds. This database should be expanded to include breakpoint aggregation terms and rules for all fund families, and should include identification of both link-eligible related parties and link-eligible products (for example, retirement plans, annuities, and insurance products and college savings plans with mutual fund holdings). The information should be presented in a chart or other form that readily facilitates comparisons among fund families, using uniform definitions for common terms. The NSCC has indicated that it could readily expand its MFPS Profile II database to accommodate breakpoint linkage information for all mutual funds.

The MFPS Profile II database should be accessible to all registered representatives, regardless of whether they work for a large wirehouse, an independent dealer that has remote one- or two-person offices, or a small introducing firm with a single office. Accordingly, data should be deliverable through broker/dealers’ internal systems as well as Web-based applications.

Of course, for this database to be effective, it must be comprehensive. Accordingly, mutual funds must fully and accurately populate the database and must update the database on a timely basis.

12 The NSCC is represented on the Task Force through its parent corporation, the DTCC.

- (C) **Mutual Fund Prospectus and Web Site Disclosure:** Mutual funds should provide the critical data regarding pricing methods, breakpoint schedules and linkage rules in their prospectuses and on their Web Sites, in a prominent and clear format.¹³ Furthermore, mutual funds should provide quick and obvious links to breakpoint information from their Web Site home pages. Providing disclosures in mutual fund prospectuses and on mutual fund Web Sites would allow investors, who generally do not have access to NSCC systems and products, which are geared to broker/dealers and other financial services professionals, to obtain information on their own, without the assistance of a financial professional. The SEC should mandate prospectus and Web Site disclosure by rule,¹⁴ and, in the absence of a rule, fund families should voluntarily make this disclosure.

These disclosures should be prominent and clear. To assist the public in understanding the disclosures regarding breakpoint opportunities, these disclosures should depict the breakpoint schedules in easily readable charts, and should contain brief and easily understood explanations about the account linkage opportunities offered by the mutual fund.

- (D) **Confirmation Disclosure:** Confirmations should reflect the entire percentage sales load charged to each front-end load mutual fund purchase transaction.¹⁵ This information would enable investors to verify that the proper charge was applied. In connection with this recommendation, the Task Force also recommends that the SEC staff revisit its April 18, 1979 No-Action Letter, which permits the omission of sales charge information from confirmations.¹⁶

13 As noted above, today there usually is extensive disclosure concerning breakpoints in the SAI. The Task Force is not recommending that mutual funds include all of this information in their prospectuses and on their Web Sites. Rather, the Task Force is recommending that the most important pricing and linkage data be clearly presented in prospectuses and on Web Sites, possibly in chart format.

14 Disclosure on a Web Site should be required only where a fund family has a Web Site.

15 The sales load charged on front-end mutual fund transactions is divided between the broker/dealer executing the transaction and the fund's underwriter; the sales load charged to the investor includes both components.

16 See Investment Company Institute, SEC No-Action Letter, 1979 SEC No-Act. LEXIS 2673 (April 18, 1979).

II. Communicating Relevant Information to and Gathering the Necessary Data From Investors to Award All Available Breakpoint Discounts

In its NtM, NASD reminded broker/dealers of their responsibility to adopt appropriate procedures to ensure that investors are charged the correct sales load charge on mutual fund transactions. As an initial matter, a broker/dealer must systematically link all link-eligible accounts that it (or its clearing firm on the introducing firm's behalf) holds for an investor in determining the investor's eligibility for a breakpoint.¹⁷ Broker/dealers generally can ascertain connected accounts of a single investor on the basis of a tax identification number ("TIN").¹⁸ To illustrate this point, an investor's individual account and IRA account usually will have the same TIN,¹⁹ and any revocable trust accounts and joint accounts in which that investor participates may also have the same TIN. Accordingly, a mechanism exists for linking related accounts with the same TIN. In order to link other accounts eligible for aggregation under a mutual fund's offered rights of accumulation, the broker/dealer must disclose aggregation opportunities to the investor; ask the investor whether there are other accounts held by the broker/dealer that may be linked for the purposes of achieving a breakpoint; and have systems in place to connect the TIN of the investor's own accounts with the TINs of other link-eligible accounts at the same broker/dealer.²⁰

