

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934  
Rel. No. 64747 / June 24, 2011

Admin. Proc. File No. 3-13055

In the Matter of the Application of  
  
AMERICAN FUNDS DISTRIBUTORS, INC.  
c/o Seth M. Schwartz, Esq.  
Skadden, Arps, Slate, Meagher & Flom LLP  
Four Times Square  
New York, NY 60443

For Review of Disciplinary Action Taken by  
  
NASD

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION – REVIEW OF DISCIPLINARY  
PROCEEDINGS

Violation of Conduct Rules

Alleged Violation of Rule Related to "Directed Brokerage" Practices

NASD member firm appeals from findings that it violated rule prohibiting mutual fund underwriters from requesting or arranging for the direction of a specific amount or percentage of brokerage commissions to member broker-dealers conditioned upon their sales of mutual fund shares. *Held*, association's findings of violations and sanctions it imposed are *set aside*.

APPEARANCES:

*Seth M. Schwartz, Raoul D. Kennedy, Jeffrey W. McKenna, and William J. O'Brien* of Skadden, Arps, Slate, Meagher & Flom LLP, for American Funds Distributors, Inc.

*Marc Menchel, Alan Lawhead, and Jante Santos*, for Financial Industry Regulatory Authority, Inc.

Appeal filed: May 29, 2008

Last brief received: September 12, 2008

## I.

American Funds Distributors, Inc. ("AFD"), an NASD member firm and principal underwriter and distributor for the American Funds, a family of twenty-nine mutual funds, appeals from NASD disciplinary action.<sup>1</sup> NASD found that AFD, from 2001 to 2003 (the "Relevant Period"), requested or arranged for the direction of specific amounts or percentages of brokerage commissions to broker-dealers that sold American Funds shares, in violation of former NASD Conduct Rule 2830(k) and Conduct Rule 2110.<sup>2</sup> NASD censured AFD and imposed a \$5 million fine. We base our findings on an independent review of the record.

## II.

## A. Regulatory Background

NASD Rule 2830(k), commonly known as the "Anti-Reciprocal Rule" (the "Rule"),<sup>3</sup> governs the conduct of NASD members in connection with mutual fund directed brokerage – the practice whereby an open-end investment company, or "mutual fund," generally acting through its adviser, directs execution of the mutual fund's portfolio securities transactions to retail broker-dealers as a form of compensation for selling the fund's shares.<sup>4</sup>

The version of the Rule in effect during the Relevant Period was adopted as part of NASD's 1981 amendments to the Rule (the "1981 Amendments"), which relaxed previous prohibitions against directing brokerage commissions to broker-dealers in connection with their

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<sup>1</sup> On July 26, 2007, NASD's Certificate of Incorporation was amended to reflect its name change to Financial Industry Regulatory Authority, Inc. ("FINRA"), in connection with the consolidation of its member firm regulatory functions with NYSE Regulation, Inc. *See* Securities Exchange Act Rel. No. 56146 (July 26, 2007), 72 Fed. Reg. 42,190 (Aug. 1, 2007) (SR-NASD-2007-053). Because the disciplinary action here was initiated before that date, we continue to use the designation NASD.

<sup>2</sup> FINRA has since revised and renumbered its rules. *See* Exchange Act Rel. No. 58643 (Sept. 25, 2008), 73 Fed. Reg. 57,174 (Oct. 1, 2008). NASD Rule 2110 was recodified as new FINRA Rule 2010, without substantive change. NASD Rule 2830(k) remained unchanged.

<sup>3</sup> NASD has referred to the Rule as the "Anti-Reciprocal Rule" since its enactment. *E.g.*, NASD Notice to Members 73-42 (May 1973); NASD Notice to Members 84-40 (July 1984).

