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9 August 2004

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W., Stop 6-9
Washington, D.C. 20459

Re: Prohibition on the Use of Brokerage Commissions to Finance Distribution (File No. S7-09-04)

Dear Mr. Katz:

The U.S. Advocacy Committee (USAC) of CFA Institute[1] appreciates the opportunity to comment on the SEC's proposal that would prohibit mutual funds from using brokerage commissions for the distribution of fund shares. The USAC is a standing committee of CFA Institute charged with responding to new regulatory, legislative, and other developments in the United States affecting the investment profession, the practice of investment analysis and management, and the efficiency of financial markets.

Summary Position

We strongly support aspects of the proposal that would prohibit mutual fund companies from directing brokerage in return for securing "shelf space" for that fund's shares. Such arrangements or understandings, however implicit, focus on considerations that are not necessarily in the best interests of the investor.

With respect to the continued use of 12b-1 plans, we believe that they have outlived their useful purpose and do not serve the interests of long-term shareholders. The $7.5 trillion mutual fund industry that exists today is dramatically different from the scope of the industry that existed when 12b-1 plans were first introduced. Should the SEC determine to retain funds' abilities to use 12b-1 fees, we strongly urge amendments to the rule that require full and transparent disclosure of these fees, so that investors can clearly and easily understand the impact of these fees on their holdings. We also recommend that such fees be deducted directly from the

[1] With headquarters in Charlottesville, VA and regional offices in Hong Kong and London, CFA Institute (formerly, the Association for Investment Management and Research®) is a non-profit professional association of 70,000 financial analysts, portfolio managers, and other investment professionals in 115 countries of which more than 57,700 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 129 Member Societies and Chapters in 50 countries and territories.

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shareholder's account rather than from fund assets as an added means of directly attributing the cost of 12b-1 fees in a meaningful way.

We discuss these positions in more detail below.

Discussion

Directed Brokerage Arrangements

As stated above, we cannot support practices that result in using directed brokerage to reward a broker for that broker's efforts to sell fund shares. While the NASD's Anti-Reciprocal Rule may have been well-intended (and the rationale for it a reasonable one), we believe that parties have found ways to circumvent it, resulting in violations of both the spirit and intent of the rule.

Given the incentives for brokers that are implicit in such arrangements, we believe that the appropriate focus of obtaining best execution is replaced with a zeal to market certain fund shares. This clearly violates industry standards and overlooks the fundamental notion that brokerage is the property of the shareholder.

It is the investment manager's responsibility to select brokers that can best execute securities transactions to add value to its client's portfolio. Accordingly, in selecting a broker-dealer to execute trades, an investment manager must consider the capabilities of the broker to provide best execution. Participating in arrangements that focus on factors other than the ability to achieve best execution, whether those arrangements are explicit or implicit, ultimately violates the manager's basic fiduciary duties to act in the client's best interests.

Moreover, we agree with the SEC's concern that the competition to gain business from funds may lead broker-dealers to market shares of those funds to investors without fully considering the suitability of those investments. To sacrifice suitability determinations for compensation concerns raises serious and troubling issues about the integrity of the investment management process. We therefore strongly support measures that would right this situation.

We recognize that the benefit from these arrangements to certain parties is substantial, and has become a market force in its own right. If the SEC formally prohibits this practice, we assume that the need to generate brokerage commissions will manifest in another practice. We thus support requirements in the final rule for fully disclosing any types of revenue-sharing arrangements involving brokerage commissions.

Rule 12b-1 Plans

The original intent of Rule 12b-1 plans was to allow smaller funds to grow their assets and achieve economies of scale that, in turn, would ultimately benefit fund shareholders by lowering fund expenses. Over time, however, it appears that 12b-1 fees have been used not so much to benefit shareholders through economies of scale as to provide investment managers with an additional source of revenue to market funds' shares. In essence, we believe that 12b-1 plans have outlived their useful purpose, and that modifications are needed.

