Fund Democracy
The Mutual Fund Shareholder's Advocate

CFA Consumer Federation of America

Consumer @ction

Consumers Union
Publisher of Consumer Reports

RECEIVED
MAY 10 2004
OFFICE OF THE SECRETARY

May 10, 2004

92

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 5th St., N.W.
Washington, D.C. 20549-0609

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

Dear Secretary Katz:

We are writing on behalf of Consumer Federation of America,[1] Fund Democracy, Inc.,[2] Consumers Union,[3] and Consumer Action[4] to express our strong support for the proposed rule to prohibit mutual funds' use of brokerage commissions to finance distribution. The Commission is to be congratulated for taking this long overdue step to end a practice that both helps drive up mutual fund portfolio transaction costs and encourages brokers to recommend funds based on factors that are not in the best interest of the client. If adopted without weakening amendments, the rule should help to eliminate one of the more egregious conflicts of interest biasing fund sales.

A ban on directed brokerage, while important, is just one component of what we believe must be a much broader initiative to eliminate abusive mutual fund sales practices and promote pro-investor competition among funds. We are encouraged that the rule proposal also requests comment on another essential component of such an initiative – reform of 12b-1 fees. Since 12b-1

---

[1] The Consumer Federation of America (CFA) is a nonprofit association of 300 consumer groups, representing more than 50 million Americans. It was established in 1968 to advance the consumer interest through research, education, and advocacy.

[2] Fund Democracy is an advocacy group for mutual fund shareholders that was founded in 2000.

[3] Consumers Union, publisher of *Consumer Reports* magazine, is an independent nonprofit testing, educational and information organization serving only the consumer.

[4] Founded in 1971, Consumer Action works on a wide range of consumer issues through its national network of 6,500 community based organizations.

fees have replaced front loads as the primary means of compensating brokers for the sale of mutual funds – a purpose for which they were never intended – a thorough reworking of this rule is definitely warranted. The goal should be to ensure that any payments for the services brokers provide to the investor in selling the fund are clearly identified as such.

Ultimately, however, even more fundamental reform is needed. In our view, the time has come for the Commission to support a reform the Division of Investment Management advocated in its 1992 review of the Investment Company Act – repeal of the retail price maintenance provisions of section 22(d) of the Investment Company Act.[5] If accompanied by a ban on directed brokerage, revenue sharing payments, and any other financial inducements from funds to brokers to promote distribution, such an approach should go a long way toward eliminating the massive conflicts of interest that are at the heart of the current system of mutual fund sales.

- **We support a prohibition on directing brokerage to pay for distribution.**

As the Commission notes in its proposing release, mutual funds routinely pay commissions and mark-ups that are higher than both the cost of the execution and those typically available to large institutional investors.[6] The fund adviser is able to use these excess commissions – or "soft dollars" – to purchase a variety of goods and services from the executing broker or, through the executing broker, from third parties. Among the services they purchase is distribution.

Because fund brokerage is an asset of the fund, it is supposed to be used only for the fund's benefit. All too often, however, fund advisers use soft dollars for questionable purposes: to purchase goods or services that ought to be paid for directly and reported as an operating expense of the fund, or to purchase goods and services that benefit the fund's adviser more than its shareholders. Directed brokerage falls into the latter category. While the fund adviser, whose compensation is based on a percentage of assets, derives a substantial advantage from promoting distribution, the benefits to shareholders are, as the Commission notes, "unclear."[7]

Furthermore, use of directed brokerage to pay for distribution is clearly designed to evade NASD limits on sales charges. The fault does not lie entirely, or perhaps even primarily, with the mutual fund companies. In a crowded marketplace, brokers who control access to a large portion of the investor population have been able to demand these and other alternative forms of distribution payments as the price of access to this population. In bowing to this reality, however,

---

[5] "Protecting Investors: A Half Century of Investment Company Regulation," Securities and Exchange Commission, Division of Investment Management, May 1992.

[6] The Proposing Release (I.A.), cites research by Miles Livingston and Edward S. O'Neal, Mutual Fund Brokerage Commissions, 19 J. FIN. RES. 273, 290 (1996) in support of this statement.

[7] Proposing Release (II).

fund companies have clearly flouted the Anti-Reciprocal Rule's exception allowing limited directed brokerage so long as the fund incurs no additional expense. As the Commission notes in the proposing release, the types of directed brokerage arrangements that are common throughout the industry today clearly require the fund to incur additional expense, by, for example, "[f]oregoing an opportunity to seek lower commission rates, to use brokerage to pay custodial, transfer agency and other fund expenses, or to obtain any available cash rebates."

