MEMO# 18369

December 22, 2004

SEC APPROVES NASD'S PROPOSED BAN ON DIRECTED BROKERAGE

[18369] December 22, 2004 TO: COMPLIANCE ADVISORY COMMITTEE No. 122-04 PENSION COMMITTEE No. 60-04 PENSION OPERATIONS ADVISORY COMMITTEE No. 85-04 SEC RULES COMMITTEE No. 100-04 SMALL FUNDS COMMITTEE No. 53-04 RE: SEC APPROVES NASD'S PROPOSED BAN ON DIRECTED BROKERAGE The Securities and Exchange Commission has approved amendments to NASD Conduct Rule 2830(k) that would prohibit broker-dealers from receiving mutual fund brokerage commissions as compensation for the sale of fund shares.1 These amendments, which were originally submitted by the NASD to the SEC in February 2004, are briefly summarized below.2 The effective date of the amendments will be set forth in a Notice to Members that the NASD will be publishing after the first of the new year. I. NASD Rule 2830(k) Currently, NASD Conduct Rule 2830(k) prohibits a broker-dealer from conditioning its efforts in distributing a fund's shares on receipt of the fund's brokerage commission. An exception in the rule allows a broker-dealer to sell shares of any fund that follows a policy, disclosed in the 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. II. The Amendments Adopted to Rule 2830(k) The amendments adopted to Rule 2830(k) eliminate the above discussed exception. Also, a new provision has been added to the rule to prohibit 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 1 See Self-Regulatory Organizations; Order Approving Proposed Rule Change by NASD, Inc., Relating to Investment Company Portfolio Transactions, Release No. 34-50883 (Dec. 20, 2004) (the "Adopting Release"), which is available on the SEC's website at: http://www.sec.gov/rules/sro/nasd/34-50883.pdf. As noted in the Adopting Release, the version of the amendments approved by the Commission is identical to the version filed with it in February. 2 As discussed in the Adopting Release, the Institute was sole commenter on the NASD proposal. 2 transactions) to a broker or dealer in consideration for the promotion or sale of the fund's shares. As discussed in the Adopting Release, these revisions are intended to strengthen the NASD's rules against quid pro quo arrangements between NASD members and fund companies whereby fund companies compensate broker-dealers for promotion of their shares with brokerage commission or similar transaction-related remuneration paid out of fund assets. In the view of the Commission, such practices pose significant conflicts of interest and may be harmful to fund shareholders in that they may provide an incentive to recommend funds that "best compensate the broker rather than funds that meet the customer's investment needs."3 The amendments adopted to NASD Rule 2830(k) are consistent with the Institute's December 2003 recommendation that directed brokerage arrangements be prohibited by

the NASD and the SEC.4 They are also consistent with the SEC's recently adopted amendments to Rule 12b-1 that ban directed brokerage arrangements.5 Rachel H. Graham Assistant Counsel 3 Adopting Release at p. 4 (quoting Prohibition on the Use of Brokerage Commissions to Finance Distributions, Release No. IC-26591 (Sept. 2, 2004) ("SEC Release No. IC-26591")). 4 See Letter from Matthew P. Fink, President, ICI, to the Honorable William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, dated Dec. 16, 2003. 5 See SEC Release No. IC-26591, which is available on the SEC's website at: http://www.sec.gov/rules/final/ic- 26591.htm.
