BEFORE THE NATIONAL ADJUDICATORY COUNCIL

FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of Department of Enforcement, Complainant, vs. American Fund Distributors, Inc. Los Angeles, CA, Respondent.	DECISION Complaint No. CE3050003 Dated: April 30, 2008

Respondent requested or arranged for the direction of a specific amount or percentage of brokerage commissions to other members conditioned upon those members' sales of the respondent's mutual funds. Held, findings and sanctions affirmed.

Appearances

For the Complainant: Jeffrey P. Bloom, Esq., Leo F. Orenstein, Esq., Daniel D. McClain, Esq., and Colleen Hanrahan, Esq., Department of Enforcement, Financial Industry Regulatory Authority

For the Respondent: Seth M. Schwartz, Esq., William J. O'Brien, Esq., Raoul D. Kennedy, Esq., and Jeffrey W. McKenna, Esq., Skadden, Arps, Slate, Meagher & Flom LLP

Decision

American Funds Distributors, Inc. ("AFD") appeals an August 30, 2006 Hearing Panel decision. The Hearing Panel found that AFD violated NASD Rule 2830(k)(3) ("Rule 2830(k)(3)") and NASD Rule 2110 ("Rule 2110") by requesting or arranging for the direction of a specific amount or percentage of brokerage commissions to other members conditioned upon those members' sales of American Funds' mutual funds. The Hearing Panel censured AFD and

imposed a fine of $5 million. After a complete review of the record, we affirm the Hearing Panel's findings and sanctions.[1]

I. Background

A. The American Fund Entities

AFD is the principal underwriter and distributor of American Funds, a family of 29 mutual funds. As of 2006, American Funds was the second largest fund family in the United States with more than 30 million shareholder accounts and aggregate assets under management of at least $750 billion. AFD is a wholly owned subsidiary of Capital Research and Management Company ("CRMC"), which serves as investment adviser to each of the mutual funds that comprise American Funds.

FINRA regulates AFD, as an underwriter and distributor of shares of an investment company. AFD has been a member of FINRA since 1972. American Funds' mutual funds are investment companies owned by their shareholders. Each of the 29 investment companies is organized under the Investment Company Act of 1940 and regulated by the Commission. The Commission regulates CRMC as American Funds' investment adviser under the Investment Advisers Act of 1940. Neither the mutual funds in the American Funds family nor CRMC are members of FINRA.

B. Procedural History

On February 16, 2005, FINRA's Department of Enforcement ("Enforcement") filed a one-cause complaint against AFD. The complaint alleged that, between January 2001 and December 2003 (the "Review Period"), AFD violated Rules 2830(k)(3) and 2110 by requesting or arranging for CRMC to direct brokerage commissions to other members conditioned upon those members' sales of American Funds' mutual funds. AFD contested the allegations in the complaint and requested a hearing, which took place in March 2006.

The Hearing Panel issued its decision on August 30, 2006. The Hearing Panel found that AFD violated Rules 2830(k)(3) and 2110 as alleged in the complaint. The Hearing Panel censured AFD and imposed a fine of $5 million. On September 21, 2006, AFD timely filed its notice of appeal. AFD's appeal challenges the Hearing Panel's findings that AFD violated Rules 2830(k)(3) and 2110 and that AFD had fair notice of the practices that Rule 2830(k)(3) prohibited. AFD also appeals the sanctions imposed.

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[1] As of July 30, 2007, NASD consolidated with the member firm regulation functions of NYSE and began operating under a new corporate name, the Financial Industry Regulatory Authority ("FINRA"). References in this decision to FINRA shall include, by reference and where appropriate, references to NASD.

II. Facts

The following facts are undisputed.

A. AFD's Business Model

AFD does not sell American Funds shares directly to the investing public. Rather, AFD enters into selling group agreements with unaffiliated retail firms that act as a distribution channel to customers. These unaffiliated retailers sell the American Funds shares directly to the investing public. For its underwriting and distribution services, AFD receives direct payments from CRMC and commission payments from American Funds for the sales of its mutual fund shares.

AFD assigned six senior staff members, known as Dealer Relationship Managers, to work with the leading retailers of American Funds to promote fund sales at the firm level. The Dealer Relationship Managers' primary job was to negotiate "Business Plans" with an assigned group of retail firms. These Business Plans outlined AFD's sales and other objectives for each retail firm and discussed methods for the retail firms to increase the sales of American Funds' mutual funds. AFD's Business Plans included past sales data, present sales goals, and training and education initiatives. The Business Plans also articulated the benefits that AFD derived from its relationship with each retailer.

As investment adviser to the mutual funds in the American Funds family, CRMC employs securities traders to place orders with market makers and other broker-dealers to buy and sell securities for the portfolios of American Funds' mutual funds. Each mutual fund compensates CRMC for its advisory services with fees computed as a percentage of the assets that CRMC manages.

To increase the sales of American Funds, in each of the three years of the Review Period, AFD provided the top-selling retail firms of American Funds with additional compensation in the form of revenue sharing payments. These revenue sharing payments were amounts beyond the concessions, networking fees, and Rule 12b-1 fees that all other retail firms received for selling shares of American Funds.[2] AFD provided two types of revenue sharing payments to the top-selling retailers of American Funds – marketing pool payments and target commissions.

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[2] Concessions are rebates, allowances, or price reductions that each of American Funds' mutual funds extended to all retail firms that sold its shares. Networking fees consist of compensation paid to all retailers that shared and transferred investment data with the mutual funds and their transfer agents. Rule 12b-1 fees are annual charges assessed to each mutual fund to pay for its distribution, marketing, advertising, and promotional costs. *See* Investment Company Act of 1940, Rule 12b-1, 17 C.F.R. § 270.12b-1 (2007).

