Securities Industry Association

120 Broadway - 35 Fl. • New York, NY 10271-0080 • (212) 608-1500, Fax (212) 968-0703 • www.sia.com, info@sia.com

Via Electronic Mail – rule-comments@sec.gov May 10, 2004

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0506

Re: Proposal to Prohibit the Use of Brokerage Commissions to Finance Distribution (file No. S7-09-04)

Dear Mr. Katz:

The Securities Industry Association ("SIA")[1] appreciates the opportunity to comment on the above referenced proposal[2] to amend rule 12b-1 under the Investment Company Act of 1940 to prohibit funds from compensating a broker-dealer for promoting or selling fund shares by directing brokerage transactions ("directed brokerage") to that broker. The proposing release also requests comment on whether the Commission should propose additional amendments to rule 12b-1, or propose to rescind the rule.

In sum, SIA supports the SEC's proposal to bar funds from using directed brokerage to compensate brokers' selling efforts. While that proposal is a positive development, we do have some concerns that the Commission's proposal could be misunderstood to interfere with best execution obligations, and below we propose a clarification on that point. On the SEC's request for comments on additional amendments to Rule 12b-1, or possible rescission of the rule, we believe that Rule 12b-1 has on the whole been a very successful rule which has helped to dramatically reduce mutual fund sales loads, while helping to make it possible for broker-dealers to provide mutual fund "super markets" and many other services available to millions of small investors. We recommend that, rather than focus on reengineering one aspect of the complex

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[1] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs 780,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated an estimated $209 billion in domestic revenue and $278 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

[2] SEC Release No. IC-26356 (February 24, 2004)

relationship between funds and broker-dealers, the Commission should convene a public roundtable to explore the entire mutual fund compensation structure, the services that it funds, possible steps to effectively improve transparency of compensation, and whether payments to broker-dealers are used in a manner consistent with their intended purpose.

Directed Brokerage

While SIA supports the current proposal, we have significant concerns that it may lead to consequences beyond its intended purpose. During the presentation of the rule proposal to the Commission at its February 11, 2004 open meeting, Division of Investment Management Director Paul Roye, in substance, stated that the intent of the rule is to prohibit the direction of brokerage to broker-dealers based on the level of fund shares distributed by the broker-dealer, but it is clearly not intended to prevent the direction of fund portfolio transactions to broker-dealers who can provide best execution, simply because they are a distributor of fund shares.

SIA very much appreciated Mr. Roye's comments at the open meeting, but we are concerned that such comments are not explicitly reflected in the content of the rule proposal or the proposing release. Therefore, we believe that it is absolutely critical that this shortcoming in the proposal be clearly addressed in any final rule (and/or adopting release) which may be issued by the Commission.

We have been told that some fund complexes have already stopped sending orders to broker-dealers that are significant distributors of their shares, even though no directed brokerage arrangement exists between the firm and the broker-dealer. We believe that heightened fund board sensitivity to conflicts of interest, while praiseworthy in many important respects, may cause boards to proscribe fund activities which create a "perception" of potential conflict, even where the reality is quite different, and the underlying activity is in the best interests of shareholders. This would clearly be the result if a fund stopped directing portfolio transactions to a broker-dealer who provided best execution, simply because that broker-dealer happened to also be a distributor of fund shares. We are worried that the practice of funds withholding orders to broker-dealers that happen to sell the fund's shares might become widespread unless the Commission provides more explicit guidance that this rule proposal is not intended in any way to compromise best execution. Investors would be doubly disadvantaged if a fund felt torn between a conflict between its best execution obligation and its (incorrect) understanding that it must abjure from sending orders to a broker-dealer that happens to market the fund. Not only would investors lose some of the benefit of best execution, but their choices would be reduced if broker-dealer distributors of mutual funds felt compelled to limit the funds they distribute to preserve their trade execution business.

