Regulatory Notice 21-07

Investment Company Products

FINRA Provides Guidance on Common Sales Charge Discounts and Waivers for Investment Company Products

Summary

Many investment companies provide sales charge discounts and waivers on their products for customers in certain circumstances described in their product offering documents (*e.g.*, prospectuses or statements of additional information). These include volume-based discounts, such as breakpoints and waivers, on mutual fund exchanges. Failure to apply these discounts or waivers correctly may adversely affect customers' rates of return on their investment and contravenes firms' obligations under FINRA rules.

FINRA has focused on firms' systems and controls to provide customers with appropriate discounts for many years. Recently, FINRA announced a targeted examination related to Rights of Reinstatement.[1] In 2015 and 2016, FINRA identified sales charge discounts and waivers as priorities in the Regulatory and Examination Priorities Letter.[2] In addition, FINRA has taken a number of enforcement actions against firms that did not provide available sales charge discounts and waivers to customers that met certain thresholds,[3] and FINRA continues to find situations where firms fail to (1) identify and apply relevant sales charge discounts or waivers; and (2) establish, maintain or enforce supervisory systems and written supervisory procedures (WSPs) reasonably designed to identify accounts that would be eligible for such discounts or waivers.

FINRA is issuing this *Notice* to:

- remind firms of their obligation to understand and, as appropriate, apply sales charge discounts and waivers for eligible customers;
- provide an overview of common sales charge discounts and waivers;
- share frequently observed findings in examinations and enforcement matters; and
- note considerations firms should review to improve their compliance programs.

This *Notice* does not create new legal or regulatory requirements or new interpretations of existing requirements. FINRA recognizes that there is no one-size-fits all approach to compliance. Firms of different sizes and business

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Notice Type
- Guidance

Suggested Routing
- Accounting
- Compliance
- Legal
- Operations
- Retail
- Senior Management

Key Topics
- 529 Plans
- Breakpoints
- Customer Refunds
- Mutual Funds
- Non-Traded Business Development Corporations
- Non-Traded Real Estate Investment Trusts
- Unit Investment Trusts

Referenced Rules & Notices
- Notice to Members 02-85
- Notice to Members 04-26

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models employ a variety of approaches reasonably designed to achieve compliance with relevant regulatory obligations. These practices are often tailored to a firm's unique circumstances, and FINRA does not attempt to capture all such practices in this *Notice*. Therefore, there should be no inference that FINRA requires firms to implement any specific practices described in this *Notice* or other approaches that extend beyond the requirements of existing securities laws, rules and regulations.

Questions or comments regarding this *Notice* may be directed to:

- Emilio Mahia, Examination Manager, Member Supervision, at (504) 412-2431 or *emilio.mahia@finra.org*; or
- Steven Polansky, Senior Director, Member Supervision, at (202) 728-8331 or *steven.polansky@finra.org*.

Background and Discussion

This *Notice* discusses some common sales charge discounts and waivers that mutual funds, 529 plans, non-traded Real Estate Investment Trusts (non-traded REITs) and non-traded Business Development Corporations (non-traded BDCs) (collectively, "relevant products") may offer customers.[4] The specific sales charge discounts and waivers investment companies make available to customers are described in each relevant product's offering documents.

Volume-Based Sales Charge Discounts

The most common discounts available across the relevant products are volume-based discounts, often referred to as "breakpoints" for mutual funds and 529 plans, and "volume discounts" for non-traded REITs and non-traded BDCs.[5] Depending on the product, customers may be eligible for a reduced front-end sales charge when their purchase exceeds certain volume levels.

Each mutual fund and 529 plan can, in accordance with applicable law and disclosure requirements, set their breakpoint terms across the fund family or vary them from fund to fund. The initial threshold to receive a volume discount for a non-traded REIT or non-traded BDC is generally between $150,000 and $500,000, *i.e.,* substantially higher than for a mutual fund.

