

MEMO# 20340

September 1, 2006

NASD Hearing Panel Fines Fund Distributor \$5 Million for Directed Brokerage Violations

©2006 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [20340] September 1, 2006 TO: BROKER/DEALER ADVISORY COMMITTEE No. 35-06 BROKER/DEALER ASSOCIATE MEMBERS No. 5-06 SEC RULES MEMBERS No. 75-06 SMALL FUNDS MEMBERS No. 60-06 RE: NASD HEARING PANEL FINES FUND DISTRIBUTOR \$5 MILLION FOR DIRECTED BROKERAGE VIOLATIONS A NASD Hearing Panel ruled that the principal underwriter and distributor of a large mutual fund family violated NASD Conduct Rule 2830(k)(3) (as it existed prior to amendment in 2004) (the Anti-Reciprocal Rule) by directing brokerage commissions to securities firms that were top sellers of the fund family's funds.¹ The Panel censured the distributor and imposed a \$5 million fine. The ruling resulted from charges brought by NASD's Department of Enforcement in February 2005.² The Panel determined that the distributor had requested and arranged for its parent company, which is also the investment adviser to the mutual fund family, to direct nearly \$100 million in brokerage commissions to its 50 leading retail firms, based on those firms' past sales of the funds. The Panel stated that Rule 2830(k)(3) was intended to abolish "reciprocal business practices in connection with the distribution of mutual fund shares, i.e., the use of portfolio brokerage of mutual funds to reward broker-dealers for sales of mutual fund shares." The Panel rejected the Department of Enforcement's arguments that the distributor's conduct was intentional or reckless, stating that the violations "were negligent, not intentional or reckless." The Panel noted that the use of directed brokerage was not uncommon, that regulators did not express 1 See NASD Hearing Panel Fines American Funds Distributors \$5 Million for Directed Brokerage Violations (press release issued by NASD, Aug. 30, 2006), available at http://www.nasd.com/PressRoom/NewsReleases/2006NewsReleases/NASDW_017294; Department of Enforcement v. American Funds Distributors, Inc., NASD Hearing Panel Decision, No. CE3050003 (Aug. 30, 2006). 2 See Department of Enforcement v. American Funds Distributors, Inc., CRD No. 6247, NASD Office of Hearing Officers, Disc. Proceeding No. CE3050003 (Feb. 16, 2005); see also Investment Company Institute Memorandum to Broker/Dealer Advisory Committee No. 4-05, Broker/Dealer Associate Members No. 1-05, SEC Rules Members No. 32-05, Small Funds Members No. 19-05 [18569], dated Feb. 25, 2005. 2 concern about the practice until 2001, and that the distributor acted voluntarily to change its practices when regulators began expressing concern. The Panel also rejected the Department of Enforcement's request for sanctions in the amount of the total directed brokerage payments. The Panel ruling may be appealed to NASD's National Adjudicatory

Council (“NAC”), or may be called for review by the NAC. The distributor has indicated that it intends to appeal the decision. Mara Shreck Assistant Counsel

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