The proposing release seeks comment on the impact that eliminating the use of portfolio transaction commissions to pay for distribution might have on commission rates and the other revenue streams that broker-dealers receive in conjunction with the distribution and other services that broker-dealers provide to fund shareholders. We believe that to the extent the unintended consequences discussed above result in fund portfolio transactions flowing to fewer broker-dealers it could lead to less competition and higher, rather than lower commissions. With regard to revenue streams, the rule might not have a significant impact on an aggregate basis, since the overall level of fund portfolio transaction business is governed by factors other than who distributes fund shares. However, smaller broker-dealers who may derive a significant portion of their fund revenue streams through step outs may have to seek ways to increase their other fund revenue streams to remain competitive.

We appreciate that the Commission recognizes that there is an inter-relationship, or synergistic effect, between the various revenue sources that broker-dealers may receive in conjunction with mutual fund transactions. We believe, that as discussed below, such synergetic effect is an important factor to consider in any discussion regarding possible further amendments to rule 12b-1 or other rules impacting broker-dealer revenue streams.

Further Amendments to Rule 12b-1 and Related Matters

Over the past year there has been much discussion regarding the various revenue streams broker-dealers receive in conjunction with mutual fund transactions, (including but not limited to rule 12b-1 payments), the potential conflicts of interest they pose, and the need for better disclosure[3] and possible restrictions with respect to such revenue streams. There has been far less discussion regarding the important and essential investment and other shareholder services which are supported through these revenue streams, and we believe that any regulatory initiatives in this area must take into account the need for it to remain economically viable for broker-dealers to continue to provide important services to fund shareholders.

SIA recently has endeavored to close the information gap through a variety of means including written submissions to the Commission[4], and testimony before Congress.[5] Additionally, we are attaching hereto a White Paper entitled "Mutual Fund Distribution and Shareholder Servicing Practices" which provides an historical perspective on how and why the current broker-dealer compensation structure evolved, and a detailed description of the distribution, administrative, recordkeeping, and other shareholder services it supports. The White Paper describes the evolution of new revenue sources over a quarter-century, to match a simultaneous burgeoning of fund shareholder servicing by broker-dealers. This evolution gives rise to a need for better transparency with regard to all revenue streams between funds and broker-dealers. We trust the Commission will find the White Paper useful in its further consideration of what modifications if any, might be appropriate regarding rule 12b-1 or any other regulations affecting broker-dealer revenue streams.

Many broker-dealers enter into a variety of types of agreements relating to 12b-1 plans, revenue sharing and other targeted services, and they tend to view these arrangements on an aggregate basis in terms of their ability to adequately fund the costs associated with all of the services they provide to fund shareholders, or costs they incur in conjunction with distribution activities. We would respectfully suggest that in reviewing the current regulatory structure impacting revenue streams, the Commission take a similar "macro" approach, rather than considering 12b-1 payments or other revenue streams separately. We believe such an approach is important, because to the extent further regulations restrict or eliminates any revenue stream, it will have to be replaced from other available sources if broker-dealers are to continue to provide the same level of shareholder servicing.

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[4] See SIA Comment Letter to Jonathan G. Katz, SEC Secretary from George R. Kramer, SIA Acting General Counsel, "Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, File No.S7-06-04 (April 12, 2004).

[5] See testimony of SIA President Marc E. Lackritz before the Senate Committee on Banking, Housing and Urban Affairs on November 18, 2003 and before the Senate Subcommittee on Financial Management, The Budget and International Security on January 27, 2004. Also see testimony of Chet Helck, President of Raymond James Financial on behalf of Raymond James and SIA before the Senate Banking Committee on March 31, 2004.

Consistent with this view, we recommend that the Commission convene a roundtable, similar to what was successfully done in the hedge fund context or some other forum, in which all interested parties can participate, to explore the overall mutual fund compensation structure, the services that are funded through this structure and the adequacy of the present disclosure regime. Specific topics might include, but not be limited to:

- Description of the various revenue sources and the regulations applicable to them.
- Description of shareholder services funded through these revenues and the role which funds, broker-dealers, intermediaries and others, play in providing these services.
- The adequacy of the current disclosure regime with respect to compensation structures, particularly from a conflict of interest standpoint, and what should be done to enhance transparency in the most effective way.
- The extent to which payments received by broker-dealers are used in a manner consistent with their intended purpose (e.g.-12b-1 payments). What measures should be taken to achieve consistency? Do rules need to be modernized to reflect current realities? Are new rules needed? Should any rules be rescinded, and what would be the consequences?

