NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. AMERICAN FUNDS DISTRIBUTORS, INC. (CRD No. 6247), Respondent.	Disciplinary Proceeding No. CE3050003 Hearing Officer – DMF **HEARING PANEL DECISION** August 30, 2006

Summary

Respondent is censured and fined $5,000,000 for requesting or arranging for the direction to NASD member firms of specific amounts of brokerage commissions conditioned upon those members' sales of American Funds shares, in violation of Rules 2830(k)(3) and 2110.

Appearances

Jeffrey P. Bloom, Esq., Daniel D. McClain, Esq. and Colleen Hanrahan, Esq., Washington, DC for Complainant.

Seth M. Schwartz, Esq. and William J. O'Brien, Esq., New York, NY, and Raoul D. Kennedy, Esq., San Francisco, CA, for Respondent.

DECISION

I. Procedural History

The Department of Enforcement filed a Complaint on February 16, 2005, charging that Respondent American Funds Distributors, Inc. (AFD) requested or arranged for the payment of brokerage commissions to other NASD members during the period 2001 through 2003 in violation of NASD Rules 2830(k)(3) and 2110. AFD filed an Answer contesting the charges and requested a hearing. The hearing was held before an

Extended Hearing Panel in Los Angeles, California, from March 20 through March 28, 2006.

II. **Facts**

A. **Respondent**

AFD has been a member of NASD since 1972. AFD is the principal underwriter and distributor of the shares of the American Funds, a mutual fund family that includes 29 separate funds.[1]

The American Funds are not sold directly to investors. Instead, AFD promotes the sale of shares of the American Funds to investors through a network of unaffiliated broker-dealers (retail brokerage firms). AFD's efforts in that regard have clearly been successful, as the American Funds have become the second largest mutual fund family in the United States, with more than $750 billion in assets under management and over 30 million shareholder accounts.[2]

AFD is a wholly owned subsidiary of Capital Research and Management Company (CRMC). CRMC is the investment adviser of the American Funds. In this role, CRMC employs securities traders who place orders with unaffiliated broker-dealers to purchase and sell securities for the portfolios of the various Funds. CRMC derives its revenues from fees paid by the American Funds for CRMC's advisory services, pursuant to contracts approved by the Funds' boards of directors. AFD, on the other hand, earns

[1] Stip. ¶¶ 1-2; Tr. 80, 1051. (In this decision, CX refers to Complainant's Exhibits, RX refers to Respondent's Exhibits, Stip. refers to the Stipulations of Fact filed by the parties on January 26, 2006, and Tr. refers to the transcript of the hearing.)

[2] Stip. ¶ 2; Tr. 80-81, 1051.

revenue from commissions on the sale of the American Funds, as well as direct payments from CRMC.[3]

B. AFD's Use of Directed Brokerage to Reward American Funds Retailers[4]

Because the American Funds are sold to investors through independent retail brokerage firms, they compete with many other funds available to registered representatives associated with those firms. Not surprisingly, therefore, AFD seeks to persuade those firms and their registered representatives to recommend American Funds to their customers, rather than the competing funds. To help accomplish this, AFD employs wholesalers who make sales calls on more than 100,000 individual registered representatives who sell American Funds.[5]

In addition, beginning in the 1990's, AFD appointed employees to serve as Dealer Relationship Managers (DRMs), responsible for working with the leading retailers of the American Funds at the firm level to promote the sale of the Funds. The DRMs most important job each year was to work out a "business plan" with each of the various retail firms assigned to them.[6]

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[3] Stip. ¶¶ 3-5; Tr. 80, 798, 1051; JX 154. The American Funds, themselves, are investment companies owned by their shareholder investors. They are organized under the Investment Company Act of 1940, governed by a board of directors elected by the shareholders and regulated by the Securities and Exchange Commission. As an investment advisor, CRMC is registered with and regulated by the SEC under the Investment Advisers Act of 1940. Neither the Funds nor CRMC is an NASD member.

[4] Most of the material facts regarding AFD's use of directed brokerage before and during the relevant period are undisputed, or clearly established by the contemporaneous documents introduced in evidence at the hearing. Nevertheless, the AFD employees who testified at the hearing, including its president, repeatedly testified that damaging documents they had written, edited or reviewed without comment during the relevant period did not really mean what the documents plainly said, did not say what the authors really meant to convey or were simply incorrect. While such testimony might be credible if offered by a single witness as to a particular document, it was not credible as a consistent theme, and the Panel found this testimony disingenuous, to say the least. Therefore, insofar as the AFD witnesses' testimony conflicted with contemporaneous documents, the Panel rejected the testimony and relied upon the documents.

[5] Tr. 523, 1052.

[6] Tr. 81-88.

The business plan outlined various "goals and objectives" of AFD and the retail firm for the coming year "to accomplish mutual success" in increasing the sales of the American Funds. Typically the plans included sales goals. To help attain these goals, AFD sought opportunities to provide information to the retailer's registered representatives at widely attended conferences, sponsored by either AFD or the retail firm, that AFD hoped would lead the representatives to recommend American Funds to their customers. AFD referred to this as "training and education." In some cases, AFD also wanted the American Funds to be included on the retailer's list of "preferred" or "recommended" fund families. AFD also sought to address issues that AFD thought put the American Funds at a competitive disadvantage. For example, some retailers imposed a "ticket charge" on their representatives for each mutual fund purchase or sale, but offered AFD and other mutual fund distributors a "ticket charge program" through which, for a price, the retailer would waive or absorb the ticket charges for trades in that mutual fund family, and AFD sometimes sought to participate in those programs. The retail firms, too, sought a variety of business-support commitments from AFD that were reflected in the business plans.[7]

The business plan also addressed, in general terms, the "financial support" that AFD would provide to the retail firm. Retailers and their representatives receive commissions, or "concessions," for the sale of the American Funds, as well as networking fees and Rule 12b-1 service fees. But the retail firms also sought additional payments, sometimes referred to as "revenue sharing," from mutual fund distributors, including AFD. By the late-1990s, AFD provided or arranged for two types of such