With the benefit of hindsight, the exception provided to the Anti-Reciprocal Rule seems to place a naive faith in the goodwill of the industry. Of course, the mutual fund marketplace of 1981 was not nearly as crowded as today's marketplace. In reviewing this exception, however, it is essential to do so in light of current realities. The intense competition for shelf space that prevails today dramatically increases the pressure on funds to find ways to provide added payments for distribution. Using portfolio transaction costs offers perfect cover for these payments, since these costs are not disclosed to investors, are not incorporated in the expense ratio, and thus are not transparent to mutual fund investors. Furthermore, the concept of best execution is subjective, making it difficult to police violations. And funds that trade actively don't need an explicit agreement with the brokerage firm to trade brokerage for distribution. Deals can be done "with a wink and a nod."

For all these reasons, we believe a total ban on directed brokerage is the only way to protect against abuses. The SEC needs to make clear that, even where there is no identifiable additional expense to the fund, directing brokerage based in any way on distribution constitutes a violation of Section 12(b). On the one hand, the rule language seems ambiguous on this point, since it refers to compensating a broker by directing brokerage. This could be interpreted to imply that some sort of additional cost or payment must be involved to trigger the ban. On the other hand, the requirement with regard to policies and procedures seems quite stringent, with its clear statement that funds must establish policies and procedures "designed to prevent ... [t]he company, and any investment adviser and principle underwriter of the company, from entering into any agreement (whether oral or written) or other understanding under which the company directs, or is expected to direct, portfolio securities transactions ... to a broker ... or dealer ... in consideration for the promotion or sale of shares issued by the company or any other registered investment company."

Assuming that the Commission intended to define directed brokerage itself as the compensation for distribution that is prohibited under 12b-1(h), we strongly concur with this interpretation. Furthermore, we believe this is the interpretation that is supported by the discussion presented in the proposing release. Based on the widespread nature of abuses of the existing Anti-Reciprocal Rule, however, we anticipate that some brokers and fund companies will seek to evade this new rule as well. We therefore strongly encourage the Commission to make crystal clear in the final rule that no additional cost to the fund is necessary to trigger a violation of the rule by expressly prohibiting the consideration of distribution in the allocation of brokerage, regardless of whether any additional cost is incurred.

Just as important, the Commission must back up the new rule with strong enforcement.

Recent developments on this front make us optimistic that this will be the case. However, there is no escaping the fact that the Commission's past failure to police compliance with the conditions of the Anti-Reciprocal Rule exception, and its willingness until very recently to ignore obvious violations, clearly played a role in allowing abuses to flourish. It must not make the same mistake again.

- **Requiring funds to adopt policies and procedures to prevent directing brokerage to promote distribution is essential to the rule's effectiveness.**

We strongly support the rule's requirement that funds or their advisers adopt very specific policies and procedures designed to prevent decisions about where portfolio transactions will be directed from being influenced by distribution considerations. This requirement is essential to the rule's effectiveness. It will require fund managers to adopt a plan to prevent violations of the rule. It will allow the Commission's inspectors to identify any instances in which policies and procedures are not adequate to prevent abuses. And it should make it easier to hold funds accountable should they fail to comply with their policies and procedures. Without these provisions, the task of proving a fund was culpable in failing to prevent directed brokerage would be much more difficult.

Specific policies and procedures should also make it easier for fund compliance officers to track compliance. The Commission should make clear in its final rule that compliance officers are required to monitor decisions about where to direct portfolio transactions, with particular attention to any decisions to direct transactions to a selling broker. Furthermore, the compliance officer should be required to report the results of its monitoring to the independent board members.

- **A soft dollar ban is needed to supplement the ban on directed brokerage.**

As long as other soft dollar practices are allowed to continue, the effectiveness of the proposed ban on directed brokerage is likely to be undermined. Brokers and fund companies intent on evading the directed brokerage restrictions could simply agree to a higher price on other products and services purchased with soft dollars as a way to pay indirectly and covertly for distribution. Because of the lack of transparency in soft dollar payments, any such violations would be difficult to detect and deter, particularly as the intense scrutiny associated with the current scandals inevitably subsides. Furthermore, without a ban on soft dollars, investors are unlikely to realize the full benefits from increased competition on brokerage commission rates that might otherwise result.

We recognize that the Commission does not have the authority to ban soft dollars. We have been disappointed, however, that the Commission has not even been willing to come out in support of legislation to ban soft dollars in recent testimony before Congress. Short of an outright ban, the Commission can and should take steps to drastically curtail the use of soft dollars. This should include requiring brokers to unbundle their commissions, so that the amount and purpose of any payments above and beyond payments for execution can be clearly identified. The Commission should also require funds to adopt the same kind of policies and procedures proposed to prevent directed brokerage abuses for soft dollars. These policies and procedures should be designed to ensure that all decisions about where to direct portfolio transactions are based on shareholders' best interests. This might not eliminate entirely the possibility that soft dollar payments ostensibly for other services would subsidize distribution, but it would significantly reduce that likelihood. It would also help to eliminate other soft dollar abuses.