SIA would be most interested in contributing to such a roundtable or similar program.

Specific Request For Comment Regarding Refashioning of Rule 12b-1

As noted above, we would envision that the appropriateness of the current regulatory structure, including rule 12b-1, be one of the principal topics that should be considered in a roundtable or similar program. However, the Commission has specifically requested comment in the proposing release on the feasibility of an approach whereby 12b-1 payments would be deducted directly from shareholder accounts rather than from fund assets. This approach appears to be based on the premise that 12b-1 payments have largely become a substitute for a sales load. While there is some truth to that premise in a no-load context, or with respect to B shares which typically carry higher 12b-1 fees in lieu of a front-end load, as a general matter most 12b-1 fees are a reflection of the on-going servicing and investment guidance which inures to the benefit of the vast majority of fund shareholders. The premise that 12b-1 fees are solely transaction-based and represent installment payments of a sales load is simply not accurate.

The attached White Paper clearly supports the premise that 12b-1 payments and other fees enable broker-dealers to provide a panoply of shareholder services that is provided on an ongoing basis. The fact that a substantial portion of mutual fund shares are held through 401(k) plans, other retirement plans, asset allocation programs or 529 college tuition plans, also adds another significant servicing component to mutual fund holdings. Eliminating 12b-1 fees would discourage broker-dealers from marketing retirement plans to small and medium-sized businesses, affecting overall pension coverage. In addition, those plans would be less likely to be offered support services that make it possible to maintain plan coverage for their employees. Therefore, while some modifications to rule 12b-1 may be appropriate, we do not believe such modifications should entail applying the fee on an individual shareholder basis.

We appreciate all of the steps the Commission has undertaken to address the problems that have surfaced with respect to mutual funds over the last year and half, and we look forward to working further with the Commission to bring about any further modifications to the regulatory structure that may be necessary to assure that the public's trust and confidence in this most important investment vehicle is justified. Any questions regarding this letter or attachment should be directed to the undersigned.

Sincerely,

Michael D. Udoff
Vice President
Associate General Counsel and Secretary

cc: The Honorable William H. Donaldson, Chairman
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Paul S. Atkins, Commissioner
The Honorable Harvey J. Goldschmid, Commissioner
The Honorable Roel Campos, Commissioner
Director Paul F. Roye, Division of Investment Management
Deputy Director Cynthia M. Fornelli, Division of Investment Management
Associate Director Robert E. Plaze, Division of Investment Management
Hester Peirce, Senior Counsel
Penelope W. Saltzman, Senior Counsel

Responding to Mutual Fund Investors' Changing Needs

MUTUAL FUND DISTRIBUTION and SHAREHOLDER SERVICING PRACTICES

WHITE PAPER

SECURITIES INDUSTRY ASSOCIATION[6]

May 10, 2004

Introduction

Compensation arrangements between fund complexes and broker-dealers support a wide range of services that benefit fund investors and facilitate the enormous diversity in fund products.

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[6] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs 780,000 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift and pension plans. In 2003, the industry generated $209 billion in domestic revenue and $278 billion in global revenues. (More information about SIA is available on its home page: www.sia.com).

Dechert LLP assisted SIA with the preparation of this *White Paper*.

Funds,[7] and the broker-dealers that sell them, offer investors an unprecedented range of investment choices. In the 1960s, investors had a relatively small number of funds from which to choose and (with the limited exception of no-load funds) could buy them only by paying an up-front load of approximately 8%. Today, investors may pick from literally thousands of funds and may pay for those investments in a variety of ways.

As the number and types of funds, the number of channels through which funds may be purchased, and the demands of clients for more sophisticated advice have increased, broker-dealers, third party retirement plan administrators and fund complexes have developed additional fee arrangements to support those broad investment choices, and the distribution, servicing and administrative costs they entail. Unfortunately, as those fee arrangements have become more diverse, it may become more difficult for investors to keep track of how these relationships work. This *White Paper* seeks to explain those relationships in simple terms. Policy makers will then have a clearer picture from which to make decisions.