17 As stated in the NtM, in addition to the rights and obligations created by virtue of applicable clearing agreements and dealer agreements, the introducing broker must ensure that its customer receives the appropriate breakpoint in a given mutual fund transaction absent a clearing arrangement in which the clearing broker expressly assumes this obligation in accordance with NASD Rule 3230(a). Therefore, introducing firms must ensure (based on the services offered by their clearing firms, other systems utilized to effect mutual fund transactions, or a combination of both) that they have the capacity and capability to deliver all applicable discounts to their customers.

18 A TIN for a natural person is the individual's Social Security number and, in the case of an entity, is the number assigned pursuant to a filing requesting such number with the Internal Revenue Service.

19 In some instances an IRA account may be designated with the TIN of a third-party administrator.

20 These systems may be electronic or manual.

Many broker/dealers already perform a similar form of linking of related accounts in a record-keeping process known as “householding,” whereby customer accounts that are connected by financial interest or familial relationship receive certain combined services as a matter of efficiency for both the broker/dealer and its customer. For example, accounts that are the subject of householding may receive a combined monthly statement sent to a single address. Broker/dealers should review their householding parameters to evaluate their capacity to identify systematically breakpoint opportunities that arise as a result of account aggregation. Since many broker/dealers link under their householding arrangements by a combination of TIN, address, and surname, it would appear that householding processing could possibly be modified, if necessary, to recognize link-eligible accounts held at the broker/dealer by TIN.²¹

In sum, broker/dealers should be able to link all eligible accounts for rights of accumulation that they hold with the same TIN independent of any involvement by the investor. Broker/dealers also should be in a position to link the TINs of other link-eligible accounts that are identified by the investor and held by the broker/dealer and continue to maintain the linkage on an ongoing basis.

A much more difficult challenge is presented by holdings that are not held at the broker/dealer processing a front-end load fund purchase. At this time, there is no technological mechanism in place that will allow a broker/dealer to automatically locate and aggregate the holdings of investor accounts that are held outside that firm. Therefore, at the point of sale, broker/dealers must, in dealing with investors, request all the relevant information from investors about the extent of their holdings and the holdings of related parties that are held away from the broker/dealer in order to accurately deliver all appropriate breakpoint discounts. Accordingly, the Task Force carefully evaluated mechanisms for gathering, recording, storing, and processing information regarding cross-broker holdings.

To assist broker/dealers in communicating with investors about breakpoint opportunities and to gather the data necessary to fully deliver all appropriate breakpoint discounts, the Task Force makes the following recommendations:

21 The Task Force appreciates that extensive system modifications may be required to modify householding processes to assist in identifying breakpoint opportunities.

Task Force Recommendations:

- (E) **Standardized Checklists or Order Verifications:** As an initial matter, broker/dealers should require registered representatives to complete electronic or paper checklists or place notations on firm paper or electronic records (for example, on order tickets) that affirmatively state that the registered representative communicated the availability of breakpoint discounts to the investor and made the necessary inquiry to gather the relevant data to calculate breakpoint discounts before transactions are processed. NASD will develop a sample template and post it on the NASD Web Site.²² Broker/dealers should maintain those documents that evidence that the registered representative has communicated this information to customers.
- (F) **Record of Linkage Information:** At the time an investor first purchases front-end load shares of a particular fund family, his broker/dealer should record the investor's linking information, preferably using a standardized worksheet.²³ NASD will develop a sample template and post it on the NASD Web Site.²⁴ Broker/dealers should develop procedures to update this information with such frequency as necessary to properly calculate breakpoint discounts.²⁵
- (G) **Prospectus Disclosure Regarding Customer's Role in Assisting in Securing Breakpoint Discounts:** The SEC should mandate that a fund's prospectus disclose that investors may need to provide their broker/dealer with the information necessary to take full advantage of the breakpoint discounts. In the absence of a

22 See <http://www.nasd.com>.

23 Broker/dealers could use either an industry-wide standardized breakpoint worksheet or a variation tailored to the broker/dealer's business to obtain and record this information.