- **Revenue sharing payments should also be banned.**

The proposing release asks whether a ban on directed brokerage would simply increase brokers' demands for revenue sharing payments. We believe this is a legitimate concern. After all, the reality of today's crowded marketplace will still prevail, and brokers will still control mutual funds' access to a large portion of the investing public. Brokerage firms are also highly unlikely, in our view, to voluntarily abandon a lucrative source of revenues. It therefore seems inevitable that brokers, if forced to accept a ban on directed brokerage, will quickly seek other methods to restore that revenue. Revenue sharing payments are likely to be a primary source.

It is a serious mistake, in our view, to downplay the conflicts associated with revenue sharing payments, as the proposing release seems to do. At the broker-dealer level, these payments are clearly intended to induce brokers to recommend products that may not be in their clients' best interests, just as directed brokerage payments are intended to do. At the fund level, few if any protections exist to ensure that these costs are not passed along to investors. Independent directors, for example, have apparently not been allowed to review sales and promotional expenses, except as part of a 12b-1 plan. Thus, they have little ability to ensure that any revenue sharing payments are actually made out of profits. If fact, there is every reason to believe that fund managers have found and, without a ban, will continue to find ways to pass along these costs to shareholders.

- **Improved disclosure does not offer a solution.**

Requiring improved disclosure of directed brokerage and revenue sharing payments will not resolve the conflicts associated with these practices. After all, any disclosures about conflicts of interest will have to compete with multi-million-dollar advertising campaigns designed to send exactly the opposite message. Investors who buy into the ads that portray brokers as objective and professional financial advisers are unlikely to suspect that these same "financial consultants" base their recommendations on what basically amounts to payola. Many unsophisticated investors would find it incomprehensible that the Commission would permit such a system.

As a result, disclosure simply cannot provide an acceptable level of protection against the massive conflicts of interest associated with these practice. For one thing, evidence strongly suggests that many investors ignore the disclosures currently provided in fund prospectuses. The

Commission, to its great credit, has proposed requiring point-of-sale disclosure of distribution-related costs and conflicts. But the proposal has some serious short-comings. First, the proposed timing comes too late in the process (as the transaction is being completed, instead of at the point of recommendation) to ensure that the information provided will actually be used to inform the purchase decision. Second, the conflicts to be disclosed are so complex that conveying the information clearly and effectively will be quite difficult. The brokerage industry is already up in arms over the costs likely to be associated with these complex disclosures, and has proposed an alternative that creates the appearance of disclosure without actually ensuring that the key information ever finds its way into the hands of investors.

Clearly, if the conflicts are too complex to be disclosed in a way that allows investors a reasonable opportunity to protect themselves, the practices that create the conflicts should be banned. That is the case, in our view, with both directed brokerage payments and revenue sharing payments.

- **The Commission should examine broker-dealer practices.**

The rule proposal focuses on the responsibility of mutual funds not to engage in directed brokerage. This represents just one aspect of the problem. The Commission must not ignore the questionable practices of broker-dealers, many of whom apparently base their recommendations of mutual funds on which offer the most generous remuneration to the selling firm rather than on which would be in their clients' best interests. This stands in sharp contrast to the image brokers promote of themselves as objective, professional financial advisers.

If, against our recommendation, the Commission stops short of banning revenue sharing payments and otherwise reforming mutual fund sales practices, it should at least crack down on broker advertising and other practices designed to mislead investors into thinking that the services brokers provide are primarily advisory in nature. While we believe investors would be best served by a Commission policy that raised the standard for broker conduct to match the image they promote, at the very least the Commission should not continue to tolerate practices that blur the lines between salespeople and advisers by firms that are not willing to adopt the standards that an advisory relationship demands – including a fiduciary duty to place the client's interests ahead of their own and to disclose any and all conflicts of interest.

- **The alternative approach to 12b-1 fees outlined in the proposing release offers substantial improvements over the existing system.**

The Commission has requested comment on an alternative approach to 12b-1 fees that would require distribution-related costs to be deducted directly from shareholder accounts rather than from fund assets. We agree that such an approach offers significant improvements over the current system. Our complaint is not with a system that allows what amounts to an "installment" load for the purchase of mutual funds. Our complaint is with a system that allows shareholder assets to be used in a manner that was never intended under the existing rule and that does so in a way that obscures the payment of broker compensation.

The use of 12b-1 fees to compensate brokers has grown up in the wake of the advent of no load funds. The availability of funds without sales charges made load funds less attractive. Using 12b-1 fees to compensate brokers allowed load funds to look like no load funds – to, in essence, hide the distribution costs from investors. Even though the 12b-1 fees are disclosed in the fund prospectus, they do not appear to be well understood by investors.

