

**MEMO# 17957**

September 8, 2004

## **SEC PROHIBITS USE OF BROKERAGE COMMISSIONS TO FINANCE DISTRIBUTION**

[17957] September 8, 2004 TO: CHIEF COMPLIANCE OFFICER COMMITTEE No. 5-04 COMPLIANCE ADVISORY COMMITTEE No. 87-04 SEC RULES MEMBERS No. 127-04 SMALL FUNDS MEMBERS No. 98-04 RE: SEC PROHIBITS USE OF BROKERAGE COMMISSIONS TO FINANCE DISTRIBUTION The Securities and Exchange Commission has adopted amendments to Rule 12b-1 under the Investment Company Act of 1940 that prohibit mutual funds from compensating their selling broker-dealers through the use of directed brokerage arrangements.<sup>1</sup> The amendments are substantively identical to those proposed by the Commission in February.<sup>2</sup> The effective date of the amendments is October 14, 2004, and the date by which funds must comply with the new requirements is December 13, 2004. The Release states that funds may make corresponding changes to their registration statements at the time of the next regularly scheduled amendment. The new requirements are briefly summarized below. I. Ban on Directed Brokerage Arrangements Rule 12b-1(h)(1) prohibits a fund from compensating a broker-dealer for promoting or selling its shares by directing brokerage transactions to that broker. It further prohibits the use of step-out and similar arrangements designed to compensate selling brokers for their sales efforts. According to the Release, the Commission adopted these prohibitions because it concluded that the practice of “trading brokerage for sales of fund shares” may harm fund investors by: (1) adversely affecting decisions on how and where to effect portfolio securities transactions, or how frequently to trade portfolio securities; (2) allowing fund advisers and 1 See Prohibition on the Use of Brokerage Commissions to Finance Distribution, SEC Release No. IC-26591 (Sept. 2, 2004) (“Release”), which is available on the Commission’s website at <http://www.sec.gov/rules/final/ic-26591.htm>. 2 Also in February, the NASD filed a proposal with the SEC to amend its rules to prohibit a broker-dealer from selling a fund’s shares if the broker knows of any agreement or understanding to direct the fund’s brokerage in exchange for the promotion or sale of the fund’s shares. See Institute Memorandum to Compliance Advisory Committee No. 31- 04, Pension Committee No. 10-04, Pension Operations Advisory Committee No. 19-04, SEC Rules Committee No. 20- 04, and Small Funds Committee No. 15-04 [17167], dated March 2, 2004; Institute Memorandum to Pension Members No. 16-04, SEC Rules Members No. 34-04, and Small Funds Members No. 27-04 [17168], dated March 2, 2004. The Release states that the Commission is currently reviewing the NASD proposal. 2 brokers to circumvent NASD rules on excessive sales charges; (3) diminishing the transparency of fund distribution costs; and (4) creating conflicts of interest between broker-dealers and their customers. II. Policies and Procedures Rule 12b-1(h)(2) prohibits a fund from directing brokerage transactions to a selling broker-dealer unless it (or its adviser) has implemented

policies and procedures reasonably designed to ensure that the fund's selection of the broker-dealer is not influenced by considerations about the sale of fund shares. The policies and procedures must be approved by the fund's board of directors, including a majority of the independent directors, and be reasonably designed to prevent: (1) the persons responsible for selecting broker-dealers from taking broker-dealers' promotional or sales efforts into account as part of the selection process; and (2) the fund, its adviser, or its distributor from entering into an agreement under which the fund directs brokerage transactions (or revenue generated by those transactions) to a broker-dealer to pay for distribution of the fund's shares.<sup>3</sup> The Release states that these policies and procedures should be incorporated into the set of the policies and procedures that a fund is required to adopt by Rule 38a-1 under the Investment Company Act. It advises that a fund's chief compliance officer should ensure that the required procedures are in place, as well as any others that he or she believes are reasonably necessary to prevent the fund from violating the ban on directed brokerage. The Release further advises that compliance officers for broker-distributed funds should consider periodic testing of brokerage allocations to determine whether there is a "significant correlation" between sales and the direction of brokerage that may suggest the existence of informal arrangements in violation of the rule.

III. Further Reform of Rule 12b-1 In its release proposing the amendments, the Commission also requested comment on whether it should propose additional changes to Rule 12b-1. The Release notes that the Commission received approximately 1,650 comments and that the comments raised a number of alternatives and suggestions, including deducting distribution costs directly from shareholder accounts (an alternative on which the Commission specifically sought comment) and concerns about revenue sharing. According to the Release, the Commission will take these and other comments into consideration as it evaluates whether and how to amend the rule further. Rachel H. Graham Assistant Counsel

3 The Release specifies that clause (2) should be interpreted broadly to cover any agreement or understanding, whether binding or not, between a fund and a broker-dealer, including an understanding to direct brokerage to a government securities dealer or a municipal securities dealer, or an understanding in which each of two funds directs brokerage to the other fund's selling broker.