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[7] JX 20, 60, 63, 72; CX 1; Tr. 90-102, 312-20.

payments to retail firms – “marketing pool” and “execution revenue” (also referred to as “target commissions”).[8]

Beginning in the early 1990s, AFD made yearly marketing pool payments directly to approximately the 75 highest selling American Funds retailers in amounts equal to five basis points (0.05%) of the retailers’ prior year’s sales of American Funds. Marketing pool payments came from AFD’s own funds.[9]

The charges in this case, however, concern only AFD’s execution revenue practices. In contrast to marketing pool dollars, execution revenue came to the retailers not from AFD, but from CRMC, in the form of commissions for the execution of purchase and sale trades in the portfolios of the various American Funds, which CRMC placed in its role as the investment adviser of the Funds. Those commissions – also referred to as “brokerage” – were assets of the Funds, and CRMC had a fiduciary obligation to place trades and pay brokerage only for the Funds’ benefit.[10]

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[8] CX 1; JX 156; Tr. 103-05, 118-19, 334-36, 516, 589, 657, 701, 808-10. The AFD employee witnesses insisted that only the marketing pool money, not the execution revenue, was provided to the retail firms in exchange for the specific benefits set forth in the business plans, but the Panel rejects this testimony. Marketing pool payments were calculated simply as a factor of the prior year’s sales, without regard to the cost of any training and education or other initiatives in the business plans, and the references to financial support in the plans did not draw any distinction between marketing pool and execution revenue support. Indeed, both AFD’s contemporaneous internal documents and retail firm documents and witnesses demonstrated that marketing pool and execution revenue were simply two forms of revenue sharing payments, and regardless of the label attached, the retail firms were free to use both marketing pool and execution revenue dollars in any manner they chose. Tr. 106-20, 152, 320-21, 658, 714-15, 722-23, 847-49, 859, 866; JX 24, 70, 195; CX 49. In any event, the Panel’s conclusions do not depend on whether execution revenue was or was not used to pay for the specific benefits conferred by the retail firms under the business plans, since it was unquestionably an element of the reciprocal business arrangement between AFD and the retailers.

[9] CX-1; JX 195; Tr. 119, 205-06, 798-99, 804-05, 1104-05. AFD also provided additional, more substantial financial support from its own funds for the top five retailers, which AFD referred to as “broker partnership payments.” Tr. 807-08, 1056-57. Like marketing pool payments, the broker partnership payments are not the subject of the charges in the Complaint.

[10] See Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26356, 2004 SEC LEXIS 418 at *12 (Feb. 24, 2004) (hereinafter “SEC Proposed Rule Notice”) (“Fund brokerage is an asset of the fund, and therefore must be used for the fund’s benefit”).

Each year, beginning no later than 1995, AFD calculated execution revenue targets for approximately the 50 largest-selling American Funds retail brokerage firms equal to 10 or sometimes 15 basis points (0.10% or 0.15%) of each firm's prior year American Funds sales. AFD then conveyed those execution revenue targets to CRMC's trading department CRMC, in turn, expected its traders to direct the purchase and sale trades that they made on behalf of the American Funds so as to satisfy AFD's targets, subject to obtaining best execution of the trades.[11] This practice, which in one form or another was wide-spread in the mutual fund industry, is referred to as "directed brokerage."[12]

Some of the retail firms that were assigned execution revenue targets were self-clearing. For those firms (executing retailers), CRMC generated execution revenue by directing trades to the firm's trading desk, paying CRMC's standard brokerage on those trades.[13] Many of the retailers, however, were not self-clearing, so CRMC could not generate execution revenue by directing trades to them. For those firms, execution revenue was generated through a "step-out" process. CRMC traders directed trades to the trading desk of the retailer's clearing firm, paying CRMC's standard brokerage to the clearing firm, but advising the clearing firm that the retail firm should receive credit for the trades. The clearing firm, in turn, "stepped out" a portion of the brokerage – typically

[11] Tr. 104-05, 118-19, 125, 336-37, 812-13, 943-49, 1053-54, 1060, 1105; JX 167.

[12] Tr. 691-92, 1145-46, 1151-52; CX 65. See also Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26591, 69 Fed. Reg. 54728 (Sept. 9, 2004) (hereinafter "SEC Final Rule Notice").

[13] Like many institutional traders, CRMC unilaterally determined the amount of commissions it would pay for all trades it placed on behalf of the American Funds – it did not negotiate commissions with the firms through which it placed the trades. There is no dispute that it paid its standard commission rates on trades it placed to generate execution revenue. Tr. 983-84.

70% or more – to the retail firm, pursuant to an agreement between the retail firm and the clearing firm. Thus, the step-out retail firms took no part in the trades, but received the bulk of the brokerage that CRMC paid to the clearing firms simply to reward them for their sales of American Funds. Directing brokerage to step-out firms in this manner was also widespread in the mutual fund industry.[14]

AFD determined the execution revenue targets unilaterally; it did not negotiate them with the retail firms. Moreover, both AFD and the retail firms understood that the execution revenue amounts were targets, not guarantees, and that neither AFD nor CRMC had any obligation to achieve those targets. But as part of the yearly business plan process, AFD's DRMs disclosed to their retail firms both the firms' execution revenue targets for the coming year and the manner in which those targets had been calculated (i.e., that they equaled 10 or 15 basis points of the retail firms' prior year's American Funds sales).[15] They also made it clear to the retail firms that eligibility for execution revenue depended on them being among the top 50 retailers of the American Funds. In addition, while the execution revenue amounts may have been targets, not guarantees, CRMC's traders, the DRMs and the retail firms tracked the actual payment of

[14] Tr. 120-21, 659, 952-53, 955-56, 1129, 1132, 1135; JX 209. See SEC Final Rule Notice, 69 Fed. Reg. at 54728.