Customers also may be eligible to receive other volume-based discounts when their purchases are aggregated through Rights of Accumulation (ROA), Letters of Intent (LOI), and householding and family discounts, which are described further in Appendix I.

Sales Charge Waivers

In addition to volume-based discounts, investment companies and 529 plans may offer specified sales charge waivers, such as for mutual fund exchanges, rights of reinstatement (RoR), net asset value transfers (NAV Transfers), or purchases by retirement accounts and charities, which are described further in Appendix II.

Table 1, below, summarizes these discounts and fee waivers for illustrative purposes only; It does not provide a comprehensive description of all types of discounts or sales charge waivers that may be available for the relevant products, nor do the sales charge discounts and waivers described necessarily apply to every fund within a product type.

Table 1: Sales Charge Discounts and Waivers (by Product Type)

PRODUCT TYPE	SALES CHARGE DISCOUNTS
Mutual Funds 529 Plans	Breakpoints Rights of Accumulation (ROAs) Letters of Intent (LOIs) Householding Discounts Family Discounts
Non-Traded REITs Non-Traded BDCs	Volume Discounts Household-based Discounts

PRODUCT TYPE	SALES CHARGE WAIVERS
Mutual Funds	Exchanges Rights of Reinstatement (RoR) Net Asset Value (NAV) Transfers Sales Charge Waivers for Retirement Accounts and Charities
529 Plans	RoR[6] Sales Charge Waivers

Common Findings

In examinations and enforcement actions, FINRA identified certain core themes in findings in firms' sales charge discounts and waivers.

Inadequate Supervisory Systems and WSPs

Firms failed to establish or maintain systems, controls and WSPs reasonably designed to identify customers eligible to receive discounts or sales charge waivers for relevant products. Some examples include:

- **Prospectus Discounts** – Firms failed to identify applicable volume discounts or sales charge waivers listed in fund prospectuses for eligible customers.
- **Surveillance Controls** – Firms failed to adopt adequate controls (*e.g.,* exception reports) to detect instances where they did not provide volume discounts or sales charge waivers to eligible customers.
- **Alert Thresholds** – Firms used a single threshold in their surveillance systems without considering variability among funds or fund families, such as using:
  - a single or limited set of breakpoint thresholds that did not reflect the specific thresholds for each of the mutual funds the firm offered; or
  - a single period (typically 90 days) to identify customer eligibility for an RoR even though some products the firm offered had much longer RoR periods, such as 180 or 270 days.

SUITABILITY CONCERNS

Notably, some firms that did not maintain sufficient controls for sales charge discounts or waivers also failed to surveil registered representatives' recommendations for mutual fund or other investment company products to confirm that they complied with relevant suitability obligations.

Relying on Associated Persons to Identify Discount and Sales Charge Waiver Opportunities

Firms relied on their associated persons to identify and apply available sales charge discounts and waivers, but failed to provide adequate guidelines, instructions or policies for those associated persons and their supervisors. In addition, firms failed to adequately notify and train their associated persons regarding the availability of volume discounts or sales charge waivers for eligible products and customers.

Insufficient Supervision of Associated Persons' Direct Business

In instances where firms permitted their associated persons to sell mutual funds and the customers' accounts are held directly with the funds' transfer agents, FINRA observed that the problems discussed earlier were often compounded, typically because firms lacked systems that were reasonably designed to capture relevant data to supervise direct business transactions.[7] FINRA found, for example, that:

- **Data Entry** – Associated persons did not enter data, did not enter data in a timely manner or did so incorrectly;
- **Data Entry Verification** – Firms did not have systems and processes to detect the data entry problems noted above;
- **Transaction Blotters** – Firms did not capture on their transaction blotters information necessary to identify customers who were eligible to receive discounts or fee waivers;
- **Incomplete Information** – Firms did not capture information about other holdings (*e.g.,* customer mutual fund shares held at a different firm or family members' holdings) that could affect the customer's eligibility to receive a discount or fee waiver; and
- **Surveillance** – Firms did not conduct surveillance for situations where customers did not receive discounts or fee waivers even though they were eligible for them.

