

# Notice to Members

JANUARY 2005

## SUGGESTED ROUTING

Executive Representatives  
Investment Companies  
Legal & Compliance  
Mutual Fund  
Registered Representatives  
Senior Management

## KEY TOPICS

Directed Brokerage  
Investment Companies  
Rule 2830(k)

## GUIDANCE

### Investment Company Directed Brokerage Arrangements

SEC Approves Amendments to NASD Rule 2830(k) to Strengthen Prohibitions on Investment Company Directed Brokerage Arrangements; **Effective Date: February 14, 2005**

#### Executive Summary

On December 20, 2004, the Securities and Exchange Commission (SEC) approved amendments to NASD Rule 2830(k), which governs NASD members' execution of investment company portfolio transactions.<sup>1</sup> The amended rule augments existing proscriptions on directed brokerage practices by prohibiting a member from selling the shares of, or acting as an underwriter for, any investment company if the member knows or has reason to know that the investment company or its investment adviser or underwriter have directed brokerage arrangements in place that are intended to promote the sale of investment company securities. The amendments also eliminate an existing provision in the rule that permits a member, subject to certain conditions, to sell or underwrite the shares of an investment company that follows a policy of considering fund sales in determining whether to send portfolio transactions to a broker-dealer.

The effective date of this rule change is **February 14, 2005**. Included with this *Notice* is Attachment A (text of rule amendments).

#### Questions/Further Information

Questions or comments concerning this *Notice* may be directed to Joseph P. Savage, Counsel, Investment Companies Regulation, Regulatory Policy and Oversight (RPO), at (240) 386-4534, or Philip A. Shaikun, Associate General Counsel, RPO, at (202) 728-8451.

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## Background and Discussion

NASD Rule 2830(k) generally prohibits NASD members from favoring the sale of shares of any investment company on the basis of brokerage commissions received or expected to be received from any source, including the investment company. Currently, however, Rule 2830(k)(7)(B) permits an NASD member to sell the shares of, or act as an underwriter for, a fund that follows a policy disclosed in its prospectus of considering sales of shares of the fund as a factor in selecting broker-dealers to execute portfolio transactions. A member may sell shares of such an investment company only if the investment company meets the requirements of best execution and the member does not violate any other provision of Rule 2830(k).

The amendments make two principal changes to the rule. First, they eliminate paragraph (k)(7)(B) from the rule. Accordingly, a member may not sell the shares of, or act as an underwriter for, a fund that follows a policy of considering sales of shares of the fund as a factor in selecting broker-dealers to execute portfolio transactions. This rule change is consistent with the SEC's recent amendments to its Rule 12b-1 under the Investment Company Act of 1940, which prohibit funds from compensating a broker-dealer for promoting or selling fund shares by directing brokerage transactions to that broker.<sup>2</sup>

Second, the amendments add a new paragraph (k)(2) to the rule. This paragraph explicitly states that a member is not permitted to sell shares of, or act as an underwriter for, an investment company that the member knows or has reason to know engages in directing brokerage in consideration for the promotion or sale of shares issued by the investment company or any other registered investment company. Thus, the amended rule would prohibit the sale and distribution of shares of a fund by a member, even where a directed brokerage arrangement is known to exist between the fund and a different broker-dealer.

Note, however, that pursuant to Rule 2830(k)(8)(A), a member that sells shares of an investment company may still execute portfolio transactions of the investment company, provided that the member does not violate any other provision of Rule 2830(k).

These rule changes become effective on **February 14, 2005**.

## Endnotes

<sup>1</sup> SEC Rel. No. 34-50883 (Dec. 20, 2004), 69 Fed. Reg. 77286 (Dec. 27, 2004).

<sup>2</sup> See SEC Rel. No. IC-26591 (Sept. 2, 2004), 69 Fed. Reg. 54727 (Sept. 9, 2004).

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## ATTACHMENT A

New text is underlined. Deleted text is bracketed.

### Text of Rule Change

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#### Rule 2830. Investment Company Securities

(a) through (j) No change.

##### (k) Execution of Investment Company Portfolio Transactions

(1) No member shall, directly or indirectly, favor or disfavor the sale or distribution of shares of any particular investment company or group of investment companies on the basis of brokerage commissions received or expected by such member from any source, including such investment company, or any covered account.

(2) No member shall sell shares of, or act as underwriter for, an investment company, if the member knows or has reason to know that such investment company, or an investment adviser or principal underwriter of the company, has a written or oral agreement or understanding under which the company directs or is expected to direct portfolio securities transactions (or any commission, markup or other remuneration resulting from any such transaction) to a broker or a dealer in consideration for the promotion or sale of shares issued by the company or any other registered investment company.

[(2)] (3) No member shall, directly or indirectly, demand or require brokerage commissions or solicit a promise of such commissions from any source as a condition to the sale or distribution of shares of an investment company.

[(3)] (4) No member shall, directly or indirectly, offer or promise to another member, brokerage commissions from any source as a condition to the sale or distribution of shares of an investment company and no member shall request or arrange for the direction to any member of a specific amount or percentage of brokerage commissions conditioned upon that member's sales or promise of sales of shares of an investment company.

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[(4)] (5) No member shall circulate any information regarding the amount or level of brokerage commissions received by the member from any investment company or covered account to other than management personnel who are required, in the overall management of the member's business, to have access to such information.

[(5)] (6) No member shall, with respect to such member's activities as underwriter of investment company shares, suggest, encourage, or sponsor any incentive campaign or special sales effort of another member with respect to the shares of any investment company which incentive or sales effort is, to the knowledge or understanding of such underwriter-member, to be based upon, or financed by, brokerage commissions directed or arranged by the underwriter-member.

[(6)] (7) No member shall, with respect to such member's retail sales or distribution of investment company shares:

(A) provide to salesmen, branch managers or other sales personnel any incentive or additional compensation for the sale of shares of specific investment companies based on the amount of brokerage commissions received or expected from any source, including such investment companies or any covered account. Included in this prohibition are bonuses, preferred compensation lists, sales incentive campaign or contests, or any other method of compensation which provides an incentive to sales personnel to favor or disfavor any investment company or group of investment companies based on brokerage commissions;

(B) recommend specific investment companies to sales personnel, or establish "recommended," "selected," or "preferred" lists of investment companies, regardless of the existence of any special compensation or incentives to favor or disfavor the shares of such company or companies in sales efforts, if such companies are recommended or selected on the basis of brokerage commissions received or expected from any source;

(C) grant to salesmen, branch managers or other sales personnel any participation in brokerage commissions received by such member from portfolio transactions of an investment company whose shares are sold by such member, or from any covered account, if such commissions are directed by, or identified with, such investment company or any covered account; or

(D) use sales of shares of any investment company as a factor in negotiating the price of, or the amount of brokerage commissions to be paid on, a portfolio transaction of an investment company or of any covered account, whether such transaction is executed in the over-the-counter market or elsewhere.

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[(7)] (8) 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; or

[(B)] a member from selling shares of, or acting as underwriter for, an investment company which follows a policy, disclosed in its prospectus, of considering sales of shares of the investment company as a factor in the selection of broker/dealers to execute portfolio transactions, subject to the requirements of best execution;]

[(C)] (B) a member from compensating its salesmen and managers based on total sales of investment company shares attributable to such salesmen or managers, whether by use of overrides, accounting credits, or other compensation methods, provided that such compensation is not designed to favor or disfavor sales of shares of particular investment companies on a basis prohibited by this paragraph (k).

(l) through (n) No change.