[15] AFD's president testified that AFD had an "unwritten policy" not to disclose execution revenue targets to retail firms (Tr. 1072-74), but this contention was squarely inconsistent with the contemporaneous AFD documents and the testimony of DRMs and retailers, which established that AFD routinely disclosed the targets and the manner in which they were calculated to the retailers, and the Hearing Panel rejects it.

brokerage against the execution revenue targets during the year. And each year CRMC's traders met most if not all the targets for both the executing and step-out firms.[16]

C. AFD's Practices During the Relevant Period

Although AFD began using directed brokerage in the 1990s, the charges in the Complaint are limited to the period 2001 through 2003 (the relevant period).[17] In 2001 and 2002, as in prior years, AFD's DRMs met with their assigned retail firms to work out business plans for the coming year.[18] And as in past years, AFD calculated execution revenue targets for its leading retailers, including approximately 18 executing firms and 28 step-out firms, equal to 10 or in some cases 15 basis points of their prior year's American Funds sales, and conveyed those amounts to CRMC and the retailers.[19]

In both 2001 and 2002, as in prior years, CRMC instructed its traders to attempt to meet AFD's targets. In keeping with these instructions, CRMC's traders directed brokerage to both executing and step-out firms, notifying the clearing broker when they placed trades for the benefit of a step-out firm. CRMC tracked the traders' success in

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[16] Tr. 106, 118-20, 122, 337-38, 361, 438-39, 602, 609, 659, 661, 694, 816-17, 826, 949-50, 1106-07; CX 1; JX 112, 168, 180. The fact that the total amount of execution revenue targets set by AFD represented only a relatively small portion – perhaps 30% – of CRMC's total yearly commission payments made it easier for the traders to meet the targets. Tr. 988, 1011.

[17] It appears that NASD staff focused its investigation and the subsequent Complaint on the 2001-2003 period simply as a matter of administrative convenience. Tr. 902, 906.

[18] A typical example was the 2001 business plan for retail firm 1717 Capital Management. It included sales goals; "action plans" setting forth various initiatives for the year; plans for "meetings and conferences," as well as "branch, regional and home office coverage"; technology improvement plans for both the retail firm and AFD; plans for "Broker Business Development training programs" to be delivered by "key American Funds personnel" to 1717 Capital Management's representatives; and "financial support" from AFD, including "Broker Marketing Pool" and "Execution Revenue." CX 1 at 1-4.

[19] Stip. ¶¶ 6-8, 14-15; JX 157, 161.

meeting the targets and made regular progress reports to AFD's DRMs, who, in turn, kept the retailers apprised.[20]

Along the way, in some cases AFD asked CRMC's traders to "turn off" trades through an executing firm when AFD was having difficulty reaching agreement with the firm on a business plan, and then to "turn on" trading once there had been agreement. In one case, to accommodate the concerns of the mutual fund sales department of an executing firm, AFD arranged for CRMC to direct trades to a different trading desk at the firm, in order to ensure that the sales department received credit for the execution revenue generated by the trades. CRMC acceded to AFD's requests.[21]

In 2001, CRMC paid more than $34 million in directed brokerage. This included more than $18 million to 18 executing firms and more than $16 million to clearing firms on behalf of 28 step-out firms.[22]

Although 2002 began as prior years, there was a notable mid-year change. As of July 1, AFD and CRMC discontinued directing execution revenue to step-out firms, in recognition of the fact that the SEC staff had informally expressed concerns about the

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[20] Stip. ¶¶ 9, 12-13; JX 140, 179, 185; Tr. 232, 349, 352-53, 355, 816-17.

[21] Tr. 144-47, 223-31, 839-40, 1002; JX 2, 6, 16-18, 23, 132.

[22] For example, CRMC paid more than $160,000 in directed brokerage to Pershing, LLC, 1717 Capital Management's clearing firm, for trades that Pershing was to credit to 1717 Capital Management. Pershing, in turn, stepped out the bulk of those commissions to 1717 Capital Management. CX 5-8.

mutual fund industry's use of step-out commissions during 2001.[23] AFD and CRMC halted their use of step-out commissions even though other firms continued to use them.[24]

In connection with the decision to halt the use of step-out commissions, in June 2002 the DRMs

> were instructed to go forth to the [step-out retailers] and indicate that at this time, given the current regulatory environment and concerns that we potentially had that rules could change, that we were no longer comfortable delivering commissions through step out broker/dealers and that we would cease the practice at the end of the month.[25]

A DRM testified that the response from the step-out firms he spoke to "was definitely disappointment that a source of revenue that many of them had been receiving for a number of years would likely no longer be available to them." As he explained, "while [execution revenue amounts] were never guaranteed and they were simply targets, many of the firms that we were working with had been partners of ours for a number of years, and they had been used to receiving commissions in this form which, to them, quite frankly was important." Indeed, according to a contemporaneous internal AFD document, another DRM reported that some of the step-out firms he spoke to were "dismayed and shocked" by the decision to stop providing them with execution revenue,

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[23] Noting that step-out firms had no involvement in the execution of trades, SEC staff suggested that step-out commissions might be a form of Rule12b-1 fees. Investment companies must disclose such fees, and NASD Rule 2830(d) precludes member firms from selling funds that impose excessive sales charges. Tr. 1014-15; see also SEC Proposed Rule Notice, 2004 SEC LEXIS 418.

[24] In fact, AFD actually ended its execution revenue support for Edward Jones, the leading step-out retailer of American Funds, at the end of 2001, and provided only direct, AFD-funded financial support to that firm in 2002. Tr. 663-65. There was no evidence explaining why AFD decided to end execution revenue for Edward Jones at the end of 2001, but continued it for the other step-out retailers until July 1, 2002. After halting the use of step-out commissions, CRMC continued to place some trades with the clearing firms, but they no longer stepped out any portion of the commissions on those trades to retail firms. Tr. 998, 1133.