COMMON METHODS OF DIRECT BUSINESS TRANSACTIONS

Application Way or "Check and App" – Associated persons complete paper account forms; customers sign the forms, write a check and then send the application and payment to the investment company for processing.

Wire Transfer – Associated persons use firm systems (or, for introducing firms, clearing firm systems) to send customer funds electronically to the investment company.

Questions for Consideration

The following questions may assist firms evaluate the adequacy of their supervisory systems, WSPs and training programs for sales charge discounts and waivers, as appropriate for their size and supervisory structure.

WSPs

- **Discounts/Fee Waiver Coverage** – Do your firm's WSPs address all sales charge discounts and waivers that customers may be eligible to receive for relevant products?
- **Multiple Discounts** – Do your firm's WSPs address situations where a customer may be eligible for multiple types of discounts and apply the largest discount available?
- **Data and Analysis** – How does your firm collect, maintain and analyze data to identify and provide sales charge discounts or waivers that a customer may be eligible to receive? These sales charge discounts and waivers include, but are not limited to:
    - **Product Discounts** – Individual customer holdings at the point of initial purchase, as well as subsequent purchase transactions;
    - **Account Discounts** – Across a single brokerage account, across multiple brokerage accounts, across account types (*e.g.,* joint or retirement accounts) and in accounts held away from your firm;
    - **Householding Discounts** – Across a household, including across accounts as discussed above;
    - **Fund Family** – Within a fund or provider family and across accounts and households as noted above; and
    - **On- and Off-Platform Transactions** – Where transactions may be processed through multiple channels (*e.g.,* by the mutual fund company itself or a clearing firm).

Investor Eligibility

- **Tracking Eligibility** – How does your firm track customers' eligibility for rollover waivers, rollover share classes or RoR sales charge waivers (or their equivalent) for 529 plans or NAV Transfer or RoR sales charge waivers for mutual funds?
    - **Relevant Time Periods** – Does your firm's mechanism for tracking sales charge discount or waiver eligibility consider the range of different time periods that may be relevant?

- **Determining Whether to Offer Certain Waivers** – How does your firm determine and document whether to offer certain sales charge waivers when offering documents state that firms may determine whether to offer certain waivers (*e.g.*, rollovers from qualified 529 plans)?
  - **Controls** – If your firm decides to offer these waivers, does it have controls that are reasonably designed to determine whether they are applied to each eligible transaction?
- **Disclosure** – Has your firm clearly disclosed to customers if it does not provide an available rollover share class or sales charge waivers?

Training and Education

- **Training for Associated Persons** – What steps does your firm take to educate associated persons about waivers and discounts? Consider if your firm educates associated persons about the following:
  - **Availability** – the availability of sales charge discounts and waivers for the relevant products;
  - **Transaction Execution** – the steps associated persons should take to execute transactions in the relevant products, so that customers receive correct discounts or sales charge waivers, including in the context of direct business transactions;
  - **Customer Discussions** – how to inform customers about sales charge discounts and waivers; and
  - **Firm Notifications** – how to inform your firm about eligible assets a customer holds in external accounts that may affect the customer's eligibility for sales charge discounts or waivers.
- **Resources for Associated Persons** – What information and tools are available to associated persons to make such determinations?
  - **Efficacy** – Are the tools and information sufficiently robust to identify and provide customers with the sales charge discounts and waivers to which they are entitled given the scale of an associated person's book of business and the potential complexity of the calculations required?
- **Training for Supervisors** – Does your firm provide training or other guidance to supervisors on the steps they should take to identify and address missed sales charge discounts and waivers?

Documentation

- **Recordkeeping** – What records does your firm create and maintain to document that customers received the appropriate sales charge discounts and waivers for the relevant products?
- **Compliance with Recordkeeping Requirements** – How does your firm confirm that it complies with recordkeeping requirements for such records?

