

MEMO# 18592

February 28, 2005

NASD SETTLES WITH BROKER-DEALERS RELATING TO DIRECTED BROKERAGE; FAILURE TO HAVE SUPERVISORY SYSTEMS TO PREVENT LATE TRADING

[18592] February 28, 2005 TO: BROKER/DEALER ADVISORY COMMITTEE No. 5-05
BROKER/DEALER ASSOCIATE MEMBERS No. 2-05 CHIEF COMPLIANCE OFFICER COMMITTEE
No. 20-05 COMPLIANCE ADVISORY COMMITTEE No. 18-05 SEC RULES MEMBERS No. 33-05
SMALL FUNDS MEMBERS No. 20-05 RE: NASD SETTLES WITH BROKER-DEALERS RELATING
TO DIRECTED BROKERAGE; FAILURE TO HAVE SUPERVISORY SYSTEMS TO PREVENT LATE
TRADING The NASD has announced the settlement of charges against two registered
broker- dealers ("Broker-Dealer One" and "Broker-Dealer Two") 1 relating to directed
brokerage arrangements. The NASD has also settled with a broker-dealer ("Broker-Dealer
Three")2 for failing to establish and maintain a supervisory system and written procedures
reasonably designed to prevent late trading in mutual fund shares (collectively,
"Respondents"). In settling each of the matters, the Respondents neither admitted nor
denied the NASD's allegations or findings. The settlements, which are attached, are briefly
described below. Directed Brokerage Actions Broker-Dealer One The NASD found that from
January 2001 through December 2003, Broker-Dealer One maintained a "preferred partner"
or "shelf space" program in which participating mutual fund complexes paid a fee in return
for preferential treatment that included: (1) enhanced access to Broker-Dealer One's sales
force, (2) placement of sales material on Broker-Dealer One's internal website; and (3) the
sale of the funds' shares by Broker-Dealer One's sales force on a broader basis than was
available for other funds. The NASD also found that two of the fund complexes 1 See NASD
Fines Quick & Reilly, Piper Jaffray \$845,000 for Directed Brokerage Violations (press release
issued by NASD, Feb. 22, 2005), available at
[http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013402
&ssSourceNodeid=1177](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013402&ssSourceNodeid=1177); In re Quick & Reilly, NASD Letter of Acceptance, Waiver and
Consent, No. CAF040118 (Feb. 2005) ("Broker- Dealer One") and In re Piper Jaffray & Co.,
NASD Letter of Acceptance, Waiver and Consent, No. CE3050002 (Feb. 2005) ("Broker-
Dealer Two"). 2 See In re Burnham Securities Inc., NASD Letter of Acceptance, Waiver and
Consent, No. C10040127 (Dec. 2004) ("Broker-Dealer Three"). 2 paid their fees for
participating in the program by directing over \$1.9 million in brokerage commissions to
Broker-Dealer One. According to the NASD, Broker-Dealer One violated applicable NASD
rules by receiving brokerage commissions to pay for the fund complexes' participation in
the partner program. Broker-Dealer One agreed to a censure and a \$570,000 fine. Broker-
Dealer Two The NASD found that from 1998 to 2003, Broker-Dealer Two maintained a
"preferred partner" program in which participating mutual fund complexes paid a fee in

return for preferential treatment that included: (1) enhanced access to Broker-Dealer Two's sales force; (2) placement of sales material on Broker-Dealer Two's internal website; and (3) the promotion of the funds' shares by Broker-Dealer Two on a broader basis than was available for other funds. The NASD further found that three of the fund complexes paid their fees for participating in the program, in part, by directing brokerage commissions to Broker-Dealer Two. According to the NASD, Broker-Dealer Two violated applicable NASD rules by receiving brokerage commissions to pay for the fund complexes' participation in the partner program. Broker-Dealer Two agreed to a censure and a \$275,000 fine. Late Trading Supervision Action The NASD found that from February 2002 through August 2003, Broker-Dealer Three failed to establish and maintain a supervisory system and written procedures reasonably designed to detect and prevent late trading in mutual fund shares. According to the NASD, Broker-Dealer Three's systems and procedures were deficient in a number of ways and violated applicable NASD rules. Specifically, Broker-Dealer Three had no procedures in place regarding the time mutual fund orders could be entered; its representatives were not required to enter orders promptly after receipt; and the firm's written supervisory procedures did not require supervisory review or approval of mutual fund orders entered after 4:00 p.m. Eastern Time. The NASD also found that Broker-Dealer Three violated Section 17(a) of the Securities Exchange Act of 1934, Exchange Act Rules 17a-3(a)(6) and 17a-4(b)(1), and applicable NASD rules by failing to create records reflecting the time of entry of mutual fund orders, and from May 2003 through August 2003, by failing to create records reflecting receipt of mutual fund orders. Broker-Dealer Three agreed to a censure and an \$85,000 fine. Jane G. Heinrichs Assistant Counsel Attachment (in .pdf format)