[25] Tr. 263.

and that his discussions with the firms in that regard "[h]ave been amo[ng] the most difficult conversations [he] [h]as had."[26]

The concerns expressed by the step-out retailers led AFD to consider whether it should make additional direct payments to the retailers to make up for the loss of execution revenue, but it decided not to do so. In any event, by the time step-out trading was halted at the end of June, CRMC traders had already directed so much trading to the clearing firms for the benefit of the step-out retailers that they had received most, if not all, of their execution revenue targets for 2002. Indeed, in 2002 CRMC directed a total of nearly $12 million in execution revenue to step-out firms – more than 90% of the total targets for these firms – as well as more than $20 million to executing firms.[27]

In 2003, AFD established specific execution revenue targets for executing firms, but not for the former step-out firms. Compensation for those firms was limited to direct payments from AFD, which were now called "additional dealer compensation" rather than marketing pool. Moreover, AFD no longer calculated either execution revenue targets or additional dealer compensation amounts by simply applying a basis point factor to the prior year's sales. Instead, the DRMs were asked to make recommendations as to the overall amount of financial support that AFD should provide to the leading retailers based on "what [the DRMs] thought [they] could sell. In other words, the number of which [they] thought might be appropriate compensation to a [retail firm] that they would view to accept, in order for us to move forward in working with them in 2003."[28]

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[26] Tr. 264, 266; JX 182.

[27] Tr. 265; JX 168-169; CX 5-8, 11. See also JX 104 (email from AFD to a step out retailer reporting that as of June 30, "WE hit **98%** of the target amount, up from the 48% I shared with you thru the month of May").

[28] Tr. 112, 183, 364-66; JX 110, 183, 186, 195.

In determining the amount of additional dealer compensation to be paid to non-executing firms, AFD considered their loss of step-out commission revenue, and accordingly increased its direct financial support for a number of those firms. But AFD was able to offset some of this increase by persuading some executing firms to accept a greater portion of their financial support in the form of execution revenue, rather than direct payments from AFD. In 2003, CRMC directed more than $31 million in brokerage to 16 executing firms in satisfaction of their 2003 execution revenue targets, as compared to less than $21 million to such firms in 2002.[29]

In 2004, in anticipation of regulatory changes, AFD stopped providing execution revenue targets to CRMC, and CRMC discontinued the practice of directing brokerage to retail firms in consideration of their sales of the American Funds.[30] Later in 2004, the SEC proposed and adopted a rule that now prohibits any investment company from compensating any broker/dealer for the promotion or sale of mutual fund shares by directing brokerage to the broker/dealer.[31] In 2004, NASD also proposed amendments to Rule 2830(k) that would prohibit the use of directed brokerage, and those became effective in 2005.[32] There is no dispute that, in light of these regulatory changes, AFD could not employ its former directed brokerage practices today, but the parties disagree about whether they were prohibited by the rules in effect at the relevant time.[33]

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[29] CX 5, 6, 82, 119; JX 98, 190, 228; Tr. 375, 774-83.

[30] Tr. 1107-08. AFD continued to provide, and in fact substantially increased, its direct additional dealer compensation payments to retailers.

[31] See SEC Proposed Rule Notice, 2004 SEC LEXIS 418; SEC Final Rule Notice, 69 Fed. Reg. 54728.

[32] Notice to Members (NTM) 05-04 (Feb. 14, 2005).

[33] Tr. 1243.

III. Discussion

The Complaint charges that AFD's use of directed brokerage during the period 2001-2003 violated Rule 2830(k)(3).[34] As adopted in 1973, Rule 2830(k)(3) provided, in relevant part: "No member shall, directly or indirectly, … request or arrange for the direction to any member, of an amount or percentage of brokerage commissions from any source as an inducement or reward for the sale of shares of an investment company."[35] At the hearing, counsel for AFD candidly acknowledged that AFD's practice of requesting or arranging for CRMC to direct brokerage to retail firms would have violated this provision, because the directed brokerage was manifestly intended to reward the retail firms for their past sales of American Funds shares and to induce them to continue their sales efforts.[36]

In 1981, however, NASD amended Rule 2830(k) in various respects. In particular, Rule 2830(k)(3) was amended by inserting the word "specific" before "amount" and by replacing the words "inducement or reward" with "conditioned upon."

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[34] Although the Complaint also cites Rule 2110, Enforcement stated that it was not asserting any independent violation of that rule, but was simply resting on the well-accepted proposition that a violation of any NASD rule is also a violation of Rule 2110.

[35] The rule provided, in full: "No member shall, directly or indirectly, offer or promise to another member, or request or arrange for the direction to any member, of an amount or percentage of brokerage commissions from any source as an inducement or reward for the sale of shares of an investment company." 1973 NTM 42, 1973 NASD LEXIS 46 (May 25, 1973).

[36] Tr. 1243.

With these revisions, the relevant portion of the rule read:

> 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.[37]

At the same time it amended Rule 2830(k)(3), NASD added a new subsection, Rule 2830(k)(7), which provided, in relevant part:

> Provided that the member does not violate any of the specific provisions of this paragraph (k), nothing herein shall be deemed to prohibit:
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> …
>
> (B) a member from … 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; ….[38]

AFD argues that following the amendment to Rule 2830(k)(3) and the adoption of Rule 2830(k)(7), the rules permitted the directed brokerage practices it employed during the relevant period. Neither provision has previously been applied in a contested disciplinary proceeding such as this, so this case presents issues of first impression.

A. <u>The Language of the Rule</u>

In interpreting NASD rules, the Hearing Panel must consider, first, the "plain language" of the rules. <u>See</u> <u>Department of Market Regulation v. Respondent</u>, No.

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[37] The amended rule read, in full: "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." NTM 81-8, 1981 NASD LEXIS 325 (Mar. 10, 1981).