1. Marketing Pool Payments

AFD made cash payments to the 75 top-selling retail firms of American Funds. This cash payment, described as a marketing allowance or "marketing pool" payment, was measured by a retail firm's total sales of American Funds. AFD calculated its marketing pool payment by multiplying five basis points by the retail firm's prior year sales of American Funds. AFD's marketing pool payments to retail firms were derived from AFD's operating revenues and were paid directly to the retailers in the form of a check from AFD. Marketing pool payments are not the subject of Enforcement's complaint.

2. Target Commissions

In addition to marketing pool payments, the 46 top-selling retail firms of American Funds also received "target commissions." Target commissions are commission payments for the execution of securities trades for the portfolios of the various American Funds' mutual funds. From January 2001 through June 2002, AFD arranged for CRMC to direct target commissions to two types of broker-dealers that sold American Funds shares: (1) firms that executed portfolio trades for American Funds and retained the commissions ("executing firms"), and (2) firms that had no capability to execute portfolio trades for American Funds, but nevertheless obtained commissions from clearing firms that executed portfolio trades ("step-out firms"). Enforcement's complaint alleges that AFD's requesting or arranging of both types of target commissions violated FINRA's rules.

During 2001 and 2002, AFD used a two-tiered calculation to determine target commissions for the top-selling retail firms. Of the 46 retailers to receive target commissions, the plan called for the top 10 retailers to receive 15 basis points of their prior year sales of American Funds, while the remaining 36 retailers received 10 basis points of prior year sales.

In 2003, AFD no longer calculated target commissions by applying a basis-point factor to a retailer's prior year sales. Instead, AFD's Dealer Relationship Managers made target commission recommendations based on an array of factors, including past sales, assets under management, rates of redemption, and the overall quality of AFD's relationship with the specific retail firm.[3] The Dealer Relationship Managers also considered marketing pool and target

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[3] Ian Bodell ("Bodell") and Michelle Bergeron ("Bergeron"), Dealer Relationship Managers at AFD during the Review Period, each testified that they considered the retail firms' mutual funds sales in 2002 to determine target commissions in 2003. For example, Bodell testified that, in 2003, Dealer Relationship Managers used "historical numbers" to calculate target commission amounts. He defined "historical numbers" as the basis point multiplier times the previous year's sales. In addition, contemporaneous communications among the Dealer Relationship Managers also demonstrate that the 2002 sales of American Funds were factored into the calculation of target commission amounts in 2003.

commission payments made to the retailers in 2002 to calculate target commission payments in 2003.[4]

Throughout the Review Period, to ensure that each retailer received the proper amount of target commissions, AFD provided CRMC with a list of commissions for each designated retailer. CRMC distributed this list to its traders who, in part, used the target commission amounts to determine where to place portfolio trades for American Funds. Throughout the year, AFD monitored the amount of target commissions that each of the top retailers received to confirm that CRMC met the commission targets. In addition, CRMC traders provided AFD with monthly updates to track the trading activity and target commissions paid to the selected retail firms. AFD also gave the 46 top-selling retailers detailed trading reports to enable them to confirm that they received the appropriate amount of commissions for the year. From 2001 through 2003, CRMC traders met, or exceeded, the target commission amounts that AFD set.

Throughout this process, AFD's Dealer Relationship Managers informed the 46 retail firms of the exact commissions that CRMC directed to them in the previous year and disclosed the amount of target commissions the retail firms could receive from CRMC in the upcoming year. AFD's Dealer Relationship Managers also told the top-selling firms that they received commissions as a reward for past sales and advised them that, if they were not among the top retailers of American Funds, they would not receive these commissions.[5] Moreover, the Dealer Relationship Managers advised the retail firms that AFD calculated commissions based upon their past sales of American Funds, and sometimes provided retail firms with the basis point formula that yielded the commission amounts. Between 2001 and 2003, American Funds paid the top-selling retail firms of American Funds more than $98 million in commissions.[6]

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[4] Bergeron testified that she considered marketing pool and target commission payments made in 2002 to determine the amount of target commissions retailers should receive in 2003.

[5] Internal communications among the Dealer Relationship Managers suggest that American Funds' target commission payments allowed AFD to participate in the retailers' sponsorship or partnership programs. These programs provided AFD with a limited number of special benefits, including American Funds' placement on the retailers' recommended or preferred list, meetings with the retail firms' registered representatives at the retailers' branch offices, and AFD-sponsored presentations at meetings that the retailers organized on behalf of AFD.

[6] In January 2004, AFD cancelled its target commissions program. Dealer Relationship Manager Bergeron testified that prior to its cancellation, AFD's target commissions program constituted a profitable, important revenue stream that retailers received for several years. When AFD and CRMC cancelled the target commissions program, retail firms stated that they were "outraged," "shocked," and "dismayed."

III. Discussion

The main issue raised in this appeal is the correct interpretation of Rule 2830(k)(3).[7] This is a matter of first impression, not decided in a previous FINRA disciplinary case.

A. AFD's Requesting or Arranging of Directed Brokerage Violated Rule 2830(k)(3)

After a de novo review of the record, we find that AFD's conduct during the Review Period violated Rule 2830(k)(3). The facts demonstrate that AFD requested or arranged for the direction of a specific amount or percentage of brokerage commissions to other members conditioned upon those members' sales of American Funds shares.

1. NASD Rule 2830(k)

In existence since July 1973, NASD Rule 2830(k) ("Rule 2830(k)") is FINRA's "Anti-Reciprocal Rule." The 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. *See NASD Notice to Members 73-42* (May 1973).[8]

Rule 2830(k) was amended in March 1981 to include the language that continued to exist throughout the Review Period (the "1981 Amendments"). The provision of Rule 2830(k) that addresses directed brokerage arrangements is Rule 2830(k)(3). During the Review Period, the relevant portion of Rule 2830(k)(3) provided:

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[7] Enforcement alleges no independent theory of violation under Rule 2110. A violation of another FINRA rule, however, is a violation of Rule 2110. *See Charles C. Fawcett, IV*, Exchange Act Rel. No. 56770, 2007 SEC LEXIS 2598, at *11-12 (Nov. 8, 2007) (stating that violations of FINRA rules are inconsistent with just and equitable principles of trade and constitute a violation of Rule 2110.).

