

**SECURITIES AND EXCHANGE COMMISSION**  
**(Release No. 34-50883; File No. SR-NASD-2004-027)**

**December 20, 2004**

**Self-Regulatory Organizations; Order Approving Proposed Rule Change by NASD, Inc.,  
Relating to Investment Company Portfolio Transactions**

**I. Introduction**

On February 10, 2004, the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“SEC” or “Commission”), 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> a proposed rule change relating to investment company portfolio transactions. On September 17, 2004, NASD filed Amendment No. 1 to the proposed rule change.<sup>3</sup> The proposed rule change, as amended, was published for comment in the Federal Register on November 5, 2004.<sup>4</sup> The Commission received one comment letter in response to the proposed rule change.<sup>5</sup> For the reasons discussed below, the Commission is approving the proposed rule change.

**II. Description of the Proposed Rule Change**

A. Description of the Proposal

NASD Rule 2830(k) governs NASD members’ execution of investment company portfolio transactions. In general, the rule prohibits NASD members from favoring the sale of shares of any investment company on the basis of brokerage commissions received or expected

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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.

<sup>4</sup> Securities Exchange Act Release No. 50611 (Oct. 29, 2004 ), 69 FR 64609 (Nov. 5, 2004) (“Notice”).

<sup>5</sup> See letter to Jonathan G. Katz, Secretary, Commission from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, dated November 24, 2004 (“ICI letter”). The comment letter is available online at [www.sec.gov/rules/sro/nasd/nasd2004027.shtml](http://www.sec.gov/rules/sro/nasd/nasd2004027.shtml).

to be received from any source, including the investment company.<sup>6</sup> However, subparagraph (7)(B) of the rule allows an NASD member, subject to the requirements of best execution, to sell the shares of, or act as an underwriter for, an investment company where that investment company “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 . . . .”

NASD now proposes to strike subparagraph (k)(7)(B) from Rule 2830 and add a new subparagraph, designated (k)(2), that would prohibit NASD members from selling the shares of, or acting as underwriter for, any 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.<sup>7</sup>

As NASD noted in its description of the proposed rule change, proposed new subparagraph (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

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<sup>6</sup> See NASD Rule 2830(k)(1).

<sup>7</sup> See Notice 69 FR at 64609.

favors or disfavors a fund based on receipt or expected receipt of brokerage commissions.”<sup>8</sup> The proposed prohibition would apply not only to the distribution of shares of the fund that directs portfolio transaction commissions to the distributing broker, but also to the distribution of the shares of any other registered investment company. Further, the rule would continue to provide that an NASD member will not violate Rule 2830(k) solely because it promotes or sells the shares of an investment company that directs fund portfolio transactions to the member, so long as the member does not engage in conduct otherwise prohibited by the rule.

B. Comment Summary

The proposal was published for comment in the Federal Register on November 5, 2004.<sup>9</sup> The SEC received one comment letter, from the Investment Company Institute (“ICI”), in response to the proposed rule change.<sup>10</sup> The ICI expressed support for the proposed rule change, asserting that it “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.”<sup>11</sup> The ICI stated that NASD’s 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.”<sup>12</sup> The ICI also supported NASD’s retention of Rule 2830(k)(7)(A) (to be re-

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<sup>8</sup> See Notice, 69 FR 64609, 64610 n. 5.

<sup>9</sup> See note 4, supra.

<sup>10</sup> See note 5, supra.

<sup>11</sup> ICI letter. See Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26591 (Sept. 2, 2004) 69 FR 54728 (Sept. 9, 2004) (adopting amendments to Rule 12b-1 [17 CFR 270.12b-1] under the Investment Company Act of 1940 [15 U.S.C. 80a] to prohibit investment companies from paying for the distribution of their shares with brokerage commissions).

