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A legal update from Dechert's Financial Services Group

SEC Approves Changes to NASD Rule on Directed Brokerage

On December 20, 2004, the Securities and Exchange Commission ("SEC" or the "Commission") approved a change to NASD's restrictions on directed brokerage.¹ The change complements the SEC's own new rule banning directed brokerage.²

Discussion

For many years, NASD has prohibited a broker-dealer from favoring the sale to its customers of a mutual fund in exchange for receiving brokerage commissions from the fund's sponsor (or others). For example, NASD Rule 2830(k)(1) provides:

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.

NASD often refers to Rule 2830(k) as the "anti-reciprocal rule," because it prohibits *quid pro quo* or reciprocal behavior in which a broker-dealer might encourage the sale of a fund to

investors in exchange for receiving portfolio transactions from the fund sponsors. Such activity could create incentives for broker-dealers or their registered representatives to recommend funds that are unsuitable for customers.³

More recently, NASD stated that "recent events in the investment company industry have heightened NASD's concern that fund brokerage may be used to inappropriately encourage members to promote or sell the shares of particular funds."⁴ Accordingly, NASD approved two changes to Rule 2830(k) and submitted them to the SEC for approval.⁵ These changes are:

1. **Eliminated Funds Sales as a "Factor" Standard** – Previously, Rule 2830(k)(7)(B) permitted 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*, subject to the requirements of best execution.

The amendment eliminated this provision from NASD Rule 2830(k). Accordingly, NASD now states that "a member may not sell the shares of, or act as an

¹ Rel. 34-50883, 69 FR 77286, Dec. 27, 2004 (the "Adopting Release"); see also NASD Notice to Members 05-04, Jan. 2005 ("NTM"), and Rel. 34-50611, 69 FR 64609, Nov., 5, 2004 (the "Proposing Release").

² Dechert Update, *SEC Adopts Amendments on Directed Brokerage and Portfolio Management Disclosure*, Sept. 2004, http://www.dechert.com/library/FS_2004_27.pdf.

³ Unsuitable recommendations also would raise issues under NASD Rule 2310 (suitability) as well as NASD Rule 2110, which provides that a "member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."

⁴ SR-NASD-2004-027 at 8.

⁵ The following discussion is drawn from NTM at 2.

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.”

NASD further suggests that 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-dealer.⁶

2. **Ban on Participating in Directed Brokerage Arrangements** – The amendments add a new paragraph (k)(2) to the rule, explicitly stating 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.⁷

NASD notes that this change:

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 prescription 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 [emphasis added].⁸

As the SEC observed in the Adopting Release:

[T]he 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.⁹

According to NASD, 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.¹⁰

Despite the strengthening of the rule, NASD notes, and the Commission reiterates, that a member may continue both to sell shares of an investment company and execute portfolio transactions of the investment company, provided that the member does not violate any other provision of Rule 2830(k).¹¹

The new provision takes effect on February 14, 2005.

Conclusion

The 1963 Special Study of the Securities Laws examined the issue of directed brokerage during the era of fixed commission rates. In the Special Study, the SEC noted that “reciprocity or ‘doing business with people who do business with you,’ is an accepted custom of the business world in general, and the securities industry is no exception.”¹² The SEC then recommended a series of reforms to ameliorate concerns associated with such reciprocal arrangements. Deregulating trading commissions addressed much of the problem that the SEC identified in 1963. But more than 40 years later, NASD, along with the SEC, continue to address these concerns.



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⁹ Adopting Release at 77287.

¹⁰ *Id.*

¹¹ 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.” Adopting Release at 77287.

¹² Report of the Special Study of the Securities Markets of the Securities and Exchange Commission, H. Doc. 95, pt. 4 (1963) at 233.

⁶ *Id.*

⁷ *Id.*

⁸ Proposing Release at n. 5.

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