[38] <u>Id.</u>

CMS030181 (June 9, 2005), at 6.[39] During the relevant period, Rule 2830(k)(3) prohibited AFD, as an NASD member, from "request[ing] or arrang[ing] for the direction" of "a specific amount or percentage of brokerage commissions" to other NASD members "conditioned upon" their sales or promise of sales of the American Funds. The evidence in this case shows, without substantial controversy, that AFD requested and arranged for CRMC to direct brokerage to its 50 leading retail firms, which were NASD members. Moreover, there is no dispute that AFD gave CRMC specific execution revenue targets for those firms, calculated by applying a basis point factor to their prior year's sales, and that CRMC attempted to meet and generally achieved the targets.

AFD contends, however, that the addition of the words "conditioned upon" to Rule 2830(k)(3) in 1981, together with the addition of Rule 2830(k)(7), had the effect of limiting the application of the rule, so that it only "barred fund underwriters from entering into any arrangement by which they would become obligated to direct brokerage in the event that another member sold fund shares in the future."[40] AFD argues that under this interpretation its directed brokerage practices during the relevant period did not violate the rule, because the execution revenue amounts were non-binding targets, not binding obligations, and were based on past, not future sales of the American Funds.

The language of Rule 2830(k)(3), however, does not support such a narrow construction. Although AFD argues that the words "conditioned upon" necessarily imply

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[39] This decision can be found on NASD's website at: http://www.nasd.com/web/groups/enforcement/documents/nac_red_disciplinary_decisions/nasdw_014664.pdf

[40] Respondent's Proposed Findings of Fact and Conclusions of Law at 32.

a binding obligation, the Panel disagrees. AFD correctly notes that in some contexts "condition" may be used in a narrow, technical sense to mean "[a] future and uncertain event upon the happening of which is made to depend the existence of an obligation …."[41] But in other contexts the word may have a broader meaning: something "that is indispensable to the appearance or occurrence of another; prerequisite."[42] In this sense, there is no question that AFD's request and arrangement for CRMC to direct brokerage to retailers was conditioned upon their past sales of American Funds – indeed, that they were among the top 50 in the prior year's sales – and that the target amount was conditioned upon the specific amount of sales attained by the retailer. Considering the remedial purposes of NASD's rules, a broad, non-technical definition is more appropriate than the narrow, technical definition urged by AFD.

AFD argues that, in the context of Rule 2830(k)(3), interpreting the word "condition" as synonymous with "prerequisite" is unjustified because it "completely eviscerates any distinction between the concepts of directing brokerage 'in consideration of sales,' and directing it 'conditioned on' sales."[43] But AFD's argument is specious. The words "in consideration of sales" did not appear in either the original or the amended rule. More importantly, for the reasons set forth below, interpreting "condition" as synonymous with "prerequisite" is consistent with the language of the rule, read as a whole, as well as the purpose of the rule, while interpreting it to require a binding obligation, as AFD proposes, would be is inconsistent with both.

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[41] Black's Law Dictionary, 6th ed.

[42] The American Heritage Dictionary of the English Language (4th ed. 2000).

[43] Respondent's Proposed Findings of Fact and Conclusions of Law at 38.

Interpreting the rule as prohibiting only binding obligations to pay directed brokerage, as AFD urges, would effectively negate the rule. In its argument, AFD loses sight of the important legal distinctions between AFD, CRMC and the Funds. The brokerage was an asset of the various American Funds. AFD was simply the underwriter and distributor of the Funds; it had no authority to obligate the Funds to pay any commissions, much less specific amounts of directed brokerage, to the retail firms. Thus, when AFD points out that the execution revenue amounts it established were merely non-binding targets, it is simply acknowledging an immutable legal limitation on its authority.[44] The relevant portion of the rule acknowledges this limitation by prohibiting underwriters such as AFD from "request[ing] or arrang[ing] for" specific amounts of directed brokerage, rather than "offering" or "promising" to pay those amounts.[45] Thus, AFD's reading of Rule 2830(k)(3) as limited to binding obligations is inconsistent with the plain language of the rule, read as a whole.

Similarly, AFD's argument that the rule applies only to directed brokerage that is conditioned on future fund sales is unduly restrictive and inconsistent with the language of the rule, read as a whole. The word "future" is neither expressed in the rule, nor implied; on the contrary, the rule's use of the word "sales," particularly when coupled

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[44] Although the rule applied only to AFD, not CRMC, and only AFD's practices are at issue here, the Panel notes that even CRMC could not have obligated itself in the manner that AFD argues was required. CRMC was only the adviser to the Funds; it did not own the brokerage. CRMC had a fiduciary obligation to execute only such trades and pay only such commissions as were in the best interest of the Funds, and in placing trades on behalf of the Funds, to obtain best execution. A binding obligation to direct specific amounts of brokerage to specific retail firms through future Funds trades would have been squarely inconsistent with these obligations. Thus, at most, CRMC could agree to attempt to meet the targets, consistent with fulfilling its fiduciary duties to the Funds. That is precisely what CRMC did, and that is what AFD conveyed to the retail firms.

[45] In contrast, the other portion of Rule 2830(k)(3), on which the Panel does not rely in reaching its conclusions in this case, prohibits an "offer or promise" of brokerage "as a condition to the sale or distribution of shares of an investment company …." See fn. 37, above, quoting the amended rule in its entirety.

with the words "or promises of sales," indicates clearly that it covers directed brokerage conditioned upon either past or future sales.

Finally, AFD's reliance on Rule 2830(k)(7) is also inconsistent with the language of that provision. AFD focuses on subsection (k)(7)(B), which permitted NASD members to act as underwriters for investment companies that "follow[ed] 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." [46] AFD points out that the various American Funds prospectuses contained such a disclosure.[47] But AFD fails to acknowledge that the availability of subsection (k)(7)(B) was expressly conditioned on AFD's compliance with "the specific provisions" of Rule 2830(k), including subsection (3). It would thus be inconsistent with the language of the rule to interpret subsection (k)(7)(B) as modifying or limiting the prohibitions imposed on AFD by Rule 2830(k)(3) in any respect.