24 See <http://www.nasd.com>.

25 The Task Force recognizes that some of the information regarding account holdings may be shielded by privacy laws, and that some investors, for a variety of reasons, may be reluctant to share information regarding all their holdings with broker/dealers. However, investors should be given the option to share the information so that they may receive all discounts to which they are entitled. By providing investors with an opportunity to share this information, broker/dealers will fulfill their obligation to provide available discounts without running afoul of whatever privacy protections investors may enjoy.

regulatory mandate, mutual funds should provide this disclosure on a voluntary basis. For example, the prospectus should inform investors that if they wish to count positions that they hold in a retirement account toward achieving a breakpoint discount, they should inform their broker about their retirement account holdings, and may need to provide an account statement to verify those holdings. Furthermore, the prospectus should plainly inform investors that they should disclose any positions that they or related parties hold at other broker/dealers if they wish to aggregate those holdings to become eligible for a breakpoint discount.²⁶ Finally, mutual fund prospectuses should clearly explain whether breakpoint discounts are available based upon the historical cost of the investor's total investment or whether they are available based only upon the NAV of the investor's holdings or the POP. If the mutual fund allows investors to rely upon historical costs to obtain breakpoint discounts, the prospectus should plainly advise the investor that he should keep the records necessary to demonstrate his historical costs because neither the mutual fund, its transfer agent, nor the broker/dealer may have the necessary data.

- (H) **Confirmation Breakpoint Legend:** Confirmations for purchases of front-end load mutual fund shares should include a disclosure legend that alerts customers that they may be eligible for breakpoint discounts and refers customers to the appropriate materials (e.g., mutual fund prospectus or Web Site) to determine breakpoint discount eligibility.
- (I) **Written Disclosure Statement:** Broker/dealers should provide to each investor a disclosure statement at the time of or prior to the confirmation of his initial purchase of front-end load fund shares. Thereafter, the statement should be provided to investors in front-end load fund shares either on a periodic basis (but not less frequent than annually) or at (or prior to) the time of confirmation of subsequent purchases of front-end load shares.

²⁶ As discussed below, pp. 18-20, in certain cases, only the books and records of the broker/dealer disclose the identity of the beneficial owner. The effect of this type of record-keeping is that there is no centralized location in which all of the positions of an investor and other link-eligible accounts may be identified (unless all of those accounts happen to reside at only one broker/dealer).

The transmission of the disclosure statement could be made through a variety of means, including as a supplement to the confirmation statement. The disclosure statement should alert the customer to breakpoint opportunities, refer him to the appropriate materials to determine breakpoint discount eligibility, and explain that, without obtaining information from the investor, the broker/dealer cannot identify and link related accounts held outside the broker/dealer (and, in some cases, held within the broker/dealer; *e.g.*, accounts held under a trustee's TIN) and that the investor may not realize the full breakpoint opportunity available to him. The statement also should advise investors about the type of documentation they may be required to provide concerning holdings in related accounts. Additionally, broker/dealers that sell mutual funds that allow breakpoints to be achieved based upon historical costs should disclose whether they maintain current account records that include an investor's historical costs, and if they do not maintain these records, should identify the information that they require investors to produce in order to obtain discounts based upon historical costs. NASD will develop guidance concerning the disclosures that firms, depending on their business models, could use, and post it on the NASD Web Site.²⁷

- (J) **Registered Representative Training:** NYSE and NASD rules require broker/dealer registered personnel to undergo periodic training.²⁸ Firms are required to provide firm element training, which covers specific requirements developed by each broker/dealer according to its own needs analyses. Regulatory element training, which covers specific requirements developed by the SROs, is administered by the SROs. Both elements of training should be enhanced for greater focus on breakpoint rules, terms, and considerations.

