

MEMO# 17726

June 30, 2004

NASD FINES FIVE BROKERAGE FIRMS FOR FAILING TO MAINTAIN SUPERVISORY SYSTEMS TO PREVENT LATE TRADING OF FUND SHARES

[17726] June 30, 2004 TO: COMPLIANCE ADVISORY COMMITTEE No. 67-04 SEC RULES MEMBERS No. 94-04 SMALL FUNDS MEMBERS No. 74-04 RE: NASD FINES FIVE BROKERAGE FIRMS FOR FAILING TO MAINTAIN SUPERVISORY SYSTEMS TO PREVENT LATE TRADING OF FUND SHARES The NASD has announced the settlement of charges against five registered broker-dealers for failing to establish and maintain adequate supervisory systems and written procedures reasonably designed to detect and prevent late trading of mutual fund shares.¹ The settlements, which are attached, are briefly summarized below. According to the NASD, the deficiencies identified in each firm's supervisory system and written procedures were in violation of NASD Conduct Rules 3010 and 2110.² Collectively, those deficiencies include the following:

- Failure to instruct registered representatives that late trading of mutual fund shares is prohibited and/or that only orders received prior to the market close are entitled to receive the current day's net asset value ("NAV").

¹ See NASD Fines Five Firms \$625,000 for Supervisory System Failures Relating to Late Trading of Mutual Funds (press release issued by NASD, June 24, 2004), available at http://www.nasdr.com/news/pr2004/release_04_043.html. The press release identifies the five firms: D.A. Davidson & Co. ("Davidson"); TD Waterhouse Investor Services, Inc.; Stifel Nicolaus & Company; National Planning Corp.; and SII Investments, Inc. The NASD also found that Davidson violated Section 17(a) of the Securities Exchange Act of 1934, Exchange Act Rules 17a-3(a)(6) and 17a-4(b)(1), and NASD Conduct Rules 3110 and 2110 by failing to preserve certain mutual fund trading records for three years and by failing to comply with a new recordkeeping rule that requires broker-dealers to record the time of receipt of orders to buy or sell mutual fund shares.

² Rule 3010(a) generally requires each NASD member to establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations and with NASD rules. Rule 3010(b) generally requires each NASD member to establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives and associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD rules. Rule 2110 requires each NASD member, in the conduct of its business, to observe high standards of commercial honor and just and equitable principles of trade.

- No procedures regarding the time that mutual fund orders could be placed into

the firm's order entry system, although each firm's system permitted registered representatives to enter fund orders after the close of the market and still receive the current day's NAV. • Failure to require that registered representatives enter mutual fund orders promptly after their receipt. • No procedures to require supervisory review or approval of mutual fund orders submitted after the market close. • No surveillance or auditing efforts to ensure that trades entered after the close of the market were not executed or processed at the current day's NAV. • No procedures requiring managers to confirm that a mutual fund order had been received prior to the market close, where the firm permitted its registered representatives, with managerial approval, to process orders after the market close in order to address trade errors and systems problems. • No procedures to prohibit error-free orders from being cancelled or modified after the 4:00 p.m. market close. • Failure to detect and correct a programming error in the firm's automatic retail order entry systems, which resulted in the processing of mutual fund orders received during the 59-second period after the market close at the current day's NAV. In four of the five settlements, the NASD noted that, according to the available evidence, a small percentage of the mutual fund orders processed by the broker-dealer at the current day's NAV were received after the market close. In settling with the NASD, the broker-dealers neither admitted nor denied the NASD's allegations or findings. Each firm consented to the imposition of a censure and a fine, which range in size from \$100,000 to \$150,000. Rachel H. Graham Assistant Counsel Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (<http://members.ici.org>) and search for memo 17726, or call the ICI Library at (202) 326-8304 and request the attachment for memo 17726. Attachment (in .pdf format)

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