[8] As adopted in 1973, Rule 2830(k)(3) 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.

This language was deleted in 1981. *See infra* note 9 and accompanying text.

> [N]o 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.[9]

The 1981 Amendments also added NASD Rule 2830(k)(7)(B) ("Rule 2830(k)(7)(B)"). The relevant portion of Rule 2830(k)(7)(B), in effect during the Review Period, stated:

> (7) 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 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;
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> * * *

After the conduct at issue in this case, two rules related to directed brokerage practices were amended. On September 9, 2004, the Commission amended Rule 12b-1 to prohibit investment companies from paying for the distribution of their shares with brokerage commissions. *See Prohibition on the Use of Brokerage Commissions to Finance Distribution*, Rel. No. IC-26591, 69 Fed. Reg. 54728 (Sept. 9, 2004). On February 14, 2005, FINRA followed suit by repealing Rule 2830(k)(7)(B) and by adding NASD Rule 2830(k)(2) ("Rule 2830(k)(2)"). *See Order Approving Proposed Rule Change by NASD, Inc., Relating to Investment Company*

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[9] During the Review Period, the full text of Rule 2830(k)(3) stated:

> 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.

The full text of Rule 2830(k) in effect during the Review Period is attached as Exhibit A.

Portfolio Transactions, Exchange Act Rel. No. 34-50883, 69 Fed. Reg. 77286 (Dec. 27, 2004).[10] These changes to Rule 2830(k) resulted in an unqualified prohibition on reciprocal brokerage arrangements and, in the future, preclude all FINRA members from selling or underwriting shares of mutual funds using directed brokerage.

2. The 1981 Amendments Did Not Create a Pro-Reciprocal Rule

On appeal, AFD's primary argument is that the 1981 Amendments transformed Rule 2830(k) from an anti-reciprocal rule to a pro-reciprocal rule. AFD is incorrect. The 1981 Amendments did not create a pro-reciprocal rule. From its inception, Rule 2830(k) has always been an anti-reciprocal rule.

FINRA adopted Rule 2830(k) to address Commission concerns about the use of reciprocal brokerage to promote the sales of investment company shares. *See Reciprocal Portfolio Brokerage for Sales of Investment Company Shares*, 37 Fed. Reg. 5290 (Mar. 14, 1972). In March 1972, the Commission issued a statement highlighting the pervasive problem of reciprocal brokerage, or directed brokerage, in the mutual fund industry. *See id.* The Commission noted that the exchange of brokerage commissions for sales of investment company shares created conflicts of interest that might cause retail firms to recommend investment company shares based on the receipt of commissions from that investment company rather than on the merits of the mutual funds. *See id.* Upon review of the reciprocal brokerage practices in the mutual fund industry, the Commission concluded that the "practices must be terminated." *Id.* In response to the Commission's concerns, FINRA adopted Rule 2830(k)(3) in July 1973. *See NASD Notice to Members 73-42*.

FINRA amended Rule 2830(k) in March 1981. The 1981 Amendments changed Rule 2830(k)(3) to the language in effect during the Review Period and added Rule 2830(k)(7)(B). These changes relaxed the prohibition on the use of directed brokerage. Subject to certain restrictions, Rule 2830(k)(7)(B) allowed FINRA members to sell or distribute shares of mutual funds that followed a disclosed policy of considering sales of their shares as a factor in the selection of retail firms to execute portfolio trades, subject to best execution. *See Order Approving Proposed Rule Change and Related Interpretation Under Section 36 of the Investment Company Act*, Exchange Act Rel. No. 17599, 1981 SEC LEXIS 1918, at *1 (Mar. 4, 1981).

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[10] Rule 2830(k)(2) states:

> 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 entered into 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.

When Rule 2830(k)(7)(B) became effective, FINRA noted that Rule 2830(k), which applied only to broker-dealers, underwriters, and distributors, influenced the actions of investment companies and their directors, entities over which FINRA had no jurisdiction. *See National Association of Securities Dealers; Proposed Rule Change; Self-Regulatory Organizations*, Exchange Act Rel. No. 17367, 45 Fed. Reg. 82777 (proposed Dec. 16, 1980) (SR-NASD-80-21). Subject to the limitations of other provisions of Rule 2830(k), Rule 2830(k)(7)(B) permitted underwriters and distributors to sell shares of mutual funds that use sales as a factor to decide where to direct trades and to pay the related commissions to retail firms. *See id.* Rule 2830(k)(7)(B) did not, however, authorize underwriters and distributors to enter into reciprocal arrangements with retail firms and did not permit underwriters and distributors to request or arrange for the direction of a specific amount or percentage of commissions conditioned upon a retail firm's specific amount of sales of mutual funds. Rule 2830(k)(3) continued to forbid such reciprocal arrangements.

Upon approving the 1981 Amendments, the Commission stated that, "it is 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 added). AFD relies heavily on this statement to contend that the 1981 Amendments authorized underwriters and distributors to promote sales through reciprocal arrangements. AFD's reliance on this statement, however, is misplaced. AFD is not an investment company. As discussed above, Rule 2830(k)(3) continued to forbid AFD, **an underwriter and distributor**, from requesting or arranging for a specific amount or percentage of commissions conditioned upon a retail firm's specific amount of sales of American Funds shares. Thus, we find that AFD's reciprocal arrangements violated Rule 2830(k)(3) and overstepped the permissible boundaries of Rule 2830(k)(7)(B).

FINRA's guidance for the 1981 Amendments to Rule 2830(k), NASD Notices to Members 81-8 and 84-40, support this reading of Rules 2830(k)(3) and 2830(k)(7)(B). Notices to Members 81-8 and 84-40 each explain that Rule 2830(k) remained FINRA's anti-reciprocal rule even after the 1981 Amendments. When Rule 2830(k)(7)(B) became effective, FINRA issued Notice to Members 81-8, which stated:

* * *

> **This new provision does not relieve members from the obligation to comply with the other specific provisions of the rule**, but it makes it clear that a member does not violate the rule simply by selling shares of an investment company which makes a disclosure in its prospectus that sales of shares are considered in selecting broker/dealers to execute portfolio transactions.