SIA notes that the developments in the relationships between funds and broker-dealers have outpaced the development of disclosure obligations regarding these relationships. Investors need more information about these marketing and servicing arrangements. Investors should have a good understanding of the fees that they are paying in connection with their investment in mutual funds. At the same time, it is not helpful to bury investors in minutiae about the relationships between funds and broker-dealers.

II. Historical Overview

Fund sales have always involved shared responsibilities between the fund complex and the broker-dealer. During the past forty years, the fund landscape has changed dramatically. In 1966, the Commission observed in a report to Congress (the "PPI Report") that:

> Some mutual funds – the so-called "no-load funds" -- sell their shares at net asset value without the imposition of a sales load. No-load funds, however, account for only a small share of total mutual fund assets and shareholder accounts. The overwhelming majority of mutual fund shareholders invest in "load" funds.
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> The purchase price of a load fund share consists of two elements — its net asset value and a sales load. The sales load is by far the most significant charge paid by mutual fund investors. Rarely is the basic load less than

[7] We use the term "funds" to refer to mutual funds, unit investment trusts, municipal fund securities, variable annuity contracts and variable life insurance policies.

> 7.5 percent of the total price that the investor pays and it has not exceeded 9 percent. An 8.5 percent sales load is most common.[8]

The PPI Report stated that mutual funds also supported sales efforts through the use of fund brokerage.[9]

Even in the 1960s, mutual fund sales were not as simple as sales of other investments. Two authors noted in a 1964 Article that:

> [T]he execution of fund share orders was not as easy to handle as executions involving other securities because of the variety of plans, withdrawal privileges, letters of intent, and other options being offered by the funds. A significant percentage of orders were said to require a telephone call to the fund's principal underwriter to clarify or verify the terms of the purchase. . . . [and] the bookkeeping operations needed to serve a fund-owning client were generally more time consuming than required for servicing a "regular" customer account.[10]

The 1964 Article also noted that it takes broker-dealers and funds more time to sell a mutual fund share than it does to sell a share of common stock.

Compare the situation of the mid-1960s to the choices available to fund investors today. The fund and securities industries developed a host of innovations and new choices that they made available to mutual fund investors. Working within the statutory framework, the SEC and NASD fostered an environment open to innovation. The private sector welcomed that opportunity and developed new products and choices to meet a broader range of investors' needs. Some examples include:

- **Expansion of "No Load" Funds** -- No load funds do not impose an initial sales charge on investors (although they do have other types of fees and expenses). By the mid-1970s, no-load mutual funds had become very popular with investors,[11] and such popularity further increased with the development of fund supermarkets in the 1990's

- **Development of Rule 12b-1** -- In 1980, the SEC adopted Rule 12b-1, which permits mutual funds to use their assets to pay for distribution, as long as the

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[8] Report of the SEC on the Public Policy Implications of Investment Company Growth[8] ("PPI Report") H.R. REP. No. 2337, 89th Cong., 2d Sess. (issued December 2, 1966), at 204.

[9] During 1965, larger mutual funds and fund complexes allocated about 53% of their combined brokerage commissions to compensate dealers who sold their shares, 13% to pay for supplementary advisory, pricing, wire and other services, and the remainder was allocated on the basis of a broker's ability to execute transactions. *Id.*, at 166.

[10] Lehr, Dennis J. and Meyer Eisenberg, MUTUAL FUND RETAILING: ASPECTS OF MARKET STRUCTURE AND DEALER OPERATIONS, at ch. 2 (June 1964) ("1964 Article").