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[46] In approving the rule, the SEC noted that it was appropriate for NASD to allow its members to defer to determinations by "the boards of directors of the investment company [i.e., mutual fund] in the exercise of their fiduciary duties." Exchange Act Release No. 17599, 1981 SEC LEXIS 1918 at *5 (Mar. 4, 1981). In 2004, however, after reviewing the actual practices in the mutual fund industry, the SEC acknowledged "the practical limitations on the ability of fund directors to actively monitor and evaluate the motivations behind the selection of brokers to effect portfolio securities transactions," (SEC Final Rule Notice, 69 Fed. Reg. at 54729), and the evidence in this case (see n. 47, below) amply supports that acknowledgment.

[47] Stip. ¶ 10. Although the American Funds prospectuses did include the required disclosure (which, however, did not mention AFD or its role), the Funds' boards approved the disclosure based on misleading advice. They were told that "[CRMC's] traders are given a 'preferred list' of brokers that have sold fund shares during the preceding year together with informal commission targets, but, consistent with NASD rules, no formal allocations or commitments are made to brokers. … Importantly, we make no formal commitments to brokers to any particular level of commissions nor do we communicate our informal targets." RX-50 ("Sample Disclosure to Fund Boards Regarding Additional Compensation and Brokerage Practices") (emphasis added). But the evidence in this proceeding establishes that, in fact, the execution revenue targets were routinely communicated to the retailers. Moreover, the Sample Disclosure fails to disclose that AFD set the targets; that they were specific percentages of the retailers' prior year's sales; or that CRMC tracked its success in meeting the targets and issued regular reports on that to AFD, which, in turn, kept the retailers apprised. And this decision confirms that the assurance that the practice conformed to NASD's rules was unwarranted.

Moreover, even considering the language of subsection (k)(7)(B) in isolation, it merely authorized AFD to act as the Funds' underwriter. But AFD did far more than underwrite the Funds – it requested and arranged for the payment of specific amounts of directed brokerage to the retail firms conditioned on their sales of the American Funds. Nothing in subsection (k)(7)(B) suggested that was permissible, notwithstanding the express prohibition in Rule 2830(k)(3), simply because the Funds disclosed that, as a general matter, they considered Fund sales in placing trades.

B. The Purpose of the Rule

AFD's proposed construction of Rule 2830(k)(3) is also inconsistent with the purpose of the rule. When Rule 2830(k) was first proposed in 1972, NASD explained that the rule, as a whole, had "for its purpose the abolition of 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."[48]

When NASD proposed to amend Rule 2830 in 1980, it did not explain the reasons for the specific language changes in subsection (k)(3). It stated, however, that Rule 2830(k) as a whole had "create[d] uncertainties for members attempting to comply with the rule which are unnecessary to accomplish its basic purposes," and expressed concern that the rule had "unfairly discriminate[d] against smaller broker-dealers and smaller investment companies"; that commission rate practices had changed; and that the rule might have inappropriately influenced "the actions of investment companies and their directors over which [NASD] has no jurisdiction." NASD also expressed the view that the fiduciary obligations of fund managers such as CRMC (which are not NASD

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[48] Notice to Members (NTM), 1972 NASD LEXIS 34 (July 27, 1972).

members) would "protect a fund against excessive portfolio transactions and brokerage commissions." And NASD stated that the addition of subsection (k)(7), as a whole, was intended to "make[] it clear that members can sell shares of an investment company which follows a disclosed policy of considering sales of its shares as a factor in the selection of broker-dealers to execute portfolio transactions," but also explained that in amending Rule 2830(k), it intended to "retain[] restrictions the Association believes to be effective in controlling potential abuses."[49]

All of this indicates that NASD intended to fine-tune the rule, not that it was abandoning its concerns about reciprocal business arrangements between NASD members.[50] While the changes to Rule 2830(k)(3), coupled with the addition of subsection (k)(7)(B), may have allowed underwriters such as AFD to recommend to funds and their investment advisers that, as a general matter, they consider sales in placing trades, during the relevant period AFD went far beyond this, using execution revenue targets tied to sales of the Funds to further its reciprocal arrangements with NASD-member retail firms.

The business plans, AFD's contemporaneous documents, and the testimony and contemporaneous documents of the retailers all confirm that marketing pool and execution revenue were simply two aspects of the overall financial support that AFD

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[49] 45 Fed Reg. 82777 (Dec. 16, 1980).

[50] In 1984 NASD issued an NTM stating that it had "been receiving an increased number of inquiries regarding the application of [Rule 2830] to certain compensation arrangements, and proposed arrangements …. These inquiries are primarily related to subsection (k) of the rule (the Anti-Reciprocal Rule) …." The NTM noted that the rule had been amended in 1981, but expressed concern that "some members may view the 1981 amendments as having altered the specific standards of the rule more extensively than was actually the case." The NTM explained that "the rule still prohibits … requesting or arranging for the direction of a specific amount … of brokerage commissions conditioned upon sales … of fund shares …." NTM No. 84-40, 1984 NASD LEXIS 75 (July 26, 1984).

used to reward and encourage the retailers' sales of the American Funds. Although the execution revenue amounts that AFD established for the retailers each year were only targets, at the beginning of each year AFD told the retailers what their targets were, the eligibility criterion for receiving a target – being among the top 50 retailers – and the manner in which the targets were calculated. Then during the year CRMC attempted – almost always successfully – to meet the targets, tracked its success and kept AFD apprised of its progress, and AFD conveyed that information to the retailers. When necessary, AFD also successfully urged CRMC to turn off, turn on, or redirect trading in order to advance its interests.

This continued year after year, establishing, by the relevant period, a course of dealing so firmly rooted that some firms expressed "dismay and shock" when AFD terminated directed brokerage for step-out firms. But although AFD had ended its use of directed brokerage for the step-out firms, it continued to request and arrange for the direction of brokerage to execution firms in 2003, and even increased the execution revenue targets for those firms, at least in part to offset the additional direct payments it was required to make to the former step-out firms to offset their loss of step-out commissions.