27 See <http://www.nasd.com>.

28 See NASD Rule 1120 (Continuing Education Requirements) and NYSE Rule 345A (Continuing Education for Registered Persons).

(K) **Investor Education:** The investing public should fully understand the availability of breakpoint discounts because there are particular instances, as cited above, in which investors must be active participants in assuring their receipt of an eligible breakpoint. Accordingly, the Task Force recommends that both participants in the sale of mutual funds and regulators develop appropriate educational materials, such as statement stuffers, which clearly explain breakpoint opportunities to retail investors. The SEC, NASD, ICI, and SIA have already published educational materials explaining mutual fund breakpoint opportunities on their respective Web Sites.²⁹ These educational materials should be viewed as the starting point for more extensive investor education efforts.

III. Meeting Challenges in Processing Breakpoint Information

Even if the parties participating in mutual fund transactions have access to and gather all the information needed to provide breakpoint discounts accurately, the broker/dealer and mutual fund transfer agent must still effectively process that information. The Task Force recognizes that a properly designed and automated system for processing transactions, which is populated with the necessary information and universally used, would ensure the accurate delivery of breakpoint discounts and, thus, would be preferable to any manual system. Accordingly, the Task Force gave substantial consideration to potential universal solutions to the breakpoint issue through the use of either a “black box” utility or mutual fund transfer agents. However, although these potential solutions appear, at first blush, to be attractive answers to this problem, the Task Force ultimately did not accept them. Before turning to the Task Force’s recommendations, we first provide a fuller explanation of the Task Force’s consideration of these two ideas.

29 On January 14, 2003, NASD issued an investor alert entitled: “Mutual Fund Breakpoints: A Break Worth Taking,” available at http://www.nasdr.com/alert_breakpoint.htm, and updated an investor alert entitled “Understanding Mutual Fund Classes,” originally published Jan. 18, 2001, available at http://www.nasdr.com/alert_mfclasses.htm, which also contains information about breakpoint discounts. See also NASD Mutual Fund Expense Analyzer, available at http://www.nasdr.com/fundcalc/expense_analyzers.asp. Information about mutual fund breakpoints also is available in the “Investor Information” section of the SEC’s Web Site available at <http://www.sec.gov/answers/breakpt.htm>. The ICI posted an explanation of mutual fund breakpoints on its Web Site, available at http://www.ici.org/funds/inv/bro_brkpts.html. The SIA also has published a brochure discussing mutual fund breakpoints, available at <http://www.sia.com/publications/html/mfbreakpoints.html>.

The “black box” model is essentially a utility that would serve as the repository for the holdings and transactions of every mutual fund investor.³⁰ This utility would take the account aggregation information provided by the investor, compare that information with available breakpoint opportunities, and apply the appropriate breakpoint discount to each transaction. The black box utility would not be an agent of either the broker/dealer or the mutual fund and, thus, would not compromise the proprietary customer information of either one.

Unfortunately, Task Force members with extensive operational expertise spanning across broker/dealers, mutual fund companies, and transfer agents believe that this solution is untenable. As a threshold matter, developing the “black box” utility would be a time-consuming and costly effort. Task Force members representing broker/dealers and transfer agents projected potential annual costs of \$10-\$20 per account. Given that there are approximately 250 million mutual fund accounts, the costs associated with this utility would be enormous. Likewise, there would be significant capital requirements in the ongoing operation of the utility. However, front-end load mutual fund purchases represent only a small fraction of mutual fund sales,³¹ and only a fraction of those who purchase front-end load funds are eligible for breakpoint discounts. Moreover, only a fraction of investors who are eligible for breakpoint discounts hold investments at the same fund family at multiple broker/dealers or other multiple platforms (such as retirement accounts).³² Therefore, it is not financially reasonable to recommend the creation of a utility with enormous costs to be borne by all mutual fund investors in order to deliver a benefit to a small fraction of those investors. Thus, the black box utility is economically inefficient and inequitable.

