

investors to aggregate fund shares owned by a person or group of persons related to the investor (e.g., family members). This option also gives a fund shareholder the ability to count earlier purchases of shares of funds in his or her accounts and in related accounts towards the reduction of the sales charge on a current purchase. A right of accumulation may often be combined with a letter of intent for further benefits.

Typically, a mutual fund values accounts in order to determine whether aggregate holdings have reached a sales load breakpoint using one of three methods: net asset value, public offering price, and historical cost. Most mutual fund families use the net asset value of an investor's holdings to determine whether a breakpoint discount is available. Some fund families, however, permit an investor's holdings to be valued using the public offering price, which is determined by adding the maximum front-end sales load charged to the net asset value. In addition, some fund families permit holdings to be valued based on the greater of market value (net asset value or public offering price) and historical cost, which is what the investor actually paid for a mutual fund at the time of purchase.

A mutual fund that offers breakpoint discounts must disclose its schedule of breakpoints in its prospectus.<sup>5</sup> A fund must disclose its aggregation rules for determining breakpoints, such as letters of intent and rights of accumulation, in either its prospectus or statement of additional information ("SAI").<sup>6</sup>

In late 2002, the staffs of the Commission and the NASD identified concerns regarding the extent to which mutual fund investors were receiving breakpoint discounts, which were first uncovered by NASD's routine examination program. As a result, the Commission and NASD launched a multifaceted action plan to address these concerns.<sup>7</sup> First, broker-dealers

were required to review the adequacy of their policies and procedures in this area, make necessary changes, and report information concerning their mutual fund businesses. Second, the Commission and NASD, along with the New York Stock Exchange ("NYSE"), initiated an examination sweep of 43 broker-dealers that sell front-end sales load mutual funds to evaluate whether samples of transactions received the sales load discounts offered by the fund. Third, NASD, the Securities Industry Association ("SIA"), and the Investment Company Institute ("ICI") formed a task force to recommend ways in which the mutual fund and broker-dealer industries could prevent breakpoint problems in the future.

The Commission, NASD, and NYSE conducted their examination sweep of broker-dealers between November 2002 and January 2003. The examination revealed that most firms, in some instances, did not provide investors with breakpoint discounts for which they appeared to have been eligible.<sup>8</sup> Of the more than 9,000 transactions reviewed, examiners identified 5,515 transactions that appeared to be eligible for a reduced sales charge. Of these 5,515 transactions, examiners found 1,757 transactions that did not receive a breakpoint discount or appeared to have incurred other unnecessary sales charges (representing 20% of all the transactions reviewed, and 32% of the transactions that were eligible for a discount). For these 1,757 transactions, the average discount not provided was \$364 per transaction. The most frequent causes for not providing a breakpoint discount involved problems with rights of accumulation, including not linking a customer's ownership of different funds in the same mutual fund family, not linking shares owned in a fund or fund family in all of a customer's accounts at the firm, and not linking shares owned in the same fund or fund family by persons related to the customer (e.g., spouse, children) in accounts at the firm.<sup>9</sup>

The NASD formed the Joint NASD/ Industry Task Force on Breakpoints together with the SIA and ICI in February 2003, to recommend ways in which the mutual fund and brokerage industries can assure that investors are not overcharged when they purchase

funds with front-end sales loads.<sup>10</sup> The Task Force issued its report in July 2003.<sup>11</sup> Consistent with the findings of the joint examination sweep of broker-dealers, the Task Force reported that many of the significant challenges in applying breakpoints correctly were with respect to rights of accumulation. The Task Force explained that to deliver breakpoint discounts based on rights of accumulation, the parties involved with the transaction must be able to link the accounts containing shares eligible to be aggregated and to ascertain the value of the accounts in order to determine whether a shareholder has met sales load breakpoints. The Task Force identified particular challenges to delivering breakpoints based on investors' rights of accumulation. First, broker-dealers have experienced difficulty in accessing and understanding the terms upon which mutual funds allow investors to aggregate both their holdings and those of related parties to reach breakpoints. Second, broker-dealers and mutual funds must communicate to investors the terms concerning rights of accumulation, and broker-dealers must obtain from investors necessary information regarding accounts eligible to be linked and, if applicable, historical costs.<sup>12</sup>

To address the challenges in providing correct breakpoint discounts to investors, the Task Force provided 13 recommendations, including: That mutual fund companies take steps to make investors aware of the availability of breakpoint discounts; that broker-dealers adopt policies and practices to gather the appropriate information from investors so that they can take advantage of all available breakpoint discounts; that transfer agents and broker-dealers modify the systems used to execute mutual fund transactions; and that regulators and the mutual fund and securities industries continue to educate investors about breakpoint opportunities. Two of the recommendations called for Commission rules that would require a fund to disclose certain information regarding breakpoints in its prospectus

<sup>5</sup> Item 8(a)(1) of Form N-1A. Rule 22d-1 under the Investment Company Act (17 CFR 270.22d-1) permits a mutual fund to sell shares at prices reflecting scheduled breakpoints if it meets certain requirements, such as furnishing to existing shareholders and prospective investors the information regarding breakpoints required by applicable registration statement form requirements.

<sup>6</sup> Items 8(a)(2) and 18(a) of Form N-1A. The SAI is part of a fund's registration statement and contains information about a fund in addition to that contained in the prospectus. The SAI is required to be delivered to investors upon request and is available on the Commission's Electronic Data Gathering, Analysis, and Retrieval System.

<sup>7</sup> *SEC and NASD Action Plan on Mutual Fund Sales Load Charges*, Securities and Exchange Commission Press Release, Jan. 16, 2003, <http://www.sec.gov/news/press/2003-7.htm>.

<sup>8</sup> Securities and Exchange Commission *et al.*, Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds 14-15 (Mar. 2003) (hereinafter Joint Report), available at <http://www.sec.gov/spotlight/breakpoints.htm>.

<sup>9</sup> *Id.* at 1-2, 14-17.

<sup>10</sup> *NASD Announces Joint NASD/Industry Breakpoint Task Force*, NASD News Release, Feb. 18, 2003, [http://www.nasdr.com/news/pr2003/release\\_03\\_006.html](http://www.nasdr.com/news/pr2003/release_03_006.html).

<sup>11</sup> *Joint NASD/Industry Breakpoint Task Force Issues Report*, NASD News Release, July 22, 2003, [http://www.nasdr.com/news/pr2003/release\\_03\\_030.html](http://www.nasdr.com/news/pr2003/release_03_030.html).

<sup>12</sup> NASD *et al.*, Report of the Joint NASD/Industry Task Force on Breakpoints 5 (July 2003) (hereinafter Task Force Report), available at [http://www.nasdr.com/pdf-text/breakpoints\\_report.pdf](http://www.nasdr.com/pdf-text/breakpoints_report.pdf).