In summary, a clearer use of directed brokerage to further reciprocal arrangements, contrary to the purpose of Rule 2830(k)(3), is difficult to imagine.[51]

AFD also argues that even if the Panel concludes that AFD's practices violated Rule 2830(k)(3), AFD cannot be sanctioned, because the rule failed to give fair notice

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[51] As the SEC observed in 2004: "These [directed brokerage] arrangements are today far from the benign practice that we approved in 1981 when we allowed funds to merely consider sales in allocating brokerage." SEC Final Rule Notice, 69 Fed. Reg. at 54728.

that AFD's practices were prohibited. Once again, the Panel disagrees. As explained above, AFD's practices were inconsistent with both the plain language and the underlying purpose of the rule. Therefore, AFD had fair notice that they were prohibited.[52]

Therefore, the Panel concludes that AFD violated Rule 2830(k)(3) during the relevant period, as charged.[53] A violation of another NASD rule is also a violation of Rule 2110.

IV. Sanctions

There are no Sanction Guidelines for violations of Rule 2830(k)(3). Enforcement urges the Hearing Panel to censure AFD and fine it an amount equal to the total amount of directed brokerage that CRMC paid to retail firms in 2001 through 2003 – more than $98 million, according to Enforcement – or, alternatively, an amount equal to the total amount of directed brokerage that CRMC paid to clearing firms for the benefit of step-out retailers in 2001 and 2002 – more than $28 million, as calculated by Enforcement.

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[52] The National Adjudicatory Council has explained:

> A respondent has sufficient notice of the breadth of a rule, however, if a reasonable person would understand that the rule prohibited the conduct at issue. See Mark H. Love, Exchange Act Rel. No. 49248, 2004 SEC LEXIS 318, at *12 (Feb. 13, 2004) (noting, in context of a vagueness challenge to NASD Rule 3040, that the rule must give fair guidance to firms, their associated persons and NASD decision makers with respect to the type of activities that are subject to its restrictions); Richard Kwiatkowski, Exchange Act Rel. No. 48707, 2003 SEC LEXIS 2568, at *18 n.15 (Oct. 28, 2003) ("Due process requires that 'laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited.'") (quoting Upton v. SEC, 75 F.3d 92, 98 (2d Cir. 1996)).

DOE v. Dieffenbach, No. C02060003, 2004 NASD Discip. LEXIS 10 at *30 (N.A.C. July 30, 2004), aff'd on other grounds, Exchange Act Release No. 51467, 2005 SEC LEXIS 728 (Apr. 1, 2005).

[53] Although AFD did not calculate the execution revenue targets for the executing firms in 2003 by applying a mathematical function to their 2002 American Funds sales, as in prior years, the Panel finds this is irrelevant to whether AFD violated the rule. As in prior years, AFD recommended and arranged for the direction of specific amounts of directed brokerage to the executing firms conditioned upon their prior year's sales of the American Funds.

In support of its proposed sanctions, Enforcement argues that AFD engaged in a pattern of misconduct over a period of years that was intentional or at least reckless, and that AFD has never acknowledged its misconduct, which Enforcement contends are aggravating factors in determining sanctions. The Panel, however, disagrees.

The record indicates that AFD's use of directed brokerage during the relevant period was consistent with practices that had arisen in the mutual fund industry over a number of years, as confirmed by the SEC's assessment when it adopted a rule to prohibit those practices in 2004.[54] And it appears that neither the SEC, which regulates investment companies, investment advisers and fund underwriters, nor NASD, which regulates only the underwriters, expressed any concern about these practices until 2001. After the SEC staff informally expressed certain concerns about the use of directed brokerage to step-out firms in 2001, AFD voluntarily ended its use of that practice, even though competitors continued to direct brokerage to step-out firms.[55] Then in 2004, when the SEC and NASD indicated that they were considering rule changes that would prohibit any use of directed brokerage, AFD voluntarily ended its practices even before the rules were adopted.

The Panel, therefore, found that AFD's violations of Rule 2830(k)(3) were negligent, not intentional or reckless. Further, while AFD may not admit that its former practices violated NASD's rules, it acted voluntarily to change those practices – even though its competitors did not – when regulators began expressing concerns about the

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[54] "[T]he use of brokerage to facilitate the sale of fund shares is widespread among funds that rely on broker-dealers to sell fund shares." SEC Final Rule Notice, 69 Fed. Reg. at 54728 (footnote omitted).

[55] Tr. 1150.

mutual fund industry's use of directed brokerage. Under these circumstances, the Panel found that AFD's violations while serious, were not egregious.

Enforcement also argues that its proposed sanctions are appropriate because the directed brokerage amounts it has calculated represent unjust enrichment to AFD – money that AFD used to advance its own interests at the expense of the shareholders of the American Funds. Enforcement argues that under NASD's Guidelines, that money should be "fined away" from AFD.[56]

The Panel, however, also disagrees with Enforcement's unjust enrichment analysis. Like AFD, Enforcement fails to acknowledge that AFD, CRMC and the Funds were independent legal entities, each with its own role and responsibilities. AFD was just the underwriter and distributor of the Funds. As explained above, it could and did only request that CRMC direct brokerage to the retail firms to meet the execution revenue targets; AFD itself did not place any trades or set or pay any commissions. That was done by CRMC, which is not an NASD member, and therefore was not subject to NASD jurisdiction or required to obey Rule 2830(k)(3). The sanctions imposed on AFD must address AFD's misconduct; they cannot be used to, in effect, sanction CRMC.