30 According to the ICI, there are over 250 million mutual fund accounts. See *ICI 2003 Mutual Fund Fact Book*, pp. 63, 65, available at <http://www.ici.org>.

31 Less than 7% of the dollar amount of all mutual fund sales in 2001 involved front-end sales loads. See Joint Report at p. 4 (citing statistic from the ICI).

32 The Task Force has been unable to obtain definitive information about the percentage of Class A mutual fund shareholders who hold (personally or through parties eligible to be linked) the same mutual fund family at more than one broker/dealer or through more than one platform (such as one broker/dealer and a retirement account or directly with the fund). Nonetheless, representatives of the Task Force reviewed the available data, which suggests that such shareholders are a small minority.

Alternatively, the transfer agent for each mutual fund could undertake the same function if the transfer agent had access to comprehensive information concerning the beneficial owner of mutual fund shares. Comparatively, the transfer agent function approach would be less costly than the “black box” utility, but, as discussed further below, would require significant changes to processing systems now in use by certain broker/dealers for many mutual fund accounts and the sharing of proprietary customer information with others in the industry. These factors represent significant obstacles to successful implementation of the transfer agent function approach.

Moreover, these two solutions do not appear to reach universal resolution of the problem because the information regarding beneficial ownership of the mutual fund shares is often not readily available to the parties who execute mutual fund transactions. For example, mutual fund positions that are held in certain trust platforms such as Section 529 college savings plans, defined benefit plans, and other fiduciary holdings may be held in accounts that are in the custody of a trust department of a bank or transfer agent in which the underlying ownership information is not recorded. Although this underlying ownership information may be relevant in assessing the total scope of linkage opportunities, mutual funds, transfer agents and broker/dealers generally do not have access to this information. Universal resolution of the breakpoint problem cannot be achieved unless information regarding beneficial ownership is readily available to all parties involved in the execution of mutual fund transactions. Consequently, the Task Force concluded that, on balance, such “universal” processing solutions were not practicable.³³

Having determined that a universal processing solution is not practicable, the Task Force considered the hurdles connected with current processing systems and platforms and record-keeping. Unrelated to breakpoints, there have been trends in mutual fund transaction processing and position record-keeping that reduce accessibility of beneficial ownership. This absence of ready access to information regarding beneficial ownership prevents broker/dealers from identifying accounts held at other broker/dealers that should be aggregated for the purposes of determining breakpoint eligibility. To understand why there is not sufficient

33 Transfer agents currently play a critical role in identifying breakpoint opportunities and should continue to play that role in the future. However, they are not in a position to identify all breakpoint opportunities.

informational access to link accounts held at other broker/dealers, it is necessary to have a basic understanding of how mutual fund transactions are executed and how mutual fund positions are held.

The vast majority of broker/dealers that sell mutual funds use (directly or through their clearing broker/dealers) an automated NSCC service known as Fund/SERV to process and settle mutual fund transactions.³⁴ In the Fund/SERV system, mutual fund purchases and redemptions are settled, and the resulting transactions are recorded on the books of the mutual fund, which are maintained by each fund's transfer agent. The manner in which those transactions are recorded on the books and records of the transfer agent is determined by the manner in which an NSCC broker/dealer participates in the NSCC's Networking service, which operates on four distinct levels. The amount of information that the broker/dealer provides to the mutual fund transfer agent varies by the Networking level used by the broker/ dealer. Depending upon the Networking level used, the broker/dealer may give the transfer agent the investor's TIN or may only provide the transfer agent with the broker identification number ("BIN"), which is generally the investor's account number at the particular broker/dealer. If the broker/dealer provides the transfer agent with the investor TIN and/or BINs, the mutual fund transfer agent has sufficient information regarding beneficial ownership of positions to identify and aggregate those holdings of individual investors. This, in turn, allows the mutual fund transfer agent to assist in identifying breakpoint opportunities and in delivering breakpoint discounts, because the transfer agent has enough information to find accounts with the same TIN and/or BIN. Similarly, if the broker/dealer identifies related accounts and provides TIN and/or BIN information for these accounts, the mutual fund transfer agent also can identify and link accounts with related TINs and/or BINs.