[11] SEC DIVISION OF INVESTMENT MANAGEMENT, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION, at 321 (1992) ("Protecting Investors Study"), *citing* SEC DIVISION OF INVESTMENT MANAGEMENT REGULATION, MUTUAL FUND DISTRIBUTION AND SECTION 22(D) OF THE INVESTMENT COMPANY ACT OF 1940, at 19, 20-22 (1974) ("1974 Distribution Report").

fees are disclosed to shareholders and scrutinized by the mutual funds' boards of directors.[12] Since Rule 12b-1 was adopted, more than half of all mutual funds have adopted Rule 12b-1 plans, using these charges, alone or with sales loads, as the primary means of financing distribution.[13] Other mutual funds have added a relatively modest Rule 12b-1 fee to pay for some sales commissions, printing prospectuses and sales literature, advertising, and similar expenses.[14] Although the SEC adopted Rule 12b-1 to assist no-load mutual funds to finance their distribution expenses, the vast majority of *load* mutual funds have adopted Rule 12b-1 plans as a complement to, or a substitute for, a front-end sales load. Such plans have also made it economically viable for fund supermarkets to more broadly offer no-load funds. Mutual fund front end sales loads have declined substantially since the adoption of Rule 12b-1.[15]

- **Development of Multiple Class Structures** -- Funds began to adopt multiple class structures in 1985. Fund complexes tailor different classes to differing needs of investors. Some multiple class funds enter into arrangements whereby particular classes of fund shares are sold to specific institutional investors, such as banks acting in a fiduciary, advisory, agency, custodial, or similar capacity on behalf of customer accounts, insurance companies, investment counselors, brokers, or other financial institutions.[16] These funds use a combination of 12b-1 fees and contingent deferred sales charges ("CDSCs"), to finance distribution of certain share classes, in lieu of front-end loads.

    - Each class of a multiple class fund must have a different arrangement for shareholder services or distribution or both, and must pay all of the expenses of that arrangement.

    - Multiple class funds may also permit investors to select the method of financing distribution best suited to their investment horizon and the size of their investment.[17] Some investors may wish to pay a front-end sales load, whereas others may wish to avoid paying a front-end sales load to enable 100% of the proceeds to be invested, and are willing to pay a Rule 12b-1 fee and potential CDSL instead.[18]

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12 *Id.*, at 322.

13 *Id.*, at 320.

14 *Id.*

15 *See* FUNDAMENTALS: INVESTMENT COMPANY INSTITUTE RESEARCH IN BRIEF, vol. 11, no. 4 (Sept. 2002), *available at* http://www.ici.org/pdf/fm-v11n4.pdf.

16 *See id.*, at 330.

17 *Id.*, at 331.

18 However, the NASD has taken enforcement actions against broker-dealers who have sold B shares to individuals in instances in which A shares would have been an economically superior investment. *See*, *e.g.*, McLaughlin, Piven, Vogel Securities, Inc. (MPV) (press release available at

As the type and level of mutual fund charges began to change, the NASD revised its rules governing the level of mutual fund sales loads and distribution fees. NASD Conduct Rule 2830(d):

- imposes aggregate limits on the front-end, deferred and asset-based sales charges paid by a fund distributed through an NASD member; and

- limits the annual amount of "service fees" that such a fund may pay, and prohibits a fund from describing itself as "no-load" if the fund's total asset-based sales charges and/or service fees exceed 0.25% of the fund's average annual net assets.

The 1990s witnessed an historic transition of administrative and shareholder servicing responsibilities from fund complexes to broker-dealers, which introduced still more complexities and broker-dealers began to replace funds as the provider of various administrative services to customers. This increased broker-dealer servicing responsibility, coupled with substantially declining sales loads and regulatory caps on 12b-1 fees engendered the need for additional revenue sources, but also engendered some transparency shortcomings that need to be addressed. We discuss these arrangements in more detail below.

Similar changes occurred with respect to payments for research. At the time that the PPI Report was issued, broker-dealers charged fixed commission rates and provided a variety of services over and above transaction execution, including research. In 1975, Congress and the SEC abolished fixed commission rates. Congress also enacted a safe harbor under Section 28(e) of the Exchange Act to protect advisers from claims that they had breached their fiduciary duties by causing clients to pay more than the lowest available commission rates in exchange for research and execution.

Since 1975, the use of soft dollars has grown, as have the number of firms that provide research and other products and services in exchange for soft dollars. An SEC staff study found that almost all investment advisers obtain products and services (both proprietary and third-party) other than pure execution from broker-dealers and use client commissions to pay for those products and services.[19] The total value of third-party research purchased annually with soft dollars is estimated to exceed $1 billion.[20]

Finally, the types of products currently available far exceed what was available when the SEC originally examined mutual fund distribution practices. Investors may now purchase mutual funds through IRAs, 401(k)s and other retirement plans. Mutual

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http://www.nasdr.com/news/pr2003/release_03_027.html).

