

**MEMO# 18204**

November 17, 2004

## **DRAFT ICI COMMENT LETTER ON NASD PROPOSAL TO BAN DIRECTED BROKERAGE -- COMMENTS ON DRAFT REQUESTED BY NOVEMBER 22ND**

[18204] November 17, 2004 TO: CHIEF COMPLIANCE OFFICER COMMITTEE No. 25-04 COMPLIANCE ADVISORY COMMITTEE No. 110-04 SEC RULES COMMITTEE No. 90-04 SMALL FUNDS COMMITTEE No. 49-04 RE: DRAFT ICI COMMENT LETTER ON NASD PROPOSAL TO BAN DIRECTED BROKERAGE -- COMMENTS ON DRAFT REQUESTED BY NOVEMBER 22ND The Securities and Exchange Commission has published for comment an NASD proposal to end the practice of broker-dealers receiving mutual fund brokerage commissions as compensation for the sale of fund shares.<sup>1</sup> Attached for your review is a draft of the Institute's comment letter on the proposal. Both the NASD proposal and the draft letter are summarized below. Comments on the NASD proposal must be filed with the SEC by Friday, November 26th. If you have any comments on the Institute's draft letter, please provide them to Rachel Graham by phone (202-326-5819), fax (202-326-5827) or e-mail (rgraham@ici.org) no later than Monday, November 22nd.

I. NASD PROPOSAL NASD Conduct Rule 2830(k) governs the execution of fund portfolio transactions. The rule 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 in Rule 2830(k) 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 1 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>. 2 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 a written or oral 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.

II. INSTITUTE COMMENT LETTER The Institute's draft 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 draft letter observes that

adoption of the NASD proposal would complement the SEC's recent amendment to Rule 12b-1 under the Investment Company Act of 1940, which prevents funds from paying for the distribution of their shares with brokerage commissions.<sup>2</sup> Finally, the draft 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) <sup>2</sup> 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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