Automated Tools and Exception Reports

- **Automated Tools** – Consider the following if your firm uses an automated system to calculate sales charge discounts and waivers:
  - **Ownership** – Which departments are responsible for developing and updating the relevant automated systems?
  - **Identifying Discounts** – Which department is responsible for identifying sales charge discounts and waivers in prospectus materials, including for new products?
  - **Capturing Customer Information** – Which department is responsible for developing the forms and processes your firm uses to capture customer information used to determine customer eligibility for sales charge discounts or waivers?
  - **Determining Discount Scenarios** – Which department captures all relevant sales charge discount and waiver scenarios for the alert system? Does the department have access to relevant data? Does the department have expertise in the relevant products' sales charge discount and waiver structures and transaction processing methods?
  - **Programming System** – Which department incorporates information about sales charge discounts and charge waivers into your firm's systems?
  - **Cross-Department Communication** – Do your firm's WSPs document the responsibilities, cross-departmental communications and processes noted above?
  - **Systems Updates** – How does your firm update its systems when an investment company makes changes to the sales charge discounts and waivers offered?
- **Exception Reporting** – Does your firm provide supervisors with exception reports identifying situations where customers may not be receiving sales charge discounts or waivers for which they are eligible?
  - **Scope of Report** – Does the exception report capture all of the sales charge discounts and waivers that are available as part of your firm's business and the relevant products?

  - **Thresholds** – Are the exception report thresholds tailored to the specific discount thresholds identified in relevant product prospectuses?
  - **Excluded Transactions** – Does your firm use any thresholds to exclude transactions from review? Are those thresholds reasonable in light of your firm's business?
  - **Householding Discounts** – How does your firm apply householding parameters when identifying accounts and transactions eligible for discounts? Is this application consistent with the eligibility description in the prospectus or other offering materials for the relevant products?
  - **Systemic Problems** – How does your firm determine whether failures to provide sales charge discounts or waivers in one or more individual instances may indicate a larger, systemic problem for your firm? If so, how does your firm address such problems?

Addressing Missed Sales Charge Discounts or Waivers

- **Remediation** – How does your firm address situations where customers did not receive sales charge discounts or waivers for which they are eligible?
  - **Restitution** – Which department is responsible for calculating any restitution that should be paid to customers? How would these calculations be performed? How would the customer be notified of the restitution?
  - **Disciplinary Measures** – What disciplinary measures, if any, would your firm impose on associated persons who did not correctly identify, calculate and apply sales charge discounts or waivers?

Direct Business Transactions

- **Policies and Procedures** – If your firm permits associated persons to engage in direct business, what are your firm's policies and procedures that govern this business, including with respect to associated persons opening accounts for customers and the execution of transactions the associated person recommends in such accounts?
- **Surveillance** – Do your firm's supervisory systems or mechanisms receive the data necessary to monitor direct business conducted by its associated persons?
  - **Review Customer Accounts for Accuracy** – How do your firm's controls account for the actions of associated persons that could interfere with customers receiving discounts or sales charge waivers, *e.g.,* failure to input relevant information in a firm's systems accurately and in a timely manner?

- **Transaction or Trade Blotters** – How does your firm confirm that all purchases and sales of the relevant products facilitated or effected by your firm's registered representatives appear on the transaction or trade blotters?
  - **Required Information** – Do your firm's transaction or trade blotters record the information required by Securities Exchange Act of 1934 Rule 17a-3(1), including:
    - customer name or designation (*i.e.,* number, symbol);
    - fund name;
    - account number;
    - transaction date;
    - purchase or sale identifier;
    - total amount of transaction;
    - number of shares/units; and
    - price per share/unit.
  - **Recommended Information** – Has your firm considered capturing the following additional information on its blotters:
    - registered representative identifier;
    - branch identifier;
    - share class;
    - solicited or unsolicited identifier;
    - identifier if purchase was for new or existing account; and
    - NAV price.