[19] SEC OFFICE OF COMPLIANCE, INSPECTIONS AND EXAMINATIONS, INSPECTION REPORT ON THE SOFT DOLLAR PRACTICES OF BROKER-DEALERS, INVESTMENT ADVISERS AND MUTUAL FUNDS (September 22, 1998), at Section I.

[20] *Id.*

funds also offer shares to qualified education plans. These types of plans and programs did not exist in the 1960s. Investors may also purchase variable annuity contracts and variable life insurance policies – these products were in their infancy in the 1960s.

III. Services Provided

Revenue sharing and other payments described in Section IV.support a broad variety of marketing distribution and shareholder servicing activities that broker-dealers provide. Some payments support administrative and recordkeeping services, including services that were previously viewed as "fund" responsibilities. Payments support training and education of a broker-dealer's registered representatives. Broker-dealers may also apply payments to defray the cost of educating retirement plan participants about the various investment options available to them. Still other payments are made in exchange for research provided by the broker-dealer. We discuss these practices in more detail below.

Marketing Support Services

Shelf space.

Mutual funds advisers typically pay wirehouses or clearing firms for "shelf space." Introducing firms typically make available to their customers those funds carried by their clearing firms; consequently, introducing firms typically do not receive payments for shelf space.

One concern about payments for shelf space is that a broker-dealer may tend to recommend one fund over another solely because the fund or the registered representative receives a greater incentive to sell that fund. However, broker-dealers typically perform initial due diligence before adding a fund or fund complex to its menu of options, and will perform continuing due diligence on the fund complex and its funds. Many broker-dealers also perform quantitative analytics with respect to funds in order to generate a list of recommended funds.[21]
SIA notes several trends:

- Many broker-dealers have essentially the same payment arrangements with all of the different mutual fund complexes they recommend, thereby minimizing the incentive to sell one fund on the recommended list over another.
- Broker-dealers typically equalize compensation to their registered representatives for selling equivalent funds, thus reducing the point-of-sale incentive to sell one fund over another.

[21] Some broker-dealers will screen only funds offered through complexes making revenue sharing payments. Other broker-dealers will screen funds, regardless of whether the fund complex makes revenue sharing payments and offer those funds even if they provide no revenue sharing payments. Still other broker-dealers will screen funds, and attempt to enter into revenue sharing arrangements with only those fund complexes whose funds "pass" the screens.

- While broker-dealers may have dealer-agreements with a large number of fund complexes, they tend to have fewer revenue sharing arrangements and may only feature or recommend a small number of funds with whom they have such arrangements. This is attributable to the fact that even large broker-dealers and their registered representatives cannot effectively master the features of thousands of different funds, and revenue sharing arrangements assist them in performing due diligence and training with respect to a manageable number of the funds.

Regardless of shelf space incentives, broker-dealers and their registered representatives have suitability obligations to their customers.[22] Broker-dealers and their registered representatives have powerful economic incentives to select funds that best meet their customers' needs. In an environment that offers thousands of funds on a multitude of platforms, customers have lots of alternatives.

SIA supports efforts to provide investors with additional disclosure about shelf space and other revenue sharing arrangements. But SIA does not believe that ending such arrangements would be in investors' best interests.

Training and Education

Payments for training and education may encompass enabling a fund's distributor to participate in, and present at, training conferences, defraying the cost of training and education intended to ensure that registered representatives are knowledgeable about funds being offered and can make suitable recommendations; and providing support and marketing concerning funds to registered representatives through internal sources (such as Internet web sites and mailings).

Such programs enhance the ability of registered representatives to help investors select funds that meet their needs. SIA believes it is entirely reasonable for the fund complex offering such products to defray some of the expenses associated with educating registered representatives about those products. NASD Conduct Rule 2830(l)(5)(C) specifically authorizes broker-dealers to accept such payments.[23] SIA believes such programs benefit investors and should continue.