<sup>4</sup> The Rule does not apply to investment companies or investment advisers because such entities do not register with NASD and are not subject to NASD jurisdiction.

sale of fund shares.<sup>5</sup> As amended, Rule 2830(k)(3) prohibited a member underwriter from "request[ing] or arrang[ing] 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."<sup>6</sup> Rule 2830(k)(7)(B) provided an exception to the general prohibitions under the Rule, permitting a member to "act[] 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 selection of broker-dealers to execute portfolio transactions, subject to the requirements of best execution."<sup>7</sup>

In 1984, NASD amended subparagraph (k)(7)(B)'s exception to clarify that it applied only if "the member d[id] not violate any of the specific provisions of . . . paragraph (k)."<sup>8</sup> The same year, NASD also issued a Notice to Members that set forth several examples of conduct that the NASD noted violated the Rule, including, as relevant here, "an offer or agreement by a principal underwriter, for a specified percentage of portfolio brokerage commissions relative to the dealer's sale of fund shares" and "an offer or agreement by a principal underwriter that portfolio orders be placed in recognition of the representative's prior or future sales of fund shares."<sup>9</sup>

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<sup>5</sup> See *Order Approving Proposed Rule Change and Related Interpretation Under Section 36 of the Investment Company Act*, Exchange Act Rel. No. 17599 (Mar. 4, 1981), 22 SEC Docket 329, 329-31 (stating that NASD would no "longer prohibit, subject to certain restrictions, members from seeking or granting brokerage commissions in connection with the sale of fund shares," and noting that "it [wa]s 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" (emphasis in original)).

<sup>6</sup> NASD Manual at 2105-4 (1981 ed.) (emphasis supplied). Previously, this subparagraph prohibited members from "request[ing] or arrang[ing] for the direction to any member of an amount or percentage of brokerage commission . . . *as an inducement or reward* for the sale of shares of an investment company." Art. III, § 26(k)(3) of NASD Rules of Fair Practice, NASD Manual at 2106 (1973 ed.) (emphasis supplied).

<sup>7</sup> NASD Manual at 2105-5 (1981 ed.); see also *Clarke T. Blizzard*, 58 S.E.C. 723, 726 (2005) (defining "best execution" as an investment adviser's duty to "seek the most favorable terms for a customer transaction reasonably available under the circumstances, which might include directing trades to brokers who also provide research or other services to the adviser").

<sup>8</sup> *National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change*, Exchange Act Rel. No. 21128 (July 10, 1984), 30 SEC Docket 1360, 1360 (stating "NASD is amending subsection (k)(7) . . . to clarify that a member must comply with the other provisions of subsection (k) notwithstanding subsection (k)(7)").

<sup>9</sup> NASD Notice to Members 84-40.

In 2004, NASD again amended the Rule (the "2004 Amendments") in response to changes to Rule 12b-1 of the Investment Company Act of 1940<sup>10</sup> that prohibited investment companies from paying for fund distribution with directed brokerage commissions.<sup>11</sup> The 2004 Amendments substantially revised the Rule, eliminating the exception contained in Rule 2830(k)(7)(B) and adding a new subparagraph (k)(2)<sup>12</sup> to "clarify that no member may . . . act as an underwriter for an investment company if the member knows . . . that such investment company, or an investment adviser or principal underwriter of the company, has a written or oral agreement or understanding" to direct brokerage transactions to broker-dealers "in consideration" for promoting or selling shares of the investment company.<sup>13</sup> AFD concedes that, as a result of the 2004 Amendments, the directed brokerage practices at issue in this case would violate the version of the Rule currently in effect, but contends that those practices did not violate the version of the Rule in effect during the Relevant Period, 2001 to 2003.<sup>14</sup>

## **B. American Funds' Directed Brokerage Practices**

Capital Research and Management Company ("CRMC") is the investment adviser to each of the American Funds. During the Relevant Period, CRMC, on behalf of the American Funds, compensated the top forty-six selling retail brokerage firms of American Funds shares (the "Retail Firms") by directing portfolio trading in the American Funds to, or for the benefit of, the Retail Firms, which generated commission revenue for these firms. For Retail Firms that lacked the capacity to execute portfolio trades, CRMC directed trading to a clearing firm that would execute the portfolio trades and then allocate, or "step out," all or part of the generated brokerage commissions to the non-executing Retail Firms (the "Step-Out Firms").