APPENDIX I – Sales Charge Discounts

This table is an example of possible breakpoints for a Class A mutual fund, and is used to help illustrate the definitions below:

INVESTMENT AMOUNT	FRONT-END SALES CHARGE
Less than $25,000	5%
$25,000 - $49,999	4.25%
$50,000 - $99,999	3.75%
$100,000 - $249,999	3.25%
$250,000 - $499,999	2.75%
$500,000 - $999,999	2%
$1,000,000 or greater	0%

Rights of Accumulation (ROAs)	Example
ROAs provide discounts on the front-end sales charge or other sales charges of mutual funds and 529 plans[8] by aggregating new purchases of shares with the customers' existing holdings to reach a volume discount threshold. The ROA reduces the sales charge to incremental new purchases, but not any prior transactions.	An investor who had already purchased $20,000 of a mutual fund's shares and purchases an additional $35,000 in the same fund would reach the $50,000 breakpoint, and thus be entitled to a 3.75 percent sales charge on this purchase, instead of the 5 percent sales charge the customer paid on the original purchase.
Letter of Intent (LOI)	**Example**
An LOI provides discounts when a customer commits to purchase a specific dollar volume of shares, typically over a 13-month period. An LOI offers the same sales charge discount on each incremental purchase.	If a customer agrees to purchase $130,000 of mutual fund shares and spreads that investment equally over 13 months, the customer would pay a 3.25 percent sales charge for each incremental $10,000 purchase.
Householding/Household-based Discounts	**Example**
Some fund families provide discounts on sales charges for aggregate shareholdings across (1) several types of accounts for each person (*e.g.*, Individual, Trust, Joint, Retirement), including accounts at other firms; or (2) accounts held by close family members, such as a spouse or child.	If the spouse of a customer owns $110,000 of a mutual fund, the customer may be able to purchase an additional $45,000 in the same fund with a 3.25 percent, rather than a 4.25 percent, front-end sales charge because the value of their accounts exceeds the $100,000 breakpoint.
Family Discounts	**Example**
Other fund families also aggregate shareholdings for breakpoint, ROA or LOI purposes by counting purchases made in other funds from the same fund family.	If a customer owns $200,000 of Fund 1 shares from Fund Family A and subsequently purchases an additional $100,000 of Fund 2 shares from Fund Family A, that customer will pay a front-end sales charge of 2.75 percent on the Fund 2 purchase because it exceeds the $250,000 threshold across both funds.

APPENDIX II – Sales Charge Waivers

Mutual Fund Exchanges
Mutual funds typically allow investors to sell shares in one fund and purchase shares in another fund in the same fund family on the same date without incurring sales charges.

Rights of Reinstatement
A fund family may allow customers to redeem or sell shares in a fund and reinvest some or all of the proceeds without paying a sales charge or recoup some or all of a contingent deferred sales charge (CDSC). Generally, in order to be eligible for a RoR: • The reinvestment must be made within a specified period of time (*e.g.*, 90 days, although time periods may vary substantially across fund families); • The redemption and reinvestment must take place in the same account; • The redeemed shares must have been subject to a front-end or deferred sales charge; and • The redemption and reinvestment must comply with any other terms and conditions required by certain investment companies (*e.g.*, reinvestments must be made in the share class of the redeemed fund).[9]

NAV Transfers
Some fund families allow customers to purchase class A shares without paying the front-end sales charge if the customer purchases such shares using proceeds from the sale of shares in a different mutual fund family for which the investor paid a front-end or back-end sales charge; these transactions are sometimes referred to as "NAV transfers." Most fund families that allow for such waivers require the customer to invest the proceeds from the sale within 30 to 90 days.

Waivers for Retirement Accounts and Charities
Some fund families waive the front-end sales charges associated with Class A shares for certain retirement plans and charitable organizations.

Waivers for 529 Plans
529 plans offer sales charge waivers in a variety of specific situations, such as: • Existing account owners currently investing in charge-waived A shares; • Group 529 plans; • Plans purchased through an investment adviser; • Certain customers approved for discount by the program manager or broker-dealer; • Rollovers from qualified 529 plans;[10] or • Special share classes.