(Emphasis added).

Notice to Members 81-8 emphasized that Rule 2830(k)(7)(B) did not relieve underwriters and distributors of their compliance obligations under Rule 2830(k). Rather, Notice to Members 81-8 established that the purpose of Rule 2830(k)(7)(B) was to permit underwriters and

distributors to sell shares of mutual funds that considered sales as a factor in the placement of brokerage. Similarly, in July 1984, FINRA issued Notice to Members 84-40, cautioning members against misreading the 1981 Amendments:

* * *

> **[S]ome members may view the 1981 [A]mendments as having altered the specific standards of the rule more extensively than was actually the case.** Members should understand that the rule **still** prohibits:
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> (2) [T]he requesting or arranging for the direction of a specific amount or percentage of brokerage commissions conditioned upon sales or promises of sales of fund shares;
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> * * *

(Emphasis added).

In addition to reiterating the prohibition on reciprocal brokerage arrangements, Notice to Members 84-40 further illustrated the limited force of the 1981 Amendments by giving specific examples of conduct inconsistent with Rule 2830(k):[11]

> [A] request by a dealer, or 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;
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> * * *
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> [A] request by a registered representative, or 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; and,
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> [A] request by a dealer, or an offer or agreement by a principal underwriter, that portfolio brokerage commissions be placed on the understanding that this would result in placement of the funds on the dealer's preferred list.
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[11] Some of these examples are based on other provisions of Rule 2830(k), not only subsection (3) of the rule.

Notice to Members 84-40 unmistakably emphasized that the 1981 Amendments did not eliminate the anti-reciprocal nature of Rule 2830(k)(3). Despite this clarification in 1984, the record establishes that, from 2001 through 2003, AFD provided retailers with a specific amount of commissions relative to their past sales of fund shares, arranged portfolio orders in recognition of a retail firm's prior sales of American Funds shares, and arranged for the direction of brokerage commissions with the understanding that this would result in placement on the retail firm's preferred list.[12]

We conclude that the 1981 Amendments did not create a pro-reciprocal rule. Moreover, for the reasons explained below, we hold that AFD's conduct throughout the Review Period violated Rule 2830(k)(3) and exceeded the permissible boundaries of Rule 2830(k)(7)(B). Rather than act as an underwriter and distributor of mutual funds that considered past sales in the selection of broker-dealers to execute portfolio trades, as permitted by Rule 2830(k)(7)(B), AFD requested and arranged for CRMC to direct brokerage to the top-selling retail firms of American Funds and made preparations to ensure that the retail firms received the commissions. To further the payment of directed brokerage, AFD identified the top-selling retail firms of American Funds, provided CRMC with the amount of commissions to be sent, monitored CRMC's trading with, and the stepping out of commissions to, the selected retail firms throughout the year, and tracked trading activity with the retail firms to ensure proper crediting of the commissions. Because Rule 2830(k)(3) prohibited AFD's conduct outright, we find that AFD violated Rule 2830(k)(3). *See generally Morgan Stanley DW Inc.*, Exchange Act Rel. No. 48789, 2003 SEC LEXIS 2732, at *17 (Nov. 17, 2003) (finding, in offer of settlement, that respondent's portfolio brokerage payments contravened Rule 2830(k) and explaining that the rule prohibits FINRA members from favoring the sale of mutual fund shares based on the receipt of brokerage commissions).

3. The 1981 Amendments Did Not Limit Application of Rule 2830(k)(3) to Legally Binding Commitments

AFD also argues that the 1981 Amendments limit application of Rule 2830(k)(3) to legally binding commitments. AFD contends that the 1981 Amendments only barred underwriters and distributors from entering into agreements that contractually obligated a mutual fund to direct commissions to retail firms that sold fund shares. Neither the language of the

[12] We find that AFD's involvement with target commission payments resulted in American Funds' placement on retailers' preferred, or recommended, fund lists. For example, internal communications among the Dealer Relationship Managers suggest that AFD's target commission payments allowed AFD to participate in the retailers' sponsorship or partnership programs. These programs provided AFD with special benefits, including the placement of American Funds on the retailers' recommended or preferred list, meetings with the retail firms' registered representatives at the retailers' branch offices, and AFD-sponsored presentations at meetings that the retailers organized on behalf of AFD.

amended rule, nor the Notices to Members interpreting the rule, however, limits the rule to legally binding commitments.[13]

Rule 2830(k)(3) prohibits requests and arrangements for the direction of brokerage conditioned upon sales. The "request or arrange" language of the rule does not require or even refer to a commitment, contract, or agreement. *Cf.* NASD Rule 2710(b)(5) (stating that underwriting *agreements* and *agreements* among underwriters must be filed with and reviewed by FINRA). Moreover, the "conditioned upon" language of the rule means only that sales of American Funds shares must be a prerequisite to the receipt of commissions, not that there must be a formal, binding agreement requiring the exchange of commissions for sales of fund shares.[14]

As an initial matter, interpreting Rule 2830(k)(3) as prohibiting only legally binding commitments would be contrary to the rule's purpose. Even after adoption of the 1981 Amendments, Rule 2830(k) prohibited reciprocal brokerage practices. *See NASD Notice to Members 81-8* (Mar. 1981); *NASD Notice to Members 84-40* (July 1984). To permit 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.

Moreover, limiting the application of Rule 2830(k)(3) to legally binding commitments would nullify the rule as to AFD because: (1) only CRMC and American Funds' mutual funds could contractually commit to portfolio trades on behalf of the funds, and (2) AFD lacked the contractual capacity to bind CRMC and the mutual funds to execute portfolio trades. In this instance, AFD could not possibly violate Rule 2830(k)(3) were the rule limited to legally binding commitments because AFD lacked contractual capacity to bind CRMC and the mutual funds to execute portfolio trades. In addition, CRMC and the American Funds could not violate Rule

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[13] Notice to Members 84-40 states that "offer[s] or agreement[s]" for reciprocal brokerage violate Rule 2830(k). Of course, offers are not binding commitments, thus, the "offer[s] or agreement[s]" language of Notice to Members 84-40 further supports the conclusion that Rule 2830(k) is not limited to legally binding commitments.

