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NASD Says Fund Family Paid Improper Fees

By RIVA D. ATLAS

NASD has accused an affiliate of American Funds, the nation's third-largest mutual fund company, of directing \$100 million in trading commissions to the brokerage firms that were top sellers of its funds.

The case is a rare blow for American Funds, whose funds have long been favorites of investors because of their low cost and strong performance. Indeed, its sales were bolstered last year as the mutual fund trading scandals dented the reputations of many of its largest competitors. American Funds, which is based in Los Angeles, manages \$600 billion and was the third most popular family of funds last year, behind Vanguard and Fidelity, according to the Financial Research Corporation.

According to yesterday's NASD complaint, American Funds directed the commissions to about 50 brokerage firms from 2001 to 2003. At the start of each year, American Funds told each brokerage firm what its target commission payments would be, and described what it expected in return, according to NASD, the brokerage industry's regulator. For example, American Funds might request that its funds be included on a list of recommended funds promoted to brokerage clients.

The commission payments, which were tied to a formula based on past sales of American Funds, violated an NASD rule prohibiting the use of commissions to "compensate brokerage firms for selling the funds' shares," NASD said in a statement.

At issue, analysts said, is whether American Funds wound up overpaying for trades made on behalf of its mutual funds. NASD did not specify the price per share paid by American Funds as part of its special arrangements with the brokerage firms.

American Funds denied that it violated NASD rules, or that it overpaid for any trades.

"We have complied fully with both the spirit and the letter of the rule, and we intend to request a hearing before an NASD panel to defend ourselves," Chuck Freadhoff, a spokesman for the Capital Group, manager of the American Funds, said in a statement.

American Funds always sought the lowest possible prices for its trades, Mr. Freadhoff said. The company took into account which brokers were big sellers of its funds, he said, but any trades promised to those brokers were "an informal target; it was never a commitment."

An NASD lawyer said that while the regulator's complaint did not address the trading costs of American Funds, the anticipated commissions from the fund manager could have compromised the advice provided by the brokers, who would have had an extra incentive to recommend the mutual funds.

"When they make recommendations, retail brokers should make them purely based on the mutual funds, rather than to gain additional rewards," said Samuel L. Israel, chief counsel for NASD's enforcement division.

The Securities and Exchange Commission has been conducting its own inquiry into payments made by American Funds to brokers promoting its funds. Officials at the S.E.C. declined to comment on the status of that investigation.

Attorney General Bill Lockyer of California is also examining payments by American Funds. That investigation is continuing, a spokesman said.

The S.E.C. has brought several cases tied to special payments by fund companies to brokerage firms. Last August, the commission prohibited mutual funds from making commission payments to brokers who market their funds.

In December, the S.E.C., NASD and the New York Stock Exchange announced a \$75 million joint settlement with Edward D. Jones & Company, a brokerage firm, tied to its failure to disclose payments that it received from certain mutual fund managers, including \$27 million paid by American Funds.

But that money, Mr. Freadhoff said, went toward broker education, an expense paid by the management of the American Funds, not its investors.

American Funds, known for its low profile, had previously steered clear of the scandals that have roiled the industry. Sales of stock and bond portfolios of American Funds rose nearly 30 percent, to \$84 billion, last year. In contrast, fund managers involved in the market-timing trading scandal, like Janus and Putnam Investments, had billions of dollars in outflows from their funds last year.

Analysts said yesterday that the damage to the reputation of American Funds might not be as severe as that done to those caught up in the market-timing scandal.

"This does cast a cloud on some of their sales practices," said Gareth Lyons, an analyst with Morningstar. But he and other analysts said it would be hard to assess how damaging the payments were to investors without knowing the prices that American Funds paid for its trades.

American Funds recently disclosed that a year ago it negotiated a one-third reduction in the commissions it paid to all brokers.

"We did not do that in reaction to the regulatory environment," Mr. Freadhoff said. "Commissions have been coming down, and whatever we can save goes directly to shareholders."