THE FINANCIAL SERVICES ROUNDTABLE

1001 PENNSYLVANIA AVENUE, NW
SUITE 500 SOUTH
WASHINGTON, DC 20004
TEL 202-289-4322
FAX 202-289-1903

E-Mail rich@fsround.org
www.fsround.org

RICHARD M. WHITING
EXECUTIVE DIRECTOR AND
GENERAL COUNSEL

May 11, 2004

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

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

Dear Mr. Katz:

The Financial Services Roundtable[1] (the "Roundtable") appreciates the opportunity to comment on the proposal issued by the Securities and Exchange Commission (the "Commission") on the prohibition of the use of brokerage commissions to finance distribution of mutual funds.

Background

The Commission has expressed concern over various arrangements fund advisers use to distribute fund shares through broker-dealers. Proposed rule 12b-1(h)(1) would prohibit funds from compensating a broker-dealer for promoting or selling fund shares by directing brokerage transactions to that broker. Proposed rule 12b-1(h)(2) would prohibit "step-outs" or other arrangements in which a portion of a fund's brokerage commissions are rebated to accounts maintained for the fund and later paid to a selling broker. Finally, the Commission's proposal seeks comment on whether to propose additional changes to rule 12b-1 to address other issues that have arisen under the rule, or whether to rescind rule 12b-1 altogether.

The Roundtable member companies support the Commission's recent efforts to increase transparency in mutual fund operations. We support enhanced disclosure

[1] The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Roundtable member companies provide fuel for America's economic engine accounting directly for $18.3 trillion in managed assets, $678 billion in revenue, and 2.1 million jobs.

of mutual fund fees and costs, including distribution and portfolio brokerage costs. We recommend that the Commission take additional steps to protect mutual fund investors. These steps include (1) improving disclosure about the use of directed brokerage commissions in order to assist investors in making informed investment decisions, (2) adopting reasonable policies and procedures to restrict the improper use of brokerage commissions, and (3) placing strict limits on those arrangements between funds and broker-dealers that are improper or that lack transparency.

Roundtable member companies oppose rescinding rule 12b-1 or prohibiting 12b-1 fees. We recommend providing additional disclosure to investors. We believe that eliminating 12b-1 fees would have a negative impact on the marketplace. Restricting 12b-1 fees would:

- Limit investors' choices by reducing the number of available funds,
- Reduce advisory services available to the investor, and
- Increase costs to the funds and the investor.

<u>Steps that Need to Be Taken with regard to Directed Brokerage</u>

We believe that additional steps need to be taken to ensure that mutual fund investors are protected. These steps include additional disclosure, guidance on impermissible business arrangements between funds and broker-dealers, and policies and procedures that would protect the investor.

Additional disclosures

There are several existing rules requiring funds to disclose information relating to arrangements by which brokerage commissions are used to compensate broker-dealers for selling fund shares. Funds disclose in the fee table listed in the prospectus the amounts paid pursuant to a 12b-1 plan. The Statement of Additional Information ("SAI") describes material aspects of the fund's plan, compensation paid to broker-dealers and how funds select the brokers. Rule 10b-10 requires disclosure of the source and extent of payments to broker-dealers. The Commission's recently proposed rule requires additional disclosure at the point of sale in mutual fund confirmation statements for commissions and revenue sharing payments.

We recommend providing additional disclosures to the investor. We believe that these disclosures should be qualitative, rather than quantitative. It would be costly and burdensome to provide disclosure of specific amounts of commissions paid. We recommend prospectus disclosures that explain the scenarios in which directed brokerage is paid and what types of arrangements, if any, exist between funds and broker-dealers. The disclosures would be provided in a format that is easy for investors to understand. These disclosures would improve the information provided in the prospectus, SAI and annual reports. Increased disclosure requirements would help reduce impermissible uses of brokerage commissions. Additional disclosure provided to the investor on a timely basis would assist the investor in making an informed investment decision.