[14] AFD argues that the definition of "condition" is the creation of a legally binding commitment upon the occurrence of a future event. We find that the most reasonable definition of "condition" in the context of Rule 2830(k)(3) is "anything essential to the existence or occurrence of something else; prerequisite." *Webster's New World Dictionary* 295 (2d ed. 1986).

2830(k)(3) because they are not subject to it. In any event, we find that neither the language nor purpose of Rule 2830(k)(3) supports limiting its application to legally binding commitments.[15]

4. Rule 2830(k)(7)(B) Does Not Protect AFD's Conduct

AFD argues that Rule 2830(k)(7)(B) protects its conduct. We disagree and find that AFD's reading of Rule 2830(k)(7)(B) is incorrect. Rule 2830(k)(7)(B) was not designed to allow underwriters and distributors like AFD to request or arrange for the direction of brokerage commissions conditioned upon sales of mutual fund shares.

Instead, FINRA enacted Rule 2830(k)(7)(B) to reduce the possible anti-competitive impact and indirect restrictions that Rule 2830(k) may have placed on investment companies and their directors. *See National Association of Securities Dealers; Proposed Rule Change; Self-Regulatory Organizations*, Exchange Act Rel. No. 17367, 45 Fed. Reg. 82777 (proposed Dec. 16, 1980) (SR-NASD-80-21). Prior to enactment of the rule, FINRA noted that Rule 2830(k), which applied only to broker-dealers, underwriters, and distributors, influenced the actions of investment companies and their directors over which FINRA had no jurisdiction. *See id.* To avoid this, Rule 2830(k)(7)(B) permitted underwriters and distributors to sell shares of mutual funds when a mutual fund's prospectus disclosed that the fund considered sales of the fund when selecting among broker-dealers to execute portfolio trades. *See id.* Rule 2830(k)(7)(B), however, did not go so far as to permit AFD, as an underwriter and distributor, to request or arrange for a specific amount or percentage of commissions conditioned upon the amount of sales of American Funds shares. Therefore, AFD's conduct violated Rule 2830(k)(3) and overstepped the permissible boundaries of Rule 2830(k)(7)(B).

AFD's violation of Rule 2830(k)(3) also precludes its reliance on Rule 2830(k)(7)(B). Rule 2830(k)(7)(B) states that it applies only if the "member does not violate any of the specific provisions of this paragraph (k)." By its own terms, then, Rule 2830(k)(7)(B) applies only if AFD does not violate any other provision of Rule 2830(k). Because we find that AFD violated Rule 2830(k)(3), we find that Rule 2830(k)(7)(B) provides no safe harbor for AFD's conduct.

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[15] In so holding, we rely on Notice to Members 84-40 and give little weight to the report of AFD's expert – Frank Formica ("Formica Report"). Although the Formica Report opines that Rule 2830(k)(3) applies only to legally binding commitments, Notice to Members 84-40 does not support this limitation. We rely on publicly available guidance, such as Notice to Members 84-40, as more authoritative in explaining the meaning of a FINRA rule, rather than an expert's report as to the rule's meaning. The responsibility to interpret the meaning of a rule is within the province of an adjudicator, not an expert witness. *See United States v. Bilzerian*, 926 F.2d 1285, 1294-95 (2d Cir. 1991) (stating that an expert witness may not usurp the role of the adjudicator as to whether the applicable facts violate the law); *Marion Bass Sec. Corp.*, Rel. No. 574, 1998 SEC LEXIS 2690, at *5-6 (Nov. 13, 1998) (same). Thus, we find that Notice to Members 84-40 provides more reliable guidance of the interpretation of Rule 2830(k). *See also Marine Eng'rs Beneficial Ass'n v. Interlake S.S. Co.*, 370 U.S. 173, 178 (1962) (finding that the interpretation and application of a statute calls for a regulator's expertise).

5. AFD Violated Literal Interpretations of Rule 2830(k)(3)

On appeal, AFD argues that it did not violate literal interpretations of Rule 2830(k)(3). We disagree. Moreover, we determine that each of AFD's proposed interpretations of Rule 2830(k)(3) would subvert the rule's purpose. *See* NASD Rule 0113 (stating that FINRA's rules shall be interpreted in such a manner as to effectuate their purposes); *cf. Meyer Blinder*, 53 S.E.C. 250, 257-58 (1997) ("[T]he securities laws should be interpreted broadly in a manner that is consistent with the statutory language and furthers the purposes of the statutes.").[16]

First, AFD argues that the target commissions were not a "specific amount or percentage" of brokerage within the meaning of Rule 2830(k)(3). In 2001 and 2002, target commissions constituted a specific amount or percentage of brokerage because AFD set commission amounts using a specific criterion – either 10 or 15 basis points of the retail firm's sales of American Funds shares for the previous year. In 2003, when AFD modified its calculation of target commissions to consider an array of factors, the commissions continued to constitute a specific amount of brokerage because AFD provided CRMC with a list that contained the exact, or specific, amount of brokerage to be sent to each retail firm.[17] Thus we find that, in each year of the Review Period, AFD set a "specific amount or percentage" of brokerage commissions for CRMC to pay to retail firms that were the top sellers of American Funds.