AFD, a wholly owned subsidiary of CRMC, calculated the target brokerage commissions for CRMC to generate under its directed trading program. Each year, AFD furnished CRMC a target commission list to distribute to its traders who, in part, used the target commission amounts to determine where to place portfolio trades for American Funds over the course of the year. In 2001 and 2002, AFD based its target commission calculations primarily on the Retail

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<sup>10</sup> 17 C.F.R. § 270.12b-1.

<sup>11</sup> *See Prohibition on the Use of Brokerage Commissions to Finance Distribution*, Investment Company Act Rel. No. 26591 (Sept. 2, 2004), 83 SEC Docket 2490.

<sup>12</sup> NASD Manual at 4306 (2006 ed.).

<sup>13</sup> *Self-Regulatory Organizations; Order Approving Proposed Rule Change by NASD, Inc., Relating to Investment Company Portfolio Transactions*, 69 Fed. Reg. 77,287 (Dec. 27, 2004) ("2004 Amendments") (stating that the new Rule "will now explicitly state that members are not permitted to sell the shares of investment companies that the member knows or has reason to know engages in such practices").

<sup>14</sup> NASD Rule 2830(k), NASD Manual at 4291-92 (2003 ed.).

Firms' previous year's sales: For the top-ten selling Retail Firms, AFD calculated target commissions equal to fifteen basis points (or 0.15%) of that firm's previous year's sales. For the next thirty-six top-selling Retail Firms, AFD calculated target commissions equal to ten basis points (or 0.10%) of the firm's prior year sales.

AFD personnel often informed the Retail Firms of the commission amount it had calculated for the firm for a given year. AFD personnel told the firms that the commissions were a reward for the firm's past year's sales, but that the amounts were non-negotiable and that it could not guarantee that CRMC, in placing portfolio trades with the firm over the year, would necessarily meet the target commissions it had calculated. While witnesses from AFD and the Retail Firms testified that they expected CRMC to meet the targeted amounts, the Retail Firms understood that the target commissions were not binding on AFD. CRMC traders generally placed enough trades with Retail Firms by year end to meet AFD's target commissions; however, the record reflects divergence between the targeted amounts and the commissions actually generated by CRMC traders. Often, CRMC paid commissions far exceeding AFD's targets (*e.g.*, by as much as 239 basis points); in other instances, CRMC failed to meet the target levels.

Unlike other firms, AFD did not enter into written contracts to provide specific amounts of brokerage commissions to retail firms in exchange for their mutual fund selling efforts; CRMC also directed brokerage commissions based "on prior year sales" rather than current year sales; and CRMC declined to make up shortfalls in the actual amount of brokerage commissions paid by year end. Record evidence also shows that, compared with the ten to fifteen basis points calculated by AFD, some of American Funds' competitors agreed to pay up to forty basis points in directed brokerage commissions.

In early 2002, Commission staff expressed concern informally to CRMC regarding its practice of directing brokerage with respect to Step-Out Firms and indicated that the Commission was considering revising Investment Company Act Rule 12b-1 to limit or prohibit the practice. As a result, CRMC and AFD began to reevaluate their directed brokerage practices. In July 2002, CRMC ceased directing brokerage commissions for the benefit of all Step-Out Firms, which were surprised by the decision because many other firms continued the practice.<sup>15</sup> Later that year, AFD determined to change the basis upon which it calculated target commissions for CRMC in 2003. Rather than basing its targets almost solely on sales, AFD relied on a combination of factors for 2003 that included past sales, previous commissions paid to the Retail Firm, assets under management, rates of redemption, and the "quality" of the relationship AFD had with the Retail Firm. In 2003, AFD also stopped its practice of informing Retail Firms of the target commission levels.

