FINRA Proposes New Rules Governing Disclosure of Revenue Sharing and Other Compensation Arrangements Relating to Investment Company Securities

BY THE INVESTMENT MANAGEMENT PRACTICE

As part of the ongoing process of developing a consolidated FINRA rulebook, FINRA has issued Regulatory Notice 09-34 requesting comment on new Rule 2341 regarding the disclosure of compensation arrangements relating to the distribution and sale of investment company securities. Proposed Rule 2341 would replace NASD Rule 2830 and, in doing so, would attempt once again to address the controversial area of revenue sharing disclosure. The revisions would:

- require disclosure of revenue sharing arrangements and other “special cash compensation” arrangements by the member to the customer at the time the account is opened. This information would have to be updated every six months. Prospectus disclosure of such arrangements would NOT satisfy this requirement;
- require members to estimate the value of all non-cash compensation received from an offeror;
- eliminate a condition regarding discounted sales of investment company securities to dealers; and
- codify past FINRA staff interpretations regarding purchases and sales of exchange traded funds (ETFs).

These changes are discussed further below. The comment period expires August 3, 2009.

Changes to the Cash Compensation Provisions

NASD Rule 2830 regulates cash and non-cash compensation arrangements for the sale and distribution of investment company securities. Currently, member firms may not accept “cash compensation” from an “offeror” (generally an investment company, its adviser, distributor or their affiliates) unless such compensation is described in the fund’s current prospectus. When special cash compensation arrangements are made available by offerors to members, which arrangements are not made available on the same terms to all members who distribute the fund’s shares, a member may not enter into these special arrangements unless the member’s name and the details of the arrangement are disclosed in the fund prospectus.

Special cash compensation, while not defined in current Rule 2830, is generally thought to include revenue sharing arrangements. However, for many years now, members and issuers have taken the position that compensation arrangements with individual dealers are not “special” where the arrangement would be available to all dealers upon request. Therefore, these arrangements have not been disclosed in fund prospectuses.
Proposed Rule 2341 would change this disclosure regime in the following way:

1. **Sales Charges and Dealer Concessions** – only standard “sales charges and service fees” will need to be disclosed in fund prospectuses. If a member receives greater (or special) sales charge or service fee compensation (which does not include revenue sharing payments), then the name of the member that receives these special sales charge or service fee compensation and the details of the arrangement would be required to be disclosed in the fund prospectus or Statement of Additional Information (“SAI”). Prospectus or SAI disclosure is required even if the fund or adviser would have made the same arrangement available to other members had they requested it. In supplementary material, FINRA would clarify that a “special sales charge or service fee arrangement” includes any arrangement under which a member firm receives greater sales charges or services fees than other member firms selling the same investment company securities.

   • So for example, if a member receives the full gross sales charge imposed on a fund share while other members receive only a portion of the gross sales charge, the member receiving the full gross sales charge has entered into a special sales charge or service fee arrangement that requires prospectus or SAI disclosure.

   • Additionally, if a member receives a cash payout in addition to the regular commission paid on the sale of investment company securities, and other members do not receive this cash payout, the member has entered into a special sales charge or service fee arrangement that requires prospectus or SAI disclosure.

As discussed below, revenue sharing payments need not be disclosed in the prospectus or SAI because they would be subject to disclosure to the customer at the time the account is opened.

2. **Revenue Sharing and Special Compensation** – A member that receives cash compensation other than the standard sales charge and service fee must make certain disclosures to its customers at the time the account is opened. “Cash compensation” for these purposes is defined to include (i) revenue sharing paid in connection with the sale and distribution of investment company securities, whether based upon the amount of investment company assets that customers hold, the amount of investment securities that the member has sold, or any other amount if the payment is related to the sale and distribution of the investment company’s securities, as well as (ii) special sales charges or service fees discussed above.

**Required Revenue Sharing and Special Cash Fee disclosures** – Under proposed Rule 2341, if a member firm receives such additional cash compensation, it would have to disclose to its customers at the time the account is opened:

   • that information about a fund’s fees and expenses may be found in the fund’s prospectus;

   • (i) that the member receives cash payments in addition to the standard sales charges and services fees disclosed in the prospectus, (ii) the nature of such payments received in the last 12 months and (iii) a list of offerors making such payments listed in descending order of payments received; and

   • a reference to a Web page or toll-free number containing updated information, which must be updated at least every six months (or if the firm elects not to maintain a Web page or toll-free number, disclose updated information to customers every six months).
The proposed rule requests comment on how this information is to be delivered to investors.

**Changes to the Non-Cash Compensation Provisions**

NASD Rule 2830 requires member firms to keep records that include, among other things, the nature and, "if known," the value of any non-cash compensation received. Proposed Rule 2341 proposes to modify this requirement by deleting the phrase "if known" regarding the value of non-cash compensation. Firms would be permitted to estimate in good faith the actual value of non-cash compensation received for which a receipt (or similar documentation) assuming a value is not available.

**Changes to Conditions for Discounts to Dealers**

NASD Rule 2830 currently prohibits investment company underwriters from selling the fund’s shares to a retail broker-dealer at a price other than the public offering price unless, among other conditions, the sale is made in conformance with NASD Rule 2420 (Dealing with Non-Members). FINRA proposes to eliminate this requirement in proposed Rule 2341 in light of the fact that today virtually all broker-dealers doing business with the public are FINRA members.

**Changes Regarding Sales of ETFs**

Proposed Rule 2341 would add a provision that would codify earlier FINRA staff interpretative letters that permit trading of ETF shares at prices other than the current net asset value consistent with applicable SEC rules or exemptive orders.

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If you have any questions concerning the new proposed Rule 2341, please do not hesitate to contact any of the following Paul Hastings Investment Management lawyers:

**Chair**
Michael R. Rosella  
212-318-6800  
mikerosella@paulhastings.com

Wendell M. Faria  
202-551-1758  
wendelfaria@paulhastings.com

Rey Pascual  
404-815-2227  
reypascual@paulhastings.com

**Vice Chair**
David A. Hearth  
415-856-7007  
davidhearth@paulhastings.com

Michael Glazer  
213-683-6207  
michaelglazer@paulhastings.com

Domenick Pugliese  
212-318-6295  
domenickpugliese@paulhastings.com

Jacqueline A. May  
212-318-6282  
jacquelinemay@paulhastings.com

Gary D. Rawitz  
212-318-6877  
garyrawitz@paulhastings.com

Mitchell E. Nichter  
415-856-7009  
mitchellnichter@paulhastings.com

Arthur L. Zwickel  
213-683-6161  
artzwickel@paulhastings.com

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If the customer does not open an account with the member but purchases the shares through the mutual fund transfer agent, this disclosure would be required to be made before the initial shares are purchased.