<sup>12</sup> ICI letter.

designated (8)(A)), which provides that an NASD member would not violate the rule solely because it sells shares of an investment company for which it also executes transactions, because NASD members might otherwise “be improperly discouraged from performing both execution and sales functions for a particular fund.”<sup>13</sup>

### **III. Discussion and Findings**

The Commission finds the proposed rule change is consistent with the Act, and in particular with Section 15A(b)(6) of the Act, which requires, among other things, that NASD's rules 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.<sup>14</sup> The Commission believes that the proposed rule change is consistent with the provisions of the Act noted above because it will strengthen NASD's rules against quid pro quo arrangements between NASD members and investment companies whereby investment companies compensate broker-dealers for promotion of their shares with brokerage commissions (or similar transaction-related remuneration), which are paid out of fund assets. The Commission has noted that such practices pose significant conflicts of interest and may be harmful to fund shareholders, as well as potential purchasers of fund shares, in that they may induce broker-dealers “to recommend funds that best compensate the broker rather than funds that meet the customer's investment needs.”<sup>15</sup>

The addition of new subparagraph (k)(2) to Rule 2830 would clarify that no member may sell the shares of, or act as an underwriter for, an investment company if the member knows, or

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<sup>13</sup> Id.

<sup>14</sup> 15 U.S.C. 78o-3(b)(6).

<sup>15</sup> Prohibition on the Use of Brokerage Commissions to Finance Distribution, note 10, supra, 69 FR 54728 at 54729-54730.

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 whereby the investment 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-dealer in consideration for the promotion or sale of shares issued by the company or any other registered investment company. As NASD noted in its description of the proposed rule change,<sup>16</sup> this requirement will differ from that in existing subparagraph (k)(1) of the rule because “the broker-dealer’s intent to favor or disfavor a particular fund would not be relevant.” Rather, the new provision will require NASD members to refrain from distributing the shares of an investment company in any case where the member knows, or has reason to know, of the investment company’s participation in such an arrangement. The Commission believes that this amendment of NASD’s rules is consistent with the protection of investors because it will clarify that broker-dealers may not enter into such quid pro quo distribution arrangements. One important purpose of Rule 2830(k) is to help eliminate conflicts of interest in the sale of investment company securities, and this rule change will improve NASD’s ability to achieve this objective.

NASD’s proposal would also strike subparagraph (7)(B) from Rule 2830(k). This provision of NASD’s rules has heretofore allowed NASD members to distribute shares of investment companies that, pursuant to a disclosed policy, consider sales of their shares by broker-dealers as a factor when selecting broker-dealers for the execution of transactions for a fund. NASD’s proposal would add new subparagraph (k)(2) to NASD Rule 2830. This subparagraph will now explicitly state that members are not permitted to sell the shares of

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<sup>16</sup> See Notice, 69 FR 64609, 64610 n. 5.

investment companies that the member knows or has reason to know engages in such practices. The Commission believes that elimination of subparagraph (k)(7)(B) of Rule 2830 should strengthen investor protection because it removes a possible incentive for brokers to recommend investments based on their own financial interests, rather than the best interests of their customers.

Finally, the Commission notes that, under subparagraph (8)(A) of Rule 2830(k),<sup>17</sup> NASD members may still sell the shares of an investment company that directs fund portfolio transactions to the member, so long as the other provisions of the rule are satisfied. The Commission believes that this existing provision of the rule makes clear that an NASD member may continue to distribute the shares of investment companies for which the member executes investment portfolio transactions, where the member's sales efforts are not connected to any arrangements for the direction of brokerage commissions in exchange for distribution. In this regard, the Commission notes that NASD Rule 3010 requires NASD members to establish and maintain a supervisory system for registered representatives and associated persons that is reasonably designed to achieve compliance with applicable securities laws and regulations and with the NASD's rules.

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<sup>17</sup> Previously designated as Rule 2830(k)(7)(A).

#### **IV. Conclusion**

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act<sup>18</sup> that the proposed rule change (SR-NASD-2004-027), as amended, be, and hereby is, approved.<sup>19</sup>

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>20</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>18</sup> 15 U.S.C. 78s(b)(2).

<sup>19</sup> In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>20</sup> 17 CFR 200.30-3(a)(12).