In a letter to the Commission dated December 16, 2003, the Investment Company Institute ("ICI") recommended that "the Commission and/or NASD adopt new rules that would

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<sup>15</sup> Contemporaneous record evidence shows that the Step-Out Firms were "outraged," "shocked," and "dismayed" by CRMC's decision.

prohibit funds from taking into account sales of fund shares in allocating fund brokerage."<sup>16</sup> Following the ICI's recommendation, on January 1, 2004, CRMC and AFD terminated their directed brokerage program with respect to all Retail Firms more than a year before NASD's 2004 Amendments took effect.

### C. NASD Proceeding

NASD's complaint alleged that AFD violated the Rule by arranging for CRMC to direct to Retail Firms a percentage of brokerage commissions conditioned upon the firms' sales of shares of American Funds during the Relevant Period.<sup>17</sup> AFD disputed NASD's charges, claiming that its directed brokerage practices were fully disclosed, did not compromise the best execution of the funds' portfolio trades, and were not based on binding agreements between AFD and the Retail Firms and, therefore, did not conflict with the Rule's prohibitions because they were not "conditioned upon" the Retail Firms' sales. NASD's Hearing Panel, after conducting a six-day hearing, disagreed, finding that AFD's "targets tied to sales of the Funds" triggered the Rule's prohibitions.

The Panel, in considering a sanction (and rejecting NASD Enforcement's request for a \$98 million fine), however, identified several factors that, in its view, mitigated AFD's violations. In particular, the Panel found that AFD's directed brokerage practices were "consistent with practices that had arisen in the mutual fund industry over a number of years." It also determined that AFD's conduct was "negligent, not intentional or reckless" and that its violations "were not serious," based on its finding that AFD "acted voluntarily to change [its] practices – even though its competitors did not – when regulators began expressing concerns about the mutual fund industry's use of directed brokerage." In addition, the Panel found no evidence that AFD was unjustly enriched as a result of its directed brokerage practices. The Panel stated, among other things, that it had not found evidence that "CRMC placed unwarranted trades or paid excessive commissions to generate directed brokerage," and therefore that AFD's practices did not harm American Funds investors. Based on these circumstances, the Panel censured AFD and fined it \$5 million.

NASD's National Adjudicatory Counsel ("NAC") affirmed the Hearing Panel's decision and sanctions it imposed. As the NAC acknowledged, the case presented a question of "the correct interpretation of Rule 2830(k)(3) . . . [,] a matter of first impression, not decided in a previous [NASD] disciplinary case." The NAC found that AFD violated the Rule because its target commissions, while considered non-binding arrangements with the Retail Firms,

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<sup>16</sup> Letter from Matthew P. Fink to then Commission Chairman William H. Donaldson, SEC Chairman, ICI Statements & Publications (Dec. 16, 2003), *available at* [http://www.ici.org/policy/comments/03\\_sec\\_soft\\_com](http://www.ici.org/policy/comments/03_sec_soft_com).

<sup>17</sup> NASD brought its action two days after the 2004 Amendments became effective.

"constituted a specific amount or percentage of brokerage for the sale of mutual fund shares, in violation of Rule 2830(k)(3)."<sup>18</sup>

In upholding the Panel's sanction determination, the NAC, like the Panel, indicated that the evidence did not show that AFD's practices had harmed American Funds' investors, stating that "[t]he portfolio trades that CRMC placed required the mutual funds to pay brokerage commissions . . . regardless of whether AFD violated [NASD] rules." In this connection, the NAC noted that NASD Enforcement had stipulated that CRMC did not violate its duty, as investment adviser to the funds, of best execution in placing portfolio trades on behalf of the American Funds. The NAC also found no evidence "that retail firms would have ceased or diminished their sales of American Funds if AFD did not violate Rule 2830(k)."

### III.

A. The parties largely agree as to the relevant facts of the case, *i.e.*, AFD's directed brokerage practices between 2001 and 2003. They disagree as to the meaning of the language used in the former Rule and whether that language was adequate to give AFD "fair notice" that its practices were prohibited.