AFD next asserts that it never "requested or arranged" for the direction of commissions. Rather, AFD states that it merely "asked CRMC to consider . . . commission targets to the extent CRMC deemed it appropriate to do so." Essentially, AFD argues that because CRMC decided which retail firms would execute its portfolio trades, AFD did not violate the rule. We find that AFD's conduct amounted to requesting or arranging within the meaning of Rule 2830(k)(3). AFD not only requested that CRMC direct commissions to the top-selling retail firms of American Funds, AFD also monitored the directed brokerage to ensure that the commissions were remitted and properly credited. AFD identified the top-selling retail firms of American

[16] We note that if a literal reading of Rule 2830(k)(3) could not be reconciled with its clear purpose, a less literal construction of the rule may be considered. *See United States v. Campos-Serrano*, 404 U.S. 293, 298 (1971); *Buffalo Crushed Stone, Inc. v. Surface Transp. Bd.*, 194 F.3d 125, 129 (D.C. Cir. 1999) ("Courts are not helpless captives when a literal application of statutory language would subvert a regulatory scheme.").

[17] AFD also argues that the commissions did not constitute a specific amount or percentage of brokerage because they were non-binding targets, not guarantees. Although we agree that the commissions were non-binding, we nevertheless find that the commissions constituted a specific amount or percentage of brokerage within the meaning of Rule 2830(k)(3). These "targets" were tangible, concrete amounts and percentages that CRMC met, if not exceeded, in each year of the Review Period. As Bergeron testified, these commissions were an important revenue stream that retailers received for several years. Indeed, when AFD cancelled its target commissions program in January 2004, retail firms were "outraged," "shocked," and "dismayed." We thus find that the evidence demonstrates that these targets constituted a specific amount or percentage of brokerage commissions within the meaning of Rule 2830(k)(3).

Funds for CRMC and provided CRMC with the amount of commissions to be sent to each retailer. Throughout the year, AFD monitored CRMC's trading with the selected retail firms to confirm that commission targets were met. AFD also obtained monthly updates from CRMC to track trading activity with the retailers to ensure proper crediting of the commissions. In so doing, we find that AFD "requested or arranged" for CRMC to direct brokerage to the top-selling retail firms of American Funds.

AFD also asserts that the commissions were not "conditioned upon" past sales of American Funds shares.[18] AFD contends that past sales were considered, if at all, only as a factor in selecting among retail firms capable of providing best execution. AFD's argument, however, does not find support in the record. First, AFD and CRMC arranged for commission payments to step-out firms that did not even execute portfolio trades on behalf of American Funds' mutual funds. Therefore, with commission payments to step-out firms, the only condition for the retailers' receipt of target commissions was the past sales of American Funds shares. Second, in the case of executing firms, the condition, or prerequisite, to a retail firm's receipt of brokerage was its prior year sales of American Funds.[19] Third, we find that the target commissions were conditioned upon past sales because AFD and CRMC used a two-tiered calculation, based on a retail firm's prior year sales of American Funds, to determine commission amounts. And fourth, even when the two-tiered calculation was not used, the evidence supports that the 2003 target commission amounts were conditioned upon the 2002

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[18] As mentioned earlier, AFD argues that the definition of "condition" is the creation of a legally binding commitment. We disagree and adopt a more reasonable definition. *See Webster's New World Dictionary* 295; *supra* note 14 and accompanying text. Both Notice to Members 84-40 and the purpose of Rule 2830(k)(3) support this definition.

[19] At the hearing and on appeal, Enforcement differentiates between transactions involving executing and step-out firms. Enforcement argues that step-out transactions present the "best example" of how AFD violated Rule 2830(k)(3). Enforcement explains that step-out transactions patently violate Rule 2830(k)(3) because step-out firms receive commissions, but provide no execution services to American Funds. While we agree that the step-out transactions present a more blatant violation of Rule 2830(k)(3), the rule forbids the direction of commissions conditioned upon past sales regardless of whether the commission payments are made to step-out or executing firms. Thus, we find that both types of payments violate Rule 2830(k)(3).

sales of American Funds shares.[20] Thus, we find that the target commissions were conditioned upon past sales of American Funds shares.

In sum, we find that AFD requested or arranged for CRMC to direct a specific amount of brokerage commissions to other members conditioned upon those members' sales of American Funds shares. In so doing, AFD violated Rule 2830(k)(3).

B. Fair Notice

Finally, AFD argues that any finding of a violation of Rule 2830(k)(3) would violate its right to due process because FINRA failed to provide fair and adequate warning of the conduct Rule 2830(k)(3) prohibited. We disagree.

Pursuant to the Securities Exchange Act of 1934, we evaluate whether AFD had fair notice of Rule 2830(k)(3)'s meaning. *See* 15 U.S.C. § 78o-3(b)(8) (requiring that self-regulatory organizations provide fair procedures); *Mark H. Love*, Exchange Act Rel. No. 49248, 2004 SEC LEXIS 318, at *12 (Feb. 13, 2004) (stating that a rule must give fair guidance to firms, their associated persons, and FINRA decision makers). We find that, under the facts and circumstances of this case, AFD had sufficient notice that Rule 2830(k)(3) prohibited its misconduct. The language of Rule 2830(k)(3), as well as the Notices to Members about Rule 2830(k), provided AFD with sufficient notice of what conduct the rule proscribed. For example, Notice to Members 84-40, which FINRA issued after the 1981 Amendments and nearly 17 years prior to the Review Period, outlined specific practices that violated the rule, including practices employed by AFD in this case. We hold, therefore, that AFD had sufficient notice of the breadth of Rule 2830(k)(3). *Cf. Rooms v. SEC*, 444 F.3d 1208, 1213 (10th Cir. 2006) (explaining that it is impractical to try to anticipate and enumerate every type of specific conduct that could violate the principles of a rule).