More Guidance is Needed on Impermissible Arrangements

Fund advisers have a fiduciary duty to seek the “best execution” for a portfolio securities transaction and thereby must attempt to provide the client with the most favorable costs and proceeds under the circumstances. Fund advisers control allocation of fund brokerage and can use excess commissions to purchase goods or services from the executing broker or third parties.

The Commission is concerned that fund advisers are using excess brokerage commissions to secure a prominent position in the selling brokers’ distribution channels (“shelf space”). The Commission is also concerned that if a broker-dealer receives commissions in exchange for shelf space, it would recommend these funds to its customers instead of funds that more adequately meet its customers’ investment objectives.

Rule 12b-1 does not explicitly address how fund brokerage commissions may be used to reward distribution. NASD Conduct Rule 2830(k) allows mutual fund advisers to take into account sales of fund shares when allocating commissions under certain conditions, including (1) the policy must be described in the fund's prospectus, (2) no broker may favor or disfavor the sale of fund shares based on commissions it receives, (3) no broker may demand commissions as a condition for selling shares of a fund, and (4) the broker must provide best execution.

The Commission has questioned the various business arrangements entered into by fund advisers and securities firms to finance distribution of fund shares and the lack of transparency in these transactions. These arrangements range from directing a selling broker to execute trades and distribute the shares to placing orders through various intermediaries or third party brokers who split or rebate commissions. The Commission’s proposed rule is geared toward eliminating these arrangements through a ban on directed brokerage.

The Roundtable appreciates the Commission’s concerns over fund advisers’ arrangements with securities firms. According to NASD Rule 2830(k), it would be appropriate to use brokerage commissions to pay selling brokers. However, as a general business practice, our member firms choose not to enter into these types of arrangements. If the Commission chooses not to ban directed brokerage, we suggest that limits be placed on the types of arrangements in which use of brokerage commissions are allowed. We recommend that the Commission establish guidelines for what constitutes a permissible arrangement in order to reduce the instances of abuse and allow the Commission to bring enforcement actions against funds or broker-dealers that enter into unauthorized arrangements.

Policy and Procedures are Necessary to Protect the Investor

The Roundtable supports implementing policy and procedures designed to ensure that its selection of brokers is not tainted by considerations about how shares are distributed and preferential "shelf space" for funds.

The Roundtable recommends that a majority of a fund's independent directors adopt policies and procedures that are reasonably designed to ensure that sales considerations do not affect the fund's brokerage allocation practices. These policies and procedures could include: (1) additional controls on individuals making brokerage allocation determinations, (2) reviewing the conduct of trading and investment personnel who select broker-dealers to make sure they did not base decisions on broker-dealers' promotional efforts, (3) prohibiting marketing personnel from engaging in the brokerage allocation process, and (4) a periodic review by fund boards of the allocation procedures of the fund and the arrangements entered into between the fund advisers and securities firms.

These safeguards would create a solid corporate governance structure allowing funds to continue using brokerage commissions in connection with the distribution of shares.

<u>12b-1 Fees Should Not Be Eliminated</u>

The Commission has requested comment on whether to amend or rescind rule 12b-1. The Roundtable supports improved disclosure of 12b-1 fees, rather than eliminating existing business practices that meet the needs of mutual fund investors. We believe that eliminating 12b-1 fees would (1) create increased costs for the funds and the investor, (2) reduce advisory services available to the investor, and (3) limit investors' choices of funds and services.

Improved Disclosure of 12b-1 fees

The Roundtable favors increased disclosure of 12b-1 fees over a prohibition. Rule 12b-1 allows funds to use their assets to pay distribution-related costs. In particular, 12b-1 fees are paid by mutual funds to help offset the costs of making fund shares available to investors. Funds are required to have a written plan, approved annually by fund shareholders and a majority of fund independent directors, that describes all of the material aspects of the distribution costs. Any increase in 12b-1 fees must also be approved. Funds that charge 12b-1 fees are required to disclose those charges in the fund prospectus. Funds are also required to disclose how 12b-1 fees increase costs over time and identify them as a separate item in the fund's fee table in the prospectus as part of the fund's annual operating expenses.