NASD contends that the phrase "conditioned upon," as used in former Rule 2830(k)(3), should be construed broadly to prohibit using mutual fund sales as a "prerequisite" to directing brokerage commissions to broker-dealers selling fund shares.<sup>19</sup> NASD further contends that the Rule's exception contained in Rule 2830(k)(7)(B) only applied, by its very terms, if "the member does not violate any of the other specific provisions of Rule 2830(k)." Because AFD violated subparagraph (k)(3), according to NASD, the exception did not apply. In addition, NASD states that it provided clear guidance of the Rule's prohibitions, most notably through written guidance it issued in a 1984 Notice to Members, which identified examples of certain practices covered by the Rule.<sup>20</sup>

AFD counters that the term "conditioned upon"<sup>21</sup> should be interpreted as prohibiting

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<sup>18</sup> The NAC also found that AFD violated NASD Rule 2110 based on its violation of Rule 2830(k)(3), noting that "a violation of another FINRA rule . . . is a violation of Rule 2110."

<sup>19</sup> Citing *The American Heritage College Dictionary* 290 (3d ed. 1997) ("condition" means "[something] indispensable to the appearance or occurrence of another; prerequisite").

<sup>20</sup> NASD Notice to Members 84-40; *see supra* text accompanying note 9.

<sup>21</sup> Citing *Black's Law Dictionary*, 312 (8th ed. 2004) ("condition" means "[a] future and uncertain event on which the existence or extent of an obligation or liability depends; an  
(continued...)

arrangements by which a fund committed or otherwise became obligated to direct brokerage commissions to firms that sold fund shares. AFD asserts that it is undisputed that the target commissions it communicated to Retail Firms were non-binding. AFD also claims that its interpretation is bolstered by the relationship between the prohibition contained in former Rule 2830(k)(3) and the exception to the Rule's coverage provided by former Rule 2830(k)(7)(B), which, according to AFD, permitted directed brokerage practices that: (1) did not compromise best execution and (2) were properly disclosed – both requirements AFD claims were met. AFD contends that, if a fund became bound by a contractual agreement or commitment to direct brokerage, best execution would necessarily be jeopardized; conversely, where a fund underwriter reserved the right, but avoided any obligation, to consider fund sales, it did not have to direct brokerage to a firm that failed to provide best execution. AFD argues that, in the event its practices ran afoul of the Rule, it was a consequence of ambiguity in the Rule's language and inadequate guidance from NASD as to the Rule's meaning.

**B.** Regulatory authorities have a fundamental obligation to "give fair warning of prohibited conduct before a person may be disciplined for that conduct."<sup>22</sup> We believe that AFD has raised valid questions about the clarity of the Rule's language and find that the Rule in place during the period at issue was ambiguous.<sup>23</sup> Indeed, evidence of potentially competing interpretations of the Rule's parameters was provided by NASD itself when, for example, the Hearing Panel chairperson observed at the pre-hearing conference:

I try to figure out what the rule means and not what [the parties] . . . want to have it mean . . . what it actually meant, actually required and prohibited . . . . [which] is not that easy . . . just reading the rule and parts of the rule history that have been provided. I read it one day I think well, it probably means this and then I read it again and I go well maybe it meant that.

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(...continued)

uncertain act or event that triggers or negates a duty to render a promised performance").

<sup>22</sup> *Rooms v. SEC*, 444 F.3d 1208, 1214 (10th Cir. 2006).

<sup>23</sup> Although we find NASD's former Rule here ambiguous, we do not intend to suggest that regulatory requirements are enforceable only to the extent the language used precisely delineates each course of conduct that is covered. See *Village of Hoffman Estates v. Flipside, Hoffman Estates, Inc.*, 455 U.S. 489, 498 (1982) (stating that "economic regulation is subject to a less strict vagueness test . . . because," among other reasons, "businesses, which face economic demands to plan behavior carefully, can be expected to consult relevant legislation in advance of action. Indeed, the regulated enterprise may have the ability to clarify the meaning of the regulation by its own inquiry, or by resort to an administrative process" (citing *United States v. Nat'l Dairy Prods. Corp.*, 372 U.S. 29 (1963))); see also *Grayned v. City of Rockford*, 408 U.S. 104, 108 (1972) (stating that, because drafters of regulations are "[c]ondemned to the use of words, we can never expect mathematical certainty from our language").