On appeal, AFD claims that certain federal court cases mandate a finding of lack of fair notice. *See Upton v. SEC*, 75 F.3d 92, 98 (2d Cir. 1996); *Diebold, Inc. v. Marshall*, 585 F.2d 1327, 1335 (6th Cir. 1978). In *Upton*, the court held that the respondent was not on reasonable notice that its conduct violated a rule because there was substantial uncertainty regarding the rule's interpretation. *See Upton*, 75 F.3d at 98. Similarly, in *Diebold*, the court determined that the respondent did not receive adequate warning of a rule where the rule did not provide

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[20] Although AFD modified its calculation of target commissions in 2003 to consider not only past sales, but also assets under management, rates of redemption, and the overall quality of AFD's relationship with a specific retail firm, we find that the change in calculation did not insulate AFD from this violation. Bodell and Bergeron each testified that they considered the retail firms' mutual funds sales in 2002 to determine target commissions in 2003. We conclude, then, that AFD continued to arrange for a specific amount of directed brokerage to retail firms in 2003, and although past sales played a diminished role, they were still a prerequisite for target commissions. Thus, we find that, in each year of the Review Period, target commissions were conditioned upon past sales of American Funds shares and that AFD violated Rule 2830(k)(3) for the entirety of the Review Period.

sufficient explanation of what activities were prohibited or required. *See Diebold*, 585 F.2d at 1335. *Upton* and *Diebold* are inapplicable in the instant case.[21] We find that AFD had sufficient notice of the meaning of Rule 2830(k)(3) and that the guidance in Notice to Members 84-40 and Notice to Members 81-8 provided adequate warning of what the rule prohibited and required. Thus, there was no uncertainty surrounding the interpretation of Rule 2830(k)(3).[22]

C. Sanctions

There are no Sanction Guidelines ("Guidelines") for violations of Rule 2830(k)(3). Nevertheless, the Guidelines provide principal considerations to guide the formulation of all sanctions.[23] In addition, the Guidelines recommend that, when a violation is not addressed specifically, we look to the guidelines for analogous violations in formulating sanctions.[24]

The Hearing Panel examined these principal considerations and determined that: (1) there was no evidence that AFD was unjustly enriched, (2) there was no evidence that American Funds' shareholders were harmed, (3) AFD's conduct was negligent, not intentional, (4) AFD's conduct was consistent with practices that had arisen in the mutual fund industry, (5) AFD ceased its directed brokerage practices ahead of its competitors, and (6) AFD ended its practices prior to regulatory intervention. The Hearing Panel concluded that AFD's violations of Rule 2830(k)(3) were serious and that a substantial sanction was required. The Hearing Panel imposed a censure and $5 million fine on AFD.

For the reasons discussed below, we affirm the censure and fine of $5 million. Although we uphold the sanctions that the Hearing Panel imposed, our application of the Guidelines' principal considerations identifies only two mitigating factors, not six factors as discussed in the Hearing Panel's decision. First, there is insufficient evidence to demonstrate that AFD was unjustly enriched by its violations of Rule 2830(k)(3). At the hearing, Enforcement asserted that the appropriate measure of sanctions was to eliminate AFD's unjust enrichment, supposedly the total amount of brokerage that AFD directed to retail firms – approximately $98 million. Enforcement premised its fine amount on the theory that target commissions were assets of the

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[21] The *Upton* court also found that, "It is undisputed that [the respondent] complied with the literal terms of the Rule at all times." *Upton*, 75 F.3d at 94. Therefore, *Upton* does not apply because, in the instant case, AFD failed to comply with the literal terms of Rule 2830(k)(3).

[22] AFD's use of *General Bond & Share Co. v. SEC*, 39 F.3d 1451, 1455-60 (10th Cir. 1994) is also misplaced. *General Bond* found that an NASD Notice to Members constituted an invalid rule change because it was not submitted to the Commission for approval. *See id.* Accordingly, the court found that the respondent could not be liable under an invalid rule. *See id.* Nothing in the record shows an invalid change to Rule 2830(k). Thus, *General Bond* does not apply.

[23] Principal Considerations in Determining Sanctions are considered in every disciplinary case. *See Guidelines*, at 6-7.

[24] *See Guidelines*, at 2.

American Funds' shareholders and that AFD's improper arrangement of directed brokerage allowed AFD to avoid making marketing pool payments to retail firms. On appeal, Enforcement continues its argument that AFD was "unjustly benefited" by the directed brokerage and asserts that the NAC should "at a minimum" affirm the $5 million fine.

We find insufficient evidence that the amount of directed brokerage represents unjust enrichment of AFD at the expense of American Funds' shareholders. The portfolio trades that CRMC placed required the mutual funds to pay brokerage commissions to firms that executed trades regardless of whether AFD violated FINRA's rules by arranging a specific amount of commissions conditioned upon sales. Our finding of violations did not include a finding that the directed brokerage unjustly enriched AFD at the expense of the mutual funds' shareholders.

There is also insufficient evidence to support Enforcement's theory that AFD would have had to pay marketing pool dollars to achieve the same sales levels that it did during the Review Period. The evidence does not support that retail firms would have ceased or diminished their sales of American Funds if AFD did not violate Rule 2830(k), especially when we also consider the other permissible payments that retail brokers receive when selling mutual funds. We conclude, therefore, that AFD's use of directed brokerage did not result in AFD's unjust enrichment.

Second, we find that there is insufficient evidence to establish that AFD's misconduct harmed American Funds' shareholders. Before the hearing, the parties stipulated that "[Enforcement] has not charged a best execution violation by CRMC or AFD in connection with any securities transaction CRMC authorized on behalf of [American Funds] between January 1, 2001 and December 31, 2003." Because of this stipulation, Enforcement did not prove, and the Hearing Panel did not address, whether CRMC's selection of executing firms for the portfolio trades comported with FINRA's best execution requirements. Thus, we cannot make any finding – or draw any inference – that CRMC failed to obtain best execution for the portfolio trades of the shareholders of American Funds' mutual funds.

There is accordingly no evidence in the record that AFD, through CRMC, placed unwarranted trades or paid excessive commissions. Moreover, Enforcement proffered no evidence to demonstrate the actual amount of alleged damage to American Funds' shareholders. If anything, Enforcement relies on the total amount of brokerage that AFD directed as a measure of damages in this case, and that is simply not an accurate gauge of the extent of shareholder harm under the circumstances of this case. We conclude that there is insufficient evidence to demonstrate shareholder harm.