APPENDIX III – Additional Resources

Through the years, FINRA has provided guidance and made tools available to firms to help them address sales charge discounts and waivers in relevant investment company transactions. Although much of this material is older, it is still relevant for firms, and FINRA includes it here for reference purposes:

- FINRA Breakpoint Topic Page and Breakpoint Checklist and Worksheet, which includes relevant Enforcement actions;
- FINRA Mutual Fund Analyzer;
- the 2015 and 2016 *Regulatory and Examination Priorities Letters*, which identified sales charge discounts and waivers as a priority;
- the joint NASD/Industry Task Force Report on Breakpoints published in 2003; and
- guidance in *Notice to Members 02-85* (NASD Requires Immediate Member Firm Action Regarding Mutual Fund Purchases and Breakpoint Schedules) and *04-26* (NASD Reminds Members of Their Duty to Ensure Proper Application of Discounts in Sales Charges to Sales of Unit Investment Trusts (UITs).

Endnotes

1. On November 11, 2020, FINRA announced a review of firms' systems and procedures for providing customers waivers and rebates available through Rights of Reinstatement (RoR) on mutual fund purchases. *See* Targeted Examination Letter on Rights of Reinstatement (RoR).
2. *See* 2015 and 2016 letters.
3. Examples of FINRA enforcement actions related to missed sales charge discounts or waivers include:
   - FINRA Sanctions Transamerica Financial Advisors, Inc. $8.8 Million for Supervisory Violations Related to Variable Annuities, Mutual Funds and 529 Plans;
   - FINRA Orders Merrill Lynch, Pierce, Fenner & Smith Inc. to Pay $7.2 Million in Restitution to Customers Overcharged for Mutual Funds;
   - FINRA Announces Final Results of Mutual Fund Waiver Initiative;
   - FINRA Orders an Additional Five Firms to Pay $18 Million in Restitution to Charities and Retirement Accounts Overcharged for Mutual Funds;
   - FINRA Sanctions 12 Firms a Total of $6.7 Million for Failing to Apply Sales Charge Discounts to Customers' Purchases of UITs; and
   - FINRA Orders Wells Fargo, Raymond James, and LPL Financial to Pay More Than $30 Million in Restitution to Retirement Accounts and Charities Overcharged for Mutual Funds.
4. Recommendations of a particular share class—*e.g.,* a mutual fund class A share vs. a class C share—can have a significant impact on customers' rates of return. Because they have varying fees and expenses, share classes should be recommended based on material information about the investor (*e.g.,* anticipated investment amount, time horizon). *See* Understanding Mutual Fund Classes.
5. In the past, Unit Investment Trusts also offered breakpoints; however, many UIT sponsors recently simplified their sales charge structures by eliminating breakpoints and instead providing a reduced sales charge on purchases, regardless of purchase volume.
6. Although 529 plans may offer such waivers, they may not be termed "Rights of Reinstatement."
7. The term "direct" has a different meaning in the context of 529 plans. Investors can purchase direct-sold 529 plans from the fund sponsor, without the involvement of a firm or registered representative.
8. For certain 529 plans, funds can be aggregated based upon the higher of either the amount invested, or the current value of existing holdings.
9. On November 11, 2020, FINRA announced a review of firms' systems and procedures for providing customers waivers and rebates available through Rights of Reinstatement (RoR) on mutual fund purchases. *See* Targeted Examination Letter on Rights of Reinstatement (RoR).
10. Some 529 product sponsors offer initial sales charge waivers to investors who hold Class A shares but decide to roll them over into another state's 529 plan. Some sponsors may also offer rollovers into Class AR shares, which are meant specifically for 529 plan rollovers and convert to Class A shares after a predefined length of time (*e.g.,* one year). Firms that sell these plans are not obligated to offer these types of qualified rollovers; however, firms that opt in must establish reasonably designed procedures to provide that the waivers are applied to each eligible transaction.

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