Moreover, although the directed brokerage payments presumably benefited AFD by encouraging the retailers to sell shares of the American Funds, it is not so clear as Enforcement suggests that this was at the expense of the existing Fund shareholders. In fact, it is well recognized that increasing sales of a mutual fund may benefit existing shareholders if it leads to economies of scale, which can reduce fund expenses. In

[56] The Sanction Guidelines advise that, "[w]here appropriate to remediate misconduct, Adjudicators should consider a respondent's ill-gotten gain when determining the amount of a fine." NASD Sanction Guidelines at 5.

recognition of this, when it approved the amendments to Rule 2830(k) in 1981, the SEC concluded that "it [was] not inappropriate for investment companies to seek to promote the sale of their shares through the placement of brokerage without the incurring of any additional expense."[57]

Even when it adopted the rule prohibiting investment companies from using directed brokerage in 2004, after the relevant period, the SEC acknowledged that if funds grew less quickly as a result of its ban on directed brokerage "fund shareholders may not benefit from the economies of scale that accompany asset growth."[58] The SEC nevertheless prohibited the use of directed brokerage because it concluded that it "involves unmanageable conflicts of interest [regarding how and where fund advisers effect portfolio securities transactions] that may harm funds and fund shareholders."[59]

While the record in this case lends support to the SEC's concerns about conflicts of interest, there is no evidence that, in fact, CRMC placed unwarranted trades or paid

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[57] Exchange Act Release No. 17599, 1981 SEC LEXIS 1918 at *4 (Mar. 4, 1981) (emphasis added). As noted above, it is undisputed that CRMC paid its standard commissions on trades that generated directed brokerage. Although Enforcement argues that CRMC could have paid lower commissions, institutional investors such as mutual funds normally pay higher than minimal commissions because they are more concerned about obtaining high quality execution of their trades than minimizing commissions. Tr. 980-84, 995, 997-98. See Applicability of the Commission's Policy Statement on the Future Structure of the Securities Markets to Selection of Brokers and Payment of Commissions by Institutional Managers, 37 Fed. Reg. 9988, 1972 SEC LEXIS 72 at *3-4 (May 9, 1972) (recognizing that fund advisers such as CRMC "should have discretion to pay a commission rate that will assure reliability and quality of service provided that it is reasonable"). The limited evidence in the record suggests that CRMC's commission rates were on a par with those paid by its competitors. Tr. 987, 1151-52. In any event, as explained above, CRMC's practices are not at issue in this proceeding.

[58] The SEC noted, however, that "fund shareholders have not always enjoyed lower expenses as a result of increased assets …." SEC Final Rule Notice, 69 Fed. Reg. at 54731 & n. 38.

[59] SEC Proposed Rule Notice, 2004 SEC LEXIS 418 at *21-22 (emphasis added). The SEC continued: "While the benefits to funds and their shareholders of using fund brokerage to promote the sale of fund shares are unclear, the benefits to fund advisers are clear. Fund advisers' compensation is based on a percentage of assets under management. A larger fund typically generates more advisory fees. Fund advisers have an incentive to use fund assets to increase the size of the fund and therefore promote the growth of their advisory fees." Id. (emphasis added).

excessive commissions to generate directed brokerage, or that, insofar as directed brokerage contributed to the very substantial sales of American Funds shares during the relevant period, those sales were of no benefit to the Funds' existing shareholders. In short, there is simply no evidence that the total amount of brokerage CRMC directed to satisfy the execution revenue targets set by AFD – or even the total amount that CRMC directed to clearing firms for the benefit of the step-out retailers – represents unjust enrichment to CRMC or AFD at the expense of the Funds' shareholders.

This does not mean, however, that AFD's violations were technical or inconsequential. On the contrary, AFD's use of directed brokerage to promote reciprocal business arrangements with the retail firms was clearly contrary to the language and purpose of Rule 2830(k)(3). AFD conveyed execution revenue targets to CRMC within an established course of dealing, whereby AFD and the retailers understood that AFD would establish such targets, calculated as a factor of the retailers' prior sales, if and only if the retailers were among the top 50 retailers of American Funds, and that CRMC would generally direct brokerage sufficient to meet the targets. This sort of reciprocal use of mutual fund brokerage is precisely what the rule was intended to proscribe.

NASD's Sanction Guidelines advise that "Adjudicators should design sanctions that are significant enough to prevent and discourage future misconduct by a respondent, to deter others from engaging in similar misconduct, and to modify and improve business practices."[60] The SEC and NASD rule changes, after the relevant period, will preclude AFD or other NASD members from using directed brokerage practices in the future. Nevertheless, to satisfy the remedial goals expressed in the Guidelines, in light of AFD's

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[60] Sanction Guidelines at 2.

serious, substantial and protracted violations of Rule 2830(k)(3) during the relevant period, the sanctions must be sufficient to convey clearly to both AFD and the industry as a whole that NASD members are expected to conform their conduct to the rules, regardless of industry practices or competitive pressures and even in the absence of affirmative regulatory enforcement efforts. Self-regulation rests on NASD firms policing their own practices to ensure that they comport with the letter and spirit of the rules.

The Panel, therefore, finds that a censure and a very substantial fine – although not at the level sought by Enforcement – are required. Accordingly, the Panel will impose a censure and a $5 million fine.[61]

V. Conclusion

Respondent American Funds Distributors, Inc. is censured and fined $5,000,000 for requesting and arranging for the direction to NASD member firms of specific amounts of brokerage commissions conditioned upon those members' sales of American Funds shares, in violation of Rules 2830(k)(3) and 2110. In addition, Respondent is ordered to pay costs in the amount of $10,687.13, which includes an administrative fee of $750 and the cost of the hearing transcript. These sanctions shall become effective on a date set by NASD, but not earlier than 30 days after this decision becomes NASD's final disciplinary action in this matter.[62]

HEARING PANEL

By: David M. FitzGerald
Hearing Officer

[61] As noted above, the Panel found that AFD's practices in 2003 violated Rule 2380(k)(3) even though they differed somewhat from the prior years. Even if AFD's 2003 practices were deemed not to violate the rule, however, the Panel would impose the same sanctions based on AFD's 2001 and 2002 violations.

[62] The Hearing Panel has considered and rejects without discussion all other arguments of the parties.

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