34 For more information on Fund/SERV, see <http://www.dtcc.com/ProductsAndServices/mutual/fundserv.html>.

However, broker/dealers that engage in Networking Level 3 usually do not share the TIN and customer's name with the mutual fund transfer agent.³⁵ Likewise, a number of broker/dealers, including several of the largest self-clearing and clearing broker/dealers holding many millions of mutual fund accounts, settle their transactions on an "omnibus basis," which means that the broker/dealer holds its customer positions in a mutual fund at that fund's transfer agent in a single position in the broker/dealer's own name. Broker/dealers that have such omnibus accounts rarely provide any identifying information regarding their customers to mutual fund transfer agents. The broker/dealer settling on an omnibus basis does all of the ownership sub-accounting and reporting from its own books and records. This also is largely true for broker/dealers that engage in Networking Level 3. In effect, the broker/dealer becomes the sub-transfer agent for the fund and is compensated by the fund for providing those services. Accordingly, broker/dealers that engage in Networking Level 3 or omnibus accounting do not provide enough information to transfer agents to allow transfer agents or mutual funds to identify and link related accounts.

The Task Force considered the option of recommending the elimination of omnibus processing to promote greater access to data concerning beneficial ownership in the settlement process, which in turn, might allow transfer agents to assist in ensuring the accurate delivery of all breakpoint discounts. However, the Task Force rejected that solution for several reasons.

First, omnibus processors firmly believe that their model is a more efficient record-keeping system, because this system involves only one set of records, located at the broker/dealer, rather than two sets of records that are kept by the broker/dealer and the transfer agent. Additionally, while some industry participants disagree, omnibus processors believe that these efficiencies allow them to operate at lower cost, reduce the number of errors, and return confirmations to customers more rapidly. Indeed, there is a trend in the industry for more broker/dealers to adopt the omnibus model. Second, a number of industry participants have expressed the view that the availability of a variety of platforms for processing and recording securities transactions and holdings represents healthy competition within the broader financial services industry and can benefit investors through better service and more efficient pricing. Unfortunately, in the context of delivering breakpoint discounts, an unintended consequence of the

35 The Networking levels also determine whether the mutual fund or the broker/dealer performs administrative services, such as tax reporting.

omnibus model is that it presents an obstacle in the breakpoint context because it makes it more difficult to identify potentially linked accounts.

After carefully weighing the costs and benefits of these alternatives, the Task Force concluded that measures can be taken to enhance the ability of broker/dealers, mutual funds, and transfer agents to deliver these discounts without requiring pervasive changes in processing and record-keeping systems and reversing the trend to expand the different methods used to perform these functions. The recommended changes described below, standing alone, are not a comprehensive answer to processing fund share transactions in a manner that will deliver all available breakpoint opportunities in connection with holdings that span multiple broker/dealers or are held in platforms outside of broker/dealers. Nevertheless, the Task Force believes that its other recommendations should greatly facilitate the ability of investors with such holdings to receive the appropriate breakpoint discounts.