Enhanced disclosure would focus on increasing the transparency of transactions both in the prospectus and annual report. Funds would be required to describe how and why fees are being paid. These disclosures would be provided in a format that is easy for the investor to understand. We believe this disclosure would be more useful to investors, and less costly to produce, than the deductions from individual shareholder accounts proposed by the Commission. We note that the SEC has already required mutual funds to disclose fund expenses, including 12b-1 fees, to investors in dollars for a hypothetical $1,000 investment. This approach allows investors to make comparisons and is less costly to prepare than would be disclosing actual costs associated with the transactions.

We urge the Commission to provide guidance on the use of 12b-1 fees. This guidance could include examples of permissible uses. Such guidance would ease compliance and assist institutions as they create disclosures aimed at making mutual fund transactions more transparent for the investor.

Increased costs to the funds and the investor

The Commission has indicated that it is concerned that 12b-1 fees are being used to substitute for a sales load and that this was not the intention of the original rule. We believe that one of the benefits of 12b-1 fees is that they allow investors to choose to pay for distribution and related costs over time, either in whole or in part, rather than in a single up-front sales commission of up to 8.5%. Eliminating 12b-1 fees would eliminate this option.

Reduced advisory services available to the investor

Many mutual fund companies rely on these fees to market and distribute their products to potential investors, including through brokers, financial planners and other third parties. These financial professionals help investors identify their investment goals and provide access to a wide array of financial products that will help them meet those goals. Nearly three-quarters of all mutual funds are held by individual investors. These investors often seek advice on where and how to invest their money. More than half of all mutual fund investors rely on financial professionals for their advice on purchasing their funds and managing their funds once the sale is completed.

Investors often have difficulty understanding their statements and the return on their mutual fund investments. Financial professionals help investors understand that is often necessary to hold mutual funds for the long-term in order to maximize their profits. Eliminating 12b-1 fees removes the compensation professionals receive for providing this critical education and mentoring of mutual fund investors. Without this compensation, funds would not be able to offer this valuable service.

Limited investors' choices
12b-1 fees provide investors with access and choices. Investors currently have access to more than 8,000 mutual funds. Investors who are seeking investment advice, or who do not want to pay an up front sales load, can choose to invest in funds that do not levy 12b-1 fees. Investors for whom low fund costs are a priority can invest in funds that do not charge 12b-1 fees. Removing 12b-1 fees would limit investors' choices and would increase costs for funds, which could be passed on to the investor. In addition, eliminating 12b-1 fees would prevent some of these funds from competing in the marketplace and thereby reducing the number of funds available to investors.

Conclusion

The Roundtable supports the Commission's ongoing effort to curb abuses in the mutual fund industry. We recommend first that the Commission provide investors with meaningful, enhanced disclosures that would adequately describe how funds select broker-dealers to carry out portfolio transactions. Second, we support creating policies and procedures, approved by a majority of a board's independent directors, which would ensure that fund advisers' fulfill their fiduciary obligation to seek best execution. Third, we believe that the Commission should provide guidance on arrangements between fund advisers and broker-dealers that they deem are improper or lack transparency.

Finally, the Roundtable strongly opposes eliminating the use of 12b-1 fees. We support providing investors with additional disclosure about 12b-1 fees. We believe that prohibiting 12b-1 fees would increase costs, reduce advisory services, and limit investment choices. By providing additional disclosure on 12b-1 fees, investors will be able to make educated choices on how they would like to invest their money. At the same time, the industry can continue providing assistance to investors who seek investment advice.

If you have any further questions or comments on this matter, please do not hesitate to contact me or John Beccia at (202) 289-4322.

Sincerely,

Richard M. Whiting

Richard M. Whiting
Executive Director and General Counsel