While we agree that the two aforementioned factors lack the evidence to support imposing a fine of nearly $98 million, we find several aggravating factors present in this case. First, we find it aggravating that AFD's reciprocal arrangements tended to undermine the rules of fair competition envisioned by the rule. AFD's target commission payments amounted to undisclosed additional sales commissions that would harm other mutual funds families' ability to compete in the market to sell their mutual funds to the investing public. AFD's target commission payments, when compared to the payments that retail firms received from other

mutual fund complexes, triggered the potential for preferential treatment for American Funds' mutual funds to the disadvantage of other mutual funds in the industry.

Second, while we determine that there is no evidence of harm to the shareholders of American Funds' mutual funds, we nevertheless find it aggravating that AFD's reciprocal arrangements potentially injured the customers of the retail firms. AFD's violations of Rule 2830(k)(3) created potential conflicts of interest in which the retailers that sold American Funds' mutual funds to the investing public would be unduly influenced by the amount of brokerage received instead of the performance, management, and other qualities of American Funds' mutual funds.

Third, we find that AFD's conduct was intentional, not negligent as the Hearing Panel concludes. The evidence demonstrates that AFD deliberately formed directed brokerage arrangements with the top-selling retailers of American Funds' mutual funds. AFD tracked CRMC's trading activity with the retail firms and monitored the execution of these arrangements to ensure proper crediting of the target commission payments. AFD also ceased payments to step-out firms, and modified its calculation of target commissions, as regulators began to question the use of directed brokerage in the mutual fund industry. There is no evidence in the record to support a finding that AFD's conduct was negligent. *See Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (stating that it is intentionally committing the act, not violating the law, which constitutes the violation); *Trautman Wasserman & Co.*, Administrative Proceeding File No. 3-12559, 2008 SEC LEXIS 83, at *44 n.36 (Jan. 14, 2008) (same).

Fourth, we disagree with AFD that the use of quid pro quo arrangements, similar to those employed here, was widespread throughout the mutual fund industry. There is no evidence in the record that, as a matter of practice, underwriters and distributors of mutual funds conditioned retailers' brokerage commissions upon their sales of mutual fund shares as AFD did in this case. Although the Commission has found that the use of brokerage commissions to facilitate the sale of fund shares was widespread among mutual funds that rely on retail firms to sell their shares, that does not necessarily mean that the directed brokerage was conditioned upon sales as it was here. *See generally Prohibition on the Use of Brokerage Commissions to Finance Distribution*, Rel. No. IC-26591, 69 Fed. Reg. 54728 (Sept. 9, 2004) (finding that directed brokerage practices are widespread among mutual funds, underwriters, distributors, and retail firms).

Fifth, even assuming arguendo that AFD's practices were widespread, this fact would not mitigate AFD's misconduct. Failure to follow FINRA's rules because "everyone else in the industry is doing it" is not a mitigating factor. It is well established that industry-wide misconduct is no defense when a firm violates FINRA's rules. *See Charles E. Kautz*, 52 S.E.C. 730, 733 (1996) (holding that it is no defense that others in the industry are also acting improperly). It is the responsibility of each FINRA member to follow FINRA's rules, and for FINRA to enforce its rules.

We also do not credit AFD with voluntarily ending its directed brokerage practices prior to regulatory intervention.[25] This is not a case in which AFD monitored its practices, remedied its violations, and self-reported its misconduct to FINRA. Instead, in the face of regulatory scrutiny regarding the use of directed brokerage, AFD modified its calculation of target commissions, but still violated Rule 2830(k)(3).[26]

Finally, we find that the subsequent modifications to Rule 2830(k) do not warrant reducing the fine in this case. AFD argues that the importance of imposing a large fine for this type of misconduct is reduced by the complete ban on reciprocal brokerage adopted by the Commission in September 2004 and by FINRA in February 2005. Subsequent rule changes in this area, however, have no bearing on AFD's obligation to follow the rules that were in place at that time. Thus, AFD's argument is unavailing.

In sum, after balancing the several aggravating and mitigating factors in this case, we conclude that AFD's violations of Rule 2830(k)(3), while not egregious, were quite serious. These violations took place over multiple years and involved numerous arrangements that violated FINRA's rules and caused potential harm to the investing public. As a result, we determine that a censure and substantial fine of $5 million are appropriate sanctions based on the facts and circumstances of this case. To calculate this fine, we take guidance from the high end of the range of fines identified in many of the Guidelines for quality of market violations – typically $100,000.[27] We also rely on the fact that AFD's misconduct involved 46 retail firms, involved numerous arrangements that violated Rule 2830(k)(3), and spanned at least three years. Thus, for violating Rules 2830(k)(3) and 2110, we censure AFD and impose a fine of $5 million. We find that these sanctions satisfy the Guidelines' goals while not exceeding their remedial purpose in this case.

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[25] *See Guidelines*, at 6 (Principal Considerations in Determining Sanctions, No. 4).

[26] After the Commission in 2001 informally expressed concerns about reciprocal brokerage arrangements with step-out firms, AFD ceased payments to step-out firms in June 2002. In addition, in 2004, when the Commission and FINRA informally indicated that they might issue a complete ban on directed brokerage, AFD ended its commission practices shortly before the rules were adopted.

[27] *See generally Guidelines*, at 49-70.

IV. Conclusion

AFD violated Rules 2830(k)(3) and 2110 by requesting or arranging for the direction of a specific amount or percentage of brokerage commissions to other members conditioned upon those members' sales of American Funds' mutual funds. For these violations, we censure AFD and impose a fine of $5 million. We also affirm the Hearing Panel's order to pay costs of $10,687.13 and assess appeal costs of $1,931.25.[28]

On behalf of the National Adjudicatory Council,

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Marcia E. Asquith,
Senior Vice President and Corporate Secretary

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[28] Pursuant to NASD Rule 8320, any member that fails to pay any fine, costs, or other monetary sanction imposed in this decision, after seven days' notice in writing, will summarily be suspended or expelled from membership for non-payment.

We also have considered and reject without discussion all other arguments of the parties.