

## COMMENT LETTER

November 24, 2004

# ICI Comments on NASD Proposal to Prohibit Directed Brokerage Practices (pdf)

November 24, 2004 Mr. Jonathan G. Katz Secretary U.S. Securities and Exchange Commission 450 Fifth Street, N.W. Washington, D.C. 20549-0609 Re: NASD Proposed Rule Change Relating to Investment Company Portfolio Transactions (File No. SR-NASD-2004-027) Dear Mr. Katz: The Investment Company Institute<sup>1</sup> appreciates the opportunity to express its support for NASD's proposed enhancements to its Conduct Rule 2830(k). NASD's proposal would strengthen the rule's current prohibition against an NASD member favoring the sale of shares of any investment company ("fund") based on brokerage commissions that the member receives or expects to receive from any source, including from the fund.<sup>2</sup> The proposal is consistent with a December 2003 recommendation by the Institute to end the practice of using fund brokerage commissions to compensate broker-dealers for the sale of fund shares.<sup>3</sup> Adoption of the NASD proposal would complement the Commission'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. The Institute supported that amendment because the practice of directed brokerage, although already strictly regulated under Rule 2830(k), may have created the appearance of conflicts of interest and presented the potential for actual conflicts.<sup>4</sup> The NASD proposal, coupled with the Commission's amendment to Rule 12b-1, would make it clear to both fund advisers and broker-dealers that distribution considerations have no appropriate role in the allocation of fund brokerage. 1 The Investment Company Institute is the national association of the American investment company industry. More information about the Institute is included at the end of this letter. 2 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>. 3 See Letter from Matthew P. Fink, President, Investment Company Institute, to the Honorable William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, dated Dec. 16, 2003. 4 See Letter from Amy B.R. Lancellotta, Acting General Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated May 10, 2004. Mr. Jonathan G. Katz November 24, 2004 Page 2 of 2 We applaud NASD's decision to retain the language in Rule 2830(k) clarifying that an NASD member would not violate the rule solely because the member promotes or sells shares of a fund for which it also executes portfolio transactions.<sup>5</sup> In today's world of integrated financial services firms,

most of the major broker-dealers that funds typically use for execution services also distribute the funds' shares. Without this language, broker-dealers might be improperly discouraged from performing both execution and sales functions for a particular fund. We appreciate the opportunity to comment on NASD's proposal. If you have any questions about our comments or need additional information, please contact me at (202) 326-5824 or Rachel H. Graham at (202) 326-5819. Sincerely, Amy B.R. Lancellotta Senior Counsel cc: Paul F. Roye, Director Division of Investment Management Securities and Exchange Commission Patrice Gliniecki Senior Vice President and Deputy General Counsel NASD 5 See NASD Conduct Rule 2830(k)(7) ("Provided that the member does not violate any of the specific provisions of this paragraph (k), nothing herein shall be deemed to prohibit: (A) The execution of portfolio transactions of any investment company or covered account by members who also sell shares of the investment company . . . ."). If the NASD proposal is adopted, this provision would be renumbered as Rule 2830(k)(8). About the Investment Company Institute The Investment Company Institute's membership includes 8,545 open-end investment companies ("mutual funds"), 630 closed-end investment companies, 135 exchange-traded funds, and 5 sponsors of unit investment trusts. Its mutual fund members manage assets of about \$7.468 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 87.7 million as of mid-2004, representing 51.2 million households.

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