

FINRA Proposes Revisions To Its Mutual Fund Cash Compensation Disclosure Rules

After a Multi-Year Review Process, New Rule Would Require Broker-Dealer Disclosure of Revenue Sharing and Other Payments at the Point of Sale and on its Web Site (or Available Via a Toll Free Telephone Number)

BY THE INVESTMENT MANAGEMENT PRACTICE

After a number of fits and starts, and a multi-year rulemaking process, FINRA has proposed to significantly revise its investment company sales compensation disclosure rule, FINRA Rule 2830, in a way that would move revenue sharing disclosure from fund prospectuses and statements of additional information (“SAI”) to the point of sale and to the internet (or made available over the phone).¹ Generalized disclosure of revenue sharing arrangements and associated conflicts would be required to be disclosed by the broker-dealer at the point-of-sale. Detailed disclosure of revenue sharing and other cash compensation arrangements would have to be maintained on an internet web site (or made available telephonically) and updated at least annually.²

The proposal would replace existing Rule 2830 with a new Rule 2341. As the proposal already takes into account comments received by FINRA in connection with its 2009 proposed revisions to Rule 2830³, the SEC has provided a short notice period ending on May 31, 2011. It can be expected that after the notice period, new Rule 2341 will be adopted largely as proposed. We describe the requirements of proposed Rule 2341 in more detail below.

Definition of “Cash Compensation” – Rule 2341 defines ‘cash compensation’ as any discount, concession, fee, service fee, commission, asset-based sales charge, loan, override or cash employee benefit received in connection with the distribution of investment company securities. Importantly, cash compensation includes revenue sharing payments.⁴

Elimination of Prospectus Disclosure Requirement – Rule 2341 does away with the current requirement in Rule 2830 that “cash compensation” arrangements be described in a mutual fund prospectus or SAI and that “special cash compensation” arrangements be described in detail (including the name of offeror and the details of the arrangements) in a fund’s prospectus or SAI.⁵

Point of Sale Disclosure - In lieu of prospectus disclosure, Proposed Rule 2341 provides that if, within the previous calendar year, a member has received, or entered into an arrangement to receive, cash compensation from an offeror⁶, *other than sales charges and fees disclosed in the prospectus fee table*, the member must make the following disclosures:

- prominent disclosure that the member has received, or entered into an arrangement to receive, cash compensation from investment companies (or their affiliates) offered to the investor, in addition to the sales charges and services fees described in the prospectus. This would include not only revenue sharing payments but also fees for services, such as sub-transfer agency and sub-administration fees.
- prominent disclosure that this additional cash compensation may influence the selection of mutual funds that the member may offer or recommend to investors.
- a prominent reference to a web page or toll-free number where the investor can obtain more detailed information about these arrangements.

Web Site/Toll-Free Telephone Number Disclosure (“Detailed Cash Compensation Disclosure”) – Detailed information of cash compensation arrangements must be available at the member’s internet web site or through a toll-free number⁷. This information must include the following:

- a narrative description of the additional cash compensation received from each offeror, and the services provided, if any, by the member for this additional cash compensation;⁸
- a narrative description of any preferred list of funds that the member maintains as a result of the receipt of cash compensation, including the names of the funds on that list;
- the names of the offerors who have paid, or entered into arrangements to pay, this additional cash compensation to the member.

Delivery Requirements/Updating

Point of Sale Disclosure – For new customers, beginning on the effective date of the rule, the Point of Sale Disclosure would be required to be provided in paper or electronic form⁹ prior to the time the customer first purchases shares through the member of the investment company paying the cash compensation. For existing customers at the time the proposed rule becomes effective, the Point of Sale Disclosure must be made in paper or electronic form by the later of either (i) 90 days after the effective date of the rule, or (ii) prior to the time the customer first purchases shares through the member of the investment company paying the cash compensation (other than purchases through dividend reinvestment, reinvestment of capital gains distributions or automatic investment plans).

Detailed Cash Compensation Disclosure - The proposal appears¹⁰ to require that the Detailed Cash Compensation Disclosure must be available at the effective date of the rule. The proposal requires that the Detailed Cash Compensation Disclosure be updated annually within 90 days of the calendar year end *or sooner if it becomes materially inaccurate between annual updates*. The proposal does not provide any guidance as to this “materially inaccurate” standard, and therefore members will need to consider this matter on a case-by case basis. Initially, it would appear to us that the addition of a new fund to a preferred list, or the entering into a new cash compensation arrangement with an offeror, would be material if the customer receives a recommendation from the member to invest in that fund. Similarly, the removal of a fund from a preferred list, or the termination of a cash compensation arrangement with an offeror, would appear to be material if the customer receives a recommendation from the member to sell shares of that fund. Members will need to develop compliance policies and procedures around these events.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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¹ See Release No. 34-64386 (May 3, 2011) available at <http://www.sec.gov/rules/sro/finra/2011/34-64386.pdf>. The proposal would replace existing Rule 2830 with a new Rule 2341.

² FINRA has **not** proposed conforming changes to the variable contracts rule, Rule 2320.

³ FINRA Regulatory Notice 09-34.

⁴ In defining “cash compensation” in this manner, the new rule will put an end to the argument about the distinction between “cash compensation” and “special cash compensation”. Currently, Rule 2830 requires more detailed disclosure of “special cash compensation” arrangements than of “cash compensation” arrangements. “Special Cash Compensation” is defined as compensation that is not made available on the same terms to all members that sell the fund’s shares. This definition of “special cash compensation” has engendered much discussion over the years, all of which will be rendered moot, as new rule 2341 no longer seeks to maintain a distinction between “cash compensation” and “special cash compensation”.

⁵ Rule 2830(l) currently implements this requirement by prohibiting a FINRA member from accepting cash compensation or special cash compensation from a mutual fund unless that compensation is disclosed in a fund’s prospectus or SAI.

⁶ “Offeror”, includes the investment company, its adviser, fund administrator, underwriter or any of their affiliated persons.

⁷ If the customer requests to receive a paper-based version of the disclosure, the FINRA member must provide it promptly.

⁸ This narrative description does not appear to require disclosure of the dollar amount, rate or other financial terms of the arrangements. While the rule proposal does not definitively address this matter, the current language of Rule 2341 appears to indicate that such detail is not required.

⁹ Electronic delivery would be permitted only if the member confirms to FINRA’s electronic delivery rules, which mimic the SEC’s rules in this area.

¹⁰ It would seem logical that the Detailed Cash Compensation Disclosure would not be required to be available until the time the first Point of Sale Disclosure is provided, however the proposed rule does not so provide.