In addition, although the Hearing Panel ultimately found that AFD's practices conflicted with the Rule, the Panel's expressed view of what practices were permitted by the Rule diverged, to some degree, from interpretations offered by NASD Enforcement and the NAC. NASD Enforcement argued before the Hearing Panel that "AFD could have simply provided [CRMC] traders with a list of dealers that sold fund shares, and even indicated which ones should get the highest priority," but the Panel held that the Rule "may have allowed underwriters . . . to recommend to funds and investment advisers that, as a general matter, they consider sales in placing trades." The NAC, in contrast, determined that the Rule prohibited any directed brokerage arrangement whereby the sale of mutual fund shares was a "'prerequisite' to the receipt of [directed brokerage] commissions."

Moreover, NASD's interpretation of the Rule could not have been ascertained from any enforcement action. For the twenty-year period following adoption of the 1981 Amendments, NASD brought no enforcement proceeding under the Rule that could have helped elucidate its meaning. Significantly, the 2004 Amendments addressed the uncertainty in the Rule identified by AFD and, as a result of these changes, the directed brokerage practices at issue are now clearly prohibited, as AFD concedes.<sup>24</sup>

In addition to our concerns about ambiguity in the Rule before the 2004 Amendments, we have considered other factors in assessing the merits of AFD's appeal – including evidence that AFD, sought proactively to ensure that its directed brokerage practices conformed to regulatory requirements. For example, as noted above, AFD and CRMC terminated their directed trading program with Step-Out Firms in mid-2002 ahead of the industry and to the consternation of the Retail Brokers, modified their target calculations for CRMC in 2003 to include consideration of factors other than just sales, and canceled their directed brokerage program altogether in 2004 – more than a year before the new Rule took effect.

Under all of the circumstances, including our concern about uncertainty resulting from the language of the Rule in effect during the period at issue, the fact that the 2004 Amendments clarified the extent of the Rule's prohibition, and the evidence of AFD's compliance efforts with

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<sup>24</sup> 2004 Amendments, 69 Fed. Reg. at 77,287 (clarifying that the Rule's prohibition applied to "written or oral agreement[s] or understanding[s]" to direct brokerage in consideration for fund sales); *see supra* note 13 and accompanying text. As noted, NASD brought its action against AFD two days after the 2004 Amendments became effective. *See supra* note 17.

While NASD's subsequent clarification here is one factor, among several, that we have considered, we are mindful that amendments to a rule often seek to clarify its meaning. Such a clarification, however, should not necessarily be construed to mean that conduct more specifically addressed thereby was outside the reach of the prior version of the rule. *See, e.g., Rentz v. Co.*, 43 S.E.C. 436, 439-40 (1967) (stating "the fact that a subsequent amendment of the NASD interpretation [against free riding that] specifically added senior officers of insurance companies . . . does not mean that such officers were not covered by the prior interpretation").

respect to directed brokerage practices, we have determined to set aside the NASD's action.

An appropriate order will issue.<sup>25</sup>

By the Commission (Commissioners CASEY and PAREDES); Commissioner AGUILAR dissenting, Chairman SCHAPIRO and Commissioner WALTER not participating.

Elizabeth M. Murphy  
Secretary

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<sup>25</sup> We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

Commissioner AGUILAR, dissenting:

Since 1973, the NASD<sup>1</sup> has maintained some form of the "Anti-Reciprocal Rule." As characterized by the NASD, "[t]he rule's goal is to curb conflicts of interest that might cause retail firms to recommend investment company shares based upon the receipt of commissions from that investment company."<sup>2</sup> After amending the rule in 1981, the NASD reiterated that the rule continues to prohibit directing brokerage commissions conditioned upon sales of fund shares and gave examples of conduct that would be inconsistent with the rule. As further described below, I believe the text, history and guidance of the rule were sufficiently clear to put AFD on notice that its directed brokerage arrangements violated the rule. Therefore, I dissent from the majority opinion setting aside the findings of violations and sanctions imposed.

