

**SECURITIES AND EXCHANGE COMMISSION**  
**(Release No. 34-50611; File No. SR-NASD-2004-027)**

October 29, 2004

**Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Investment Company Portfolio Transactions**

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on February 10, 2004, the National Association of Securities Dealers, Inc. (“NASD”), filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. NASD amended the proposed rule change on September 17, 2004.<sup>3</sup> The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.<sup>4</sup>

**I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE**

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Letter from Patrice Gliniecki, Senior Vice President and Deputy General Counsel, NASD, to Katherine England, Assistant Director, Division of Market Regulation, Commission, dated September 16, 2004 (“Amendment No. 1”). Amendment No. 1 modified proposed Rule 2830(k)(2) to clarify that its prohibition would apply to situations in which an investment company directs or is expected to direct portfolio transactions in exchange for distribution. Amendment No. 1 also modified that proposed prohibition to clarify that it would apply not only to the distribution of shares of a fund that directs portfolio transaction commissions to the distributing broker, but also to the distribution of the shares of any other registered investment company. Amendment No. 1 further clarified the description of the purpose of the proposed rule change.

<sup>4</sup> The Commission recently amended rule 12b-1, 17 CFR 270.12b1-1, under the Investment Company Act of 1940, 15 U.S.C. 80a, to prohibit open-end management investment companies from paying for the distribution of their shares with brokerage commissions. See Investment Company Act Release No. 26591 (Sept. 2, 2004), 69 FR 54728 (Sept. 9, 2004). This NASD rule proposal corresponds with the Commission’s action.

NASD is proposing to amend NASD Conduct Rule 2830(k). Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in [brackets].

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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.

[(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.

[(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;

[(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.

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## **II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE**

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

### **A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change**

#### **1. Purpose**

Rule 2830(k) governs members' execution of investment company portfolio transactions. The rule generally prohibits members from favoring the sale of shares of any investment

company on the basis of brokerage commissions received or expected by the member from any source, including the fund. The rule is designed to prevent *quid pro quo* arrangements in which brokerage commissions, which represent an asset of the fund, are used to compensate members for selling fund shares. Rule 2830(k)(7)(B) permits a member to sell the shares of, or act as an underwriter for, an investment company that 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 fund portfolio transactions, subject to the requirements of best execution. NASD proposes to eliminate this provision, due to concerns that members have misconstrued the limited nature of the provision and the fact that the provision does not change the general prohibitions of the rule.

The proposed rule change also would include language, in new Rule 2830(k)(2), that would clarify that no member may sell the 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 the 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.<sup>5</sup> Under the proposed rule change, a member would not violate Rule 2830(k) solely because the member promotes or sells the shares of an investment company that directs fund portfolio transactions to the member. However, a member

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<sup>5</sup> Proposed new paragraph (k)(2) would add an objective proscription, in that the broker-dealer's intent to favor or disfavor a particular fund would not be relevant to that prohibition. The existing proscription of paragraph (k)(1), in contrast, turns upon the question of whether a broker-dealer favors or disfavors a fund based on receipt or expected receipt of brokerage commissions.

would violate Rule 2830(k) if the member engages in the type of conduct prohibited under paragraphs (1) through (7).

## 2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>6</sup> which requires, among other things, that NASD rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. One important purpose of Rule 2830(k) is to help eliminate conflicts of interest in the sale of investment company securities, and the proposed rule change will improve NASD's ability to achieve this objective.

### B. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

### C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

## III. **DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION**

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. by order approve such proposed rule change, or

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<sup>6</sup> 15 U.S.C. 78o-3(b)(6).

- B. institute proceedings to determine whether the proposed rule change should be disapproved.

#### **IV. SOLICITATION OF COMMENTS**

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change as amended is consistent with the Act. Comments may be submitted by any of the following methods:

##### Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASD-2004-027 on the subject line.

##### Paper Comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-NASD-2004-027. The file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW, Washington, DC 20549.



Copies of such filing will also be available for inspection and copying at the principal office of NASD. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NASD-2004-027 and should be submitted by [insert date 21 days from the date of publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>7</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>7</sup> 17 CFR 200.30-3(a)(12).