

## NASD Reminds Members of Their Responsibilities Regarding Sales of Mutual Fund Shares and Dealer Agreements



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A mutual fund dealer agreement between the principal underwriter of a mutual fund and a selling broker-dealer sets forth the terms and conditions under which the broker-dealer may participate in the sale and distribution of shares of the fund. This Member Alert reminds members that fund sales must be consistent with the federal securities laws, disclosure provided to customers (including the fund prospectus), and any applicable dealer agreement. Dealer agreements should adequately delineate the respective responsibilities of the parties in a manner reasonably designed to help ensure that the mutual fund sales and distribution process protects investors. Members also should be mindful that a failure to adhere to obligations under the terms of a dealer agreement might be inconsistent with just and equitable principles of trade, and therefore a violation of NASD Conduct Rule 2110, particularly if the failure results in financial harm to investors.\*

Mutual fund dealer agreements help ensure the integrity of mutual fund sales and distribution. For example, it is typical for a dealer agreement to include a provision under which a member agrees to sell shares only in accordance with the current prospectus of each fund covered by the agreement. Some agreements also state that the member will sell shares in accordance with the federal securities laws. Others may augment this provision with references to the member's obligation to comply with specific provisions of the prospectus, such as those regarding late trading and market timing activities.

Recent enforcement actions by the SEC and the NASD highlight the importance of members' compliance with the federal securities laws in the sales of mutual funds. For example, recent actions involving the failure of some broker-dealers to properly apply breakpoint discounts provided in the funds' prospectuses and those involving late trading and market timing of mutual funds highlight the importance of member adherence to the terms of the prospectus, the federal securities laws, and undertakings in dealer agreements. While these cases involved failures to comply with the federal securities laws, in certain instances the SEC also alleged that brokers had engaged in these activities despite specific prohibitions in applicable dealer agreements.

NASD Rule 2110, adopted in 1939, provides that "[a] member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." Rule 2110 is very broad in scope and its application is not restricted to conduct that violates other laws or regulations. NASD cautions members that it may violate Rule 2110 for any member to fail to comply with a provision of a dealer agreement, particularly if the failure results in financial harm to investors (e.g., a failure to comply with the agreement's required procedures with respect to late trading and market timing). NASD urges mutual fund underwriters and dealers to review their mutual fund dealer agreements to determine whether they adequately delineate the respective responsibilities of the parties in a manner reasonably designed to help ensure that the mutual fund sales and distribution process protects investors. Members also should implement appropriate procedures reasonably designed to ensure that they comply with their obligations under those agreements.

\* In addition, a member is, of course, obligated to sell mutual fund shares in conformity with the federal securities laws and NASD rules, including Section 22(d) of the Investment Company Act of 1940 (Investment Company Act), Rule 22c-1 under the Investment Company Act, Section 5 of the Securities Act of 1933 and Section 15(c) of the Securities Exchange Act of 1934. Moreover, even absent an undertaking in a dealer agreement, a member has responsibilities under the federal securities laws and Rule 2110 with regard to late trading and market timing of mutual fund shares. See [Notice to Members 03-50](#) (2003).