AFD, as principal underwriter and distributor of American Funds, had numerous non-binding arrangements to direct brokerage commissions to broker-dealers as partial compensation for their sale of American Fund shares. For those firms that lacked the capacity to execute the portfolio trades, Capital Research and Management Company ("CRMC"), the investment adviser to the American Funds, directed trading to the clearing firm that executed the portfolio trades and would then allocate, or "step-out," all or part of the brokerage commissions to the brokerage firms. Pursuant to these arrangements, the American Funds paid \$98 million in brokerage commissions to top-selling retail brokerage firms during the relevant time period.

Based on this conduct, the NASD found that AFD requested or arranged for the direction of specific amounts or percentages of brokerage commissions to broker-dealers that sold shares in the American Funds, in violation of former NASD Rule 2830(k). Rule 2830(k) is the NASD's "Anti-Reciprocal Rule."

The rule in effect during the relevant period, as amended in 1981, provided that: 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.<sup>3</sup>

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<sup>1</sup> The "NASD" designation is used throughout this opinion because the disciplinary action was initiated by the NASD prior to its name change to Financial Industry Regulatory Authority, Inc. ("FINRA").

<sup>2</sup> NASD Notice to Members 73-42.

<sup>3</sup> NASD Manual at 2105-4 (1981 ed.). The 1981 Amendments also added NASD Rule 2830(k)(7)(B), which read in relevant part: "(7) Provided that the member does not violate any of the specific provisions of this paragraph (k), nothing herein shall be deemed to prohibit

(continued...)

The parties disagree whether AFD's brokerage practices were "conditioned upon" the retail firms' sales or promises of sales of shares in the American Funds, and furthermore, whether AFD had fair notice that its brokerage practices were prohibited by the rule. Based on my review of the facts of this case, I believe that Rule 2830(k) was sufficiently clear in proscribing AFD's directed brokerage practices. I am compelled to this conclusion not only because the NASD's interpretation of its rule is reasonable, but also because of the obvious arbitrage opportunities that AFD's interpretation would have created under the former rule.

In essence, AFD advocates an interpretation of the phrase "conditioned upon" that would limit the rule's application to only binding arrangements that obligated a fund to direct brokerage to particular firms. I cannot accept AFD's invitation to interpret the rule so narrowly. To do so would be to adopt an interpretation that eviscerates the rule's effectiveness. AFD's interpretation of the rule would have permitted members to circumvent the rule by simply maintaining non-binding agreements that nevertheless perpetuate the same conflicts of interest the rule was designed to alleviate. To this end, I agree with the NASD's observation that allowing "AFD to circumvent Rule 2830(k) with a quid pro quo arrangement calling for reciprocal brokerage practices would have the same corrupting influence as an agreement memorialized in writing and enforceable under contract law."

While the version of the rule in effect during the relevant period may not have been a model of clarity,<sup>4</sup> I find more reasonable the NASD's interpretation of the "conditioned upon" phrase as prohibiting fund sales as a "prerequisite" to directing brokerage commissions to broker-dealers selling fund shares. It is true that the rule provided an exception to member firms that did not otherwise violate paragraph (k), if the directed brokerage policy was properly disclosed and where consideration of mutual fund sales was a "factor" in the selection of executing broker-dealers, "subject to the requirements of best execution."<sup>5</sup> Disclosure and best execution only become relevant, however, if the member firm does not violate the rule's general prohibition against reciprocal arrangements. Because AFD's arrangements constituted a quid pro quo of directing brokerage in exchange for sales, it did not comply with the rule's general prohibitions and thereby violated 2830(k). Thus, I believe that the NASD's interpretation of the anti-reciprocal rule is the more reasonable one.

