



All that's hot in the mutual fund industry

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Gaps Seen in Broker Disclosure Rule Proposal

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The SEC has just released its rule proposal requiring brokers to disclose information to customers about mutual fund payments and conflicts of interest. Investors generally support the proposal, but some industry experts note that the SEC has still left several issues unaddressed.

Those include whether the disclosures will apply to no-load funds, closed-end funds and variable annuities. It's also not clear whether disclosure of supermarket and recordkeeping fees will be required and the proposal does not provide a concrete definition of revenue sharing.

The commission first gave the go-ahead for the rule proposal at a mid-January open meeting. Commissioners and staff both voiced the need to provide mutual fund customers with more information before they make purchase decisions. They also said that the rule, which addresses point-of-sale disclosures, should be updated, since it was last visited in 1977.

This proposal would require disclosure of information about front-end and deferred sales loads and other distribution costs that impact shareholder returns. It would require brokers to disclose their compensation for selling the product, along with any information about revenue-sharing arrangements and portfolio brokerage arrangements that could create conflicts of interest. Additionally, it would require brokers to inform customers about whether they receive extra compensation for selling certain fund shares or fund share classes.

The requirements would apply to mutual fund shares, UIT interests and 529 plans. So brokers, dealers and municipal securities dealers would be subject to the rule.

To assist reps in providing that information to customers, the SEC is proposing new forms for confirmation of disclosure and point-of-sale disclosure.

It's also proposing to amend form N-1A, the mutual fund registration form. An updated form would require more detailed disclosure of sales loads and revenue-sharing deals.

Previously, the SEC didn't require specific broker disclosure of third-party compensation as long as the customer received a prospectus that contained general information about the fund's broker compensation. That disclosure, however, didn't have to be detailed, and it didn't have to be duplicated on other SEC forms.

At first glance, the changes appear comprehensive. But some industry observers say the SEC may have left a few things out.

"I don't know if the rule will apply to no-load groups," says one fund attorney. "The rule provides five samples, but none are no-load funds."

Also, he says, amendments to form N-1A are proposed, but updates to the corresponding registration forms for closed-end funds and variable annuities are not.

"What about forms N-2 and N-4?" he asks. "These payments are going on in those funds too. The SEC should address everything. Why not do it all at once? They should get all the comments in at the same time, so they don't look like they're picking only on one industry."

Then, he says, there are supermarket fees. **Schwab**, for example, typically charges 40 or 45 basis points to list a mutual fund. Many firms pay for those listings from sub-transfer fees, 12b-1 fees or directed brokerage. The proposal doesn't require disclosure to investors of those payments.

Niels Holch, a partner with **McGuinness & Holch**, says the proposal is a good start but could still be improved.

"Broker cost and conflict information needs to be clearly disclosed to an investor before an investment decision is made," he says. "The new POS [point of sale] rules are an excellent first step toward ensuring that an investor is

properly informed about a transaction handled by a broker-dealer."

But, he says, those disclosures should be in writing and firms should keep a record that they were made. The rule doesn't require either of those conditions.

There's also some ambiguity in the proposal's definition of revenue sharing.

"The definition of revenue sharing is so broad that it seems that any payment from an advisor or any affiliate of an advisor to a broker could be defined as a revenue-sharing arrangement," says **Schulte, Roth & Zabel** attorney George Silfen.

The proposal, he says, doesn't specify exactly what kinds of relationships these involve. So some payments unrelated to sales could be inadvertently swept into the definition.

The Securities Industry Association also supports beefing up disclosure of mutual fund costs and compensation arrangements. It's been an active participant in the breakpoint task force that recently made recommendations for improving disclosure to shareholders of sales-discount information.

Spokesman Dan Michaelis says the SIA will be filing a comment letter with the SEC, but he didn't detail any areas of particular concern in the new proposal.

Ultimately, says Holch, point-of-sale disclosures are just one of a long list of fixes that need to be made in the fund industry.

"We have to look at the whole picture," he says. "That includes transaction costs, accounting practices and excessive trading through market timing. Everything taken together paints a dismal picture."

Holch says he's still waiting for more clear and effective disclosure of transaction costs and operating expenses and measures taken to reduce excessive trading for arbitrage purposes.

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