

**MEMO# 18273**

November 30, 2004

# **INSTITUTE COMMENT LETTER ON NASD PROPOSAL TO BAN DIRECTED BROKERAGE**

[18273] November 30, 2004 TO: CHIEF COMPLIANCE OFFICER COMMITTEE No. 31-04 COMPLIANCE ADVISORY COMMITTEE No. 116-04 SEC RULES MEMBERS No. 168-04 SMALL FUNDS MEMBERS No. 125-04 RE: INSTITUTE COMMENT LETTER ON NASD PROPOSAL TO BAN DIRECTED BROKERAGE The Securities and Exchange Commission recently published for comment an NASD proposal to prohibit the practice of broker-dealers receiving mutual fund brokerage commissions as compensation for the sale of fund shares.<sup>1</sup> The Institute filed the attached comment letter with the Commission on the proposal. Both the proposal and the comment letter are briefly summarized below. I. NASD PROPOSAL Currently, NASD Conduct Rule 2830(k) prohibits broker-dealers from conditioning their efforts in distributing a fund's shares on receipt of the fund's brokerage commissions. An exception in the rule, however, allows a broker-dealer to sell shares of any fund that follows a policy, disclosed in its prospectus, of considering sales of its shares as a factor in the selection of broker-dealers to execute portfolio transactions, subject to the requirements of best execution. The NASD proposal would eliminate this exception due to concerns that the exception undermines the rule's general prohibition against quid pro quo arrangements in which brokerage commissions are used to compensate broker-dealers for selling fund shares. The proposal also would add a provision to Rule 2830(k) prohibiting any NASD member from selling a fund's shares if the member knows or has reason to know that the fund (or its adviser or principal underwriter) has entered into any agreement or understanding under which the fund is expected to direct its portfolio transactions (or commissions or markups from such transactions) to a broker or dealer in consideration for promotion or sale of the fund's shares. <sup>1</sup> See Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Investment Company Portfolio Transactions, 69 Fed. Reg. 64609 (Nov. 5, 2004), available on the SEC's website at <http://www.sec.gov/rules/sro/nasd/34-50611.pdf>. <sup>2</sup> II. INSTITUTE COMMENT LETTER The Institute's comment letter expresses support for the NASD proposal. It states that the proposal is consistent with a December 2003 recommendation by the Institute to prohibit directed brokerage arrangements. The letter observes that adoption of the NASD proposal would complement the SEC's recent amendment to Rule 12b-1 under the Investment Company Act, which prevents funds from paying for the distribution of their shares with brokerage commissions.<sup>2</sup> Finally, the letter expresses support for the NASD's decision to retain language in Rule 2830(k) clarifying that a broker-dealer would not violate the rule solely because it promotes or sells shares of a fund that directs portfolio transactions to the broker-dealer. Rachel H. Graham Assistant Counsel Attachment (in .pdf format) 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 18273, or call the ICI Library at (202) 326-8304 and request the attachment for memo 18273. 2 See Institute Memorandum to Chief Compliance Officer Committee No. 5-04, Compliance Advisory Committee No. 87-04, SEC Rules Members No. 127-04 and Small Funds Members No. 98-04 [17957], dated Sept. 8, 2004.

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