Requiring at least the portion of the 12b-1 fee that goes to compensate the broker to be deducted from the shareholder account would make these payments more visible and would clarify the purpose of the payments. Investors would be less likely to be misled into thinking their B or C shares were "no load." We also agree with the Commission analysis that such an approach would benefit investors by ensuring the existing shareholders are not forced to pay the cost of selling the fund to new investors and by ensuring that investors who hold the fund over a long period are not forced to pay more than their share of distribution costs.

It is not clear, however, that sales practice abuses associated with the existence of separate fund classes would be eliminated. If a broker benefited more from one form of commission payment than from another (receiving all of the money up front, for example), it would still have an incentive to encourage its sales force to promote that form of payment, regardless of whether it was in the client's best interest. Thus, sales practice abuses might change, but would not necessarily disappear. If the Commission adopts this approach, it would need to remain on the alert for such abuses.

- **The Commission should fundamentally reform the way in which broker compensation for mutual fund sales is set.**

The proposals on directed brokerage and 12b-1 fees are important steps in the right direction. Ultimately, however, they stop well short of the bold reform we believe is needed to transform the mutual fund marketplace into one in which pro-investor competition flourishes.

It seems counterintuitive to suggest that investors do not benefit from competition in the mutual fund marketplace. After all, there are thousands of funds offered by hundreds of fund companies. The reality, however, is that while competition flourishes, that competition does not necessarily serve to benefit investors. In fact, in the broker-sold portion of the market, funds compete to be sold, not bought. When funds compete to be bought, they compete by offering a good product and good service at a reasonable price. When funds compete to be sold, they do so by offering generous financial incentives to the sales force. Far from benefitting investors, this reverse competition tends to drive costs up, not down, and it allows mediocre high-cost funds to survive, and even thrive.

The primary reason investors are being denied the benefits of competition is the legal requirement that funds set the compensation that brokers are paid for the services that those brokers provide to the investor. While there may have been reasons to adopt such an approach at one time, there is simply no justification for continuing to do so, as the Commission staff itself concluded in its 1992 review of the Investment Company Act:

> "Today, there no longer seems to be any basis for restricting retail price competition in mutual fund distribution. Developments in the last fifty years, most notably the introduction of mandatory forward pricing, have eliminated the original rationales for retail price maintenance."[8]

If that was true twelve years ago, it is all the more true in the thriving mutual fund marketplace of today.

Eliminating the price-fixing provisions has the potential to turn the current conflict-laden system of mutual fund sales on its head. Instead of competing to be sold by offering ever more generous financial incentives to the selling broker, mutual funds would have to compete by offering high quality funds, supported by good service, and with reasonable operating costs. With the cost of brokers' services unfixed, we could expect the advent of the same kind of competition for mutual fund sales charges that has had such a dramatic effect on commissions on stock transactions. Best of all – if this approach were accompanied by a ban on directed brokerage, revenue sharing payments, and any other such financial incentives paid by funds to brokers to promote distribution – brokers would no longer have any incentive to recommend a fund that wasn't in their client's best interests. The benefits to investors would be enormous. For these reasons, we strongly urge the Commission to support repeal of the retail price maintenance provisions of Section 22(d) of the Investment Company Act.

- **Conclusion**

Mutual funds form the foundation of average Americans' investments for retirement, college, and other long-term goals. Recent investigations by the Commission, NASD, and the states have exposed pervasive abuses in the way mutual funds are sold. These sales practices stand in sharp contrast to the image brokers promote of themselves as unbiased, professional

---

[8] "Protecting Investors: A Half Century of Investment Company Regulation, SEC Division of Investment Management, May 1992, p. 299.

advisers. If the Commission wants to bring reality into line with this image, it must take bold steps to promote sweeping reforms in the way mutual funds are sold. As positive a step as it is, the proposed rule to ban directed brokerage is still essentially tinkering with a system that has a fundamental design flaw. We urge the Commission to seize the opportunity that has presented itself and redesign the system so that it better serves investors' interests and rewards those mutual funds and brokers that differentiate themselves in the marketplace based on quality and price.

Respectfully submitted,

Barbara Roper
Director of Investor Protection
Consumer Federation of America

Mercer Bullard
Founder and President
Fund Democracy, Inc.

Sally Greenberg
Senior Counsel
Consumers Union

Kenneth McEldowney
Executive Director
Consumer Action

cc: Chairman William Donaldson
Commissioner Paul Atkins
Commissioner Roel Campos
Commissioner Cynthia Glassman
Commissioner Harvey Goldschmid
Paul Roye, Director, Division of Investment Management