As currently used, we believe that 12b-1 fees pose an obvious area for conflicts of interest. Given that advisers' fees are based on a percentage of fund assets, growing the fund positions the advisers to derive higher fees. Rather than achieving economies of scale that benefit shareholders, these plans offer the opportunity for increasing the amount of advisory fees, thereby putting the investment adviser in a position of self-interest.

In this scenario, the investment adviser faces powerful incentives to gain shelf space with brokers to grow the fund, placing the fiduciary duty to obtain best execution second. Moreover, reports indicate that shareholders in funds with 12b-1 plans do not receive lower expenses but pay the same, if not higher expenses, as shareholders in funds without 12b-1 plans. These misplaced priorities that focus on achieving benefits for investment advisers, rather than for shareholders affect the quality of portfolio transactions, the ultimate return to shareholders, and the overall integrity of the industry.

Moreover, we understand that shareholders in funds with 12b-1 plans are often assessed twice for their account without receiving concomitant benefits. For example, in fee-based accounts, shareholders pay a fee, based on a percentage of assets under management. However, if the investment is in a mutual fund with a 12b-1 charge, the investor is paying an additional amount to that adviser, for essentially performing the same functions related to that account. In fact, for long-term shareholders, those functions are extremely minimal. The average investor does not realize that s/he is paying twice for the same service. Similarly, we understand that some funds that are closed to new investors continue to charge 12b-1 fees, although they have ceased any marketing activities and thus do not accrue those expenses.

Although we question the continued benefit of Rule 12b-1 plans, if the SEC determines that they still have a legitimate place in the mutual fund industry, we urge modifications that honor the original intent of Rule 12b-1. We strongly urge the adoption of rule modifications that make information surrounding the existence and use of 12b-1 fees fully transparent so that investors can make informed decisions about whether to invest in funds that engage in 12b-1 arrangements. Simply requiring the renaming of "12b-1 fees" in fund materials to "marketing expenses" would help demystify this term for investors and invite them to question the purpose of the fees.

We urge more than just a renaming of this term; we believe that investors need to be provided a better context in which to evaluate fund expenses, including marketing expenses. Investors need more information about how the adviser is compensated, including "perks" related to marketing efforts, and long-term compensation related to an account. Only with a fuller understanding of all aspects of adviser compensation can the investor ask the relevant questions about fees related to his or her account. Along these lines, we ask the SEC to clarify the appropriate use of the terms "fee" versus "commission" for these purposes. Anecdotally, we are aware of numerous instances where shareholders were told by advisers that their compensation consisted only of a "fee" only to learn after investing that the funds carried a 12b-1 charge.

We also recommend that funds be required to deduct distribution-related costs directly from shareholder accounts as a separate line item, rather than from fund assets. This adds transparency that allows a shareholder to assess exactly how much 12b-1 fees are costing, and to assess future involvement in that fund.

Conclusion

We believe that current directed brokerage practices and the use of 12b-1 fees are placing the interests of the fund manager first and that of the investor second. Directed brokerage arrangements that aim to reward the broker for sales of fund shares while guaranteeing funds greater shelf space overlook the fundamental precept that fund brokerage belongs to shareholders.

Similarly, 12b-1 arrangements that provide little benefit to shareholders but are used to increase compensation to advisers undermine the legitimacy of these payments. Fuller transparency is required if shareholders are to obtain the information that they are entitled to receive. At the least, we believe this transparency should manifest in clearer terminology, more accurate representations to potential investors, a fuller explanation of adviser compensation practices, and a requirement that 12b-1 expenses be deducted directly from shareholder accounts.

If we can provide additional information, please do not hesitate to contact James W. Vitalone at 704.969.0339, jwvitalone@carolina.rr.com or Linda Rittenhouse at 434.951.5333, linda.rittenhouse@cfainstitute.org.

Sincerely,

/s/ James W. Vitalone, CFA	*/s/ Linda L. Rittenhouse*
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Chair, U.S. Advocacy Committee	CFA Institute Advocacy

cc: U.S. Advocacy Committee
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