Task Force Recommendations:

- (L) **Broker/Dealer Transmission of TIN/BIN Data To Mutual Funds:** Non-omnibus broker/dealers should transmit TIN/BIN data to mutual funds to assist in the linking of accounts. Non-omnibus broker/dealers could transmit this information to mutual funds or their transfer agents in a variety of ways, depending upon the way in which they execute, settle, and record mutual fund transactions. To facilitate wider access to information, the following steps should be taken; they are not intended to discourage broker/dealers from developing different mechanisms for conveying this information.
 - Fund/SERV should add data fields that request the BIN, TIN, and any letter of intent of the investor purchasing mutual funds, as well as the BINs and TINs for all related accounts held by that investor or parties whose accounts can be aggregated with that investor for the purpose of determining eligibility for a breakpoint discount.

- Fund/SERV should specify each field's particular purpose and include logic that would prevent the processing of orders where the inappropriate information is entered into a particular field, thereby ensuring that funds and broker/dealers are using the same fields for the same purposes.³⁶
 - For omnibus or Networking Level 3 processing of orders that do not reveal the TIN/BIN of the beneficial owner of the mutual funds, broker/dealers should explore the feasibility of developing alternative mechanisms for providing TIN/BIN information to mutual funds or their transfer agents. The Task Force believes that such systems could facilitate linkage of holdings for which a particular firm is the broker/dealer of record, even if some of those holdings are "carried away" from that broker/dealer. The Task Force understands that at least one broker/dealer that engages in omnibus processing has developed a proprietary system for submitting individual TINs/BINs to mutual funds on a weekly basis. The mutual funds, in turn, provide the broker/dealer firm with information on holdings carried away from the broker/dealer but for which that firm is the broker/dealer of record.
- (M) **Transfer Agent Searches:** Transfer agents should perform automated searches of the TIN and/or BIN, and letter of intent, data supplied by the broker/dealers to calculate and verify breakpoint discounts across broker/dealers on transactions that are executed on a fully disclosed basis. Some mutual fund transfer agents already have this capability. Broker/dealers should have electronic access to their customer account information that result from TIN/BIN searches, in order to enable them to maintain or update breakpoint information prior to order execution.

36 The examinations, discussed above, see page 2, identified situations where investors did not receive breakpoint discounts because their broker/dealers and mutual funds used the same Fund/SERV field for different purposes.

Implementation of Recommendations

The ICI and SIA, which have served as members of this Task Force, already are working with their respective members to help ensure that they take appropriate action to deliver breakpoint discounts to all investors who are entitled to such discounts. They will continue to work with their members to adopt the industry-wide best practices represented by the Task Force recommendations to meet this goal. The NSCC, too, has begun work to implement the recommendations in this report. After three months, and again after six months from the issuance of this report, and thereafter if necessary, the SIA, ICI, and NSCC will report on implementation progress to NASD and the SEC.

In addition, as part of their examination programs, NASD, the NYSE, and SEC will examine firms to see if they are meeting their responsibilities to deliver available breakpoint discounts to eligible investors and will take appropriate actions against firms that do not meet this obligation.

It is critical that investors are afforded the opportunity to receive the full panoply of benefits offered to them; delivery of breakpoint discounts in the sale of front-end sales load mutual fund shares is no exception. The Task Force believes that the shortfall in such delivery is the unintended consequence of two broad, independently occurring trends: greater competition among mutual funds to attract investors, which caused an increase in the opportunities to earn breakpoint discounts; and greater variation in the processing of mutual fund transactions, which led to a lack of access to information, but also created new models for providing services for investors. This has occurred against the backdrop of continual expansion of the number of funds available to the public. Although both trends were driven by the desire to provide greater opportunities and cost savings to investors, both have had the unintended consequence of complicating the process of ensuring the accurate delivery of breakpoint discounts. Notwithstanding these trends, broker/dealers and mutual funds have an obligation to deliver the appropriate breakpoint discounts to investors. The adoption of the recommendations set forth in this report presents a balanced approach that will meet the challenge and obligation of delivering breakpoint discounts to mutual fund investors, while preserving benefits that have occurred as the result of natural market forces.

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