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<sup>3</sup> (...continued)

. . . (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."

<sup>4</sup> As noted in the majority opinion<sup>4</sup>, for example, there were indications in the record of competing interpretations of the rule's parameters within the NASD.

<sup>5</sup> See *supra* note 3.

In addition, I note that it is well established that self-regulatory organizations are accorded "some level of deference"<sup>6</sup> in interpreting and applying their rules. I believe this should apply here as well.

Additionally, while the text of the rule may have been open to a certain amount of varying interpretation, the NASD's subsequent guidance undermines AFD's claims that it lacked fair notice. In 1984, the NASD issued a Notice to Members concerning compensation arrangements with respect to the sale of mutual fund shares.<sup>7</sup> In this guidance, the NASD noted that some members may have incorrectly viewed the amendments "as having altered the specific standards of the rule more extensively than was actually the case." The NASD went on to provide examples of specific situations that would be inconsistent with the rule. Among these examples were practices that resembled AFD's brokerage practices, including, an offer or agreement by a principal underwriter:

- "for a specified percentage of portfolio brokerage commissions relative to the dealer's sales of fund shares";
- "that portfolio orders be placed in recognition of the representative's prior or future sales of fund shares"; or
- "that portfolio brokerage commissions be placed on the understanding that this would result in placement of the funds on the dealer's preferred list."

In this matter, the NASD found that AFD calculated and recommended target brokerage commissions; identified top-selling retail firms of American Funds; provided CRMC with the amount of commissions to be sent to the firms; monitored CRMC's trading with, and the stepping out of commissions to, the brokerage firms; and tracked the trading activity to ensure proper crediting of the commissions. In light of these findings, AFD's arrangements constituted a clear quid pro quo of directing brokerage commissions in exchange for sales of American Fund shares. And while there may have been some ambiguity at the margins, AFD's arrangements were in the zone of conduct readily identifiable as violating the rule, particularly in light of the 1984 Notice to Members. Thus, given the 1984 Notice to Members and these facts, I find that AFD had "fair notice" that its directed brokerage practices in place during the relevant period were prohibited by Rule 2830(k).

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<sup>6</sup> *Heath v. SEC*, 586 F.3d 122, 139 (2d Cir. 2009) (citing *Shultz v. SEC*, 614 F.2d 561, 571 (7th Cir. 1980) ("[B]ecause these are rules of the Exchange, the Exchange should be allowed discretion in determining their meaning.")).

<sup>7</sup> NASD Notice to Members 84-40.

Finally, I note the majority's contention that the "NASD's interpretation of the Rule could not have been ascertained from any enforcement action." While there may have been some ambiguity as to the precise contours of the rule's prohibitions during the relevant period, AFD's arrangements did not fall within any perceptible grey area at the margin. To the contrary, AFD's arrangements – particularly with respect to the "step-out" firms – amounted to a clear quid pro quo of directing commissions in exchange for mutual fund sales. As described above, the text, history and guidance of the anti-reciprocal rule was sufficiently clear to have put AFD on notice that its directed brokerage practices violated the rule.

For all of the reasons I have stated, I respectfully dissent.

UNITED STATES OF AMERICA  
before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934  
Rel. No. 64747 / June 24, 2011

Admin. Proc. File No. 3-13055

In the Matter of the Application of  
AMERICAN FUNDS DISTRIBUTORS, INC.  
c/o Seth M. Schwartz, Esq.  
Skadden, Arps, Slate, Meagher & Flom LLP  
Four Times Square  
New York, NY 60443

For Review of Disciplinary Action Taken by  
NASD

ORDER SETTING ASIDE DISCIPLINARY ACTION TAKEN BY REGISTERED  
SECURITIES ASSOCIATION

On the basis of the Commission's opinion issued this day, it is

ORDERED that the findings of violations and the sanctions imposed by NASD in this  
action against American Funds Distributors, Inc., be, and they hereby are, set aside.

By the Commission.

Elizabeth M. Murphy  
Secretary