Administrative Services

As noted above, broker-dealers provide various administrative, recordkeeping and transfer agency services on behalf of funds. These services include:

- sub-accounting;
- shareholder account set up and maintenance;
- shareholder assistance;

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22 *See e.g.* NASD Conduct Rule 2310.

23 *See also* NASD Conduct Rule 2820(g)(4)(C), which also authorizes payments for training of associated persons with respect to the sale and distribution of variable contracts.

- transaction processing and settlement;
- preparation and distribution of account statements and transaction confirmations;
- payment of fund distributions;
- distribution of prospectuses; and
- clearing and custodial services.[24]

These services have proven to be particularly important in connection with qualified retirement plans and qualified tuition programs. Broker-dealers have invested heavily in infrastructure to support sales of mutual fund shares.

Networking provides a concrete example of how revenue streams from fund complexes to broker-dealers may be beneficial to investors. Although there are a variety of such arrangements, let us examine a basic form of networking. Fund complexes (including their transfer agents) need to keep accurate records of which investors own their funds. The fund complex may choose to delegate this task to the broker-dealers that sell their funds (*i.e.,* with whom they have dealer agreements). Instead of incurring the recordkeeping expenses itself, the fund complex pays the broker-dealers to keep the shareholder records for its customers. Broker-dealers keep detailed records of purchases and sales in those mutual funds.

Networking offers advantages that go beyond a simple delegation of responsibility from one entity to another. Networking permits broker-dealers to provide investors with a single account statement detailing all of their mutual funds and other securities holdings, even if the investors have purchased shares of several different funds. In addition, investors will receive tax-related information from a single source. Consolidation of this information improves the quality of service to investors and may help them manage their accounts more effectively. For example, by consolidating all of this information, investors and their financial advisers can allocate assets and diversify their portfolios with greater ease than if they had to keep track of multiple statements from different fund complexes. In short, the flow of revenue from the fund complex to the broker-dealer to pay for networking offers clear advantages to investors.[25]

Another example of such services is when a broker-dealer provides telephone support to shareholders and hires staff dedicated to answering questions of registered representatives regarding the funds. These arrangements afford customers with an extensive range of choices; an investor may have access to more than 10,000 different mutual funds and share classes through a single broker-dealer.

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[24] When an investor invests in a fund directly, the fund typically pays its service providers for providing these administrative services to the customers. *Investment Company Institute* (SEC No-action Letter) (pub. avail. Oct. 30, 1998).

[25] SIA does not mean to suggest that broker-dealers that do not enter into networking arrangements do not provide good service; we simply note that when fund complexes pay revenue to broker-dealers, they are paying for a service that the fund complex would otherwise have to provide and that investors may benefit as a consequence of the arrangement. It belies the notion that all payments from fund complexes to broker-dealers are somehow nefarious.

IV. Sources of Revenue

Broker-dealers receive payments in connection with sales of funds and the servicing of fund shareholders from a variety of sources including individual fund shareholders, fund assets and third parties including investment advisers, fund distributors or other affiliates.

These payments may take a variety of forms, including among other things:

- Payments from fund distributors, either from front-end sales charges or from the distributors assets (subsequently repaid through a deferred sales load).
- 12b-1 distribution and servicing payments from fund assets
- Sub-transfer agent and other servicing fees and operating expense reimbursements from fund assets or fund affiliates
- Revenue sharing payments from management fees received from fund advisers or from fund affiliates.

In addition, broker-dealers may receive compensation from mutual fund complexes through directed brokerage[26] or soft dollar[27] arrangements in the form of commissions for effecting fund portfolio transactions.

Fund affiliates typically make hard dollar payments to broker-dealers. Some payments involve continuous revenue streams, which may be paid as a percentage of sales, as a percentage of net assets attributable to the broker-dealer's accounts, or as a combination of both. Fund affiliates may also make episodic payments – these payments usually support particular activities, rather than continuing activities. Both the form and amount of payments and the types of services provided in exchange for payments may depend upon whether the recipient is an introducing broker, a clearing broker, or a

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[26] It should be noted that directed brokerage has decreased in popularity recently, and many broker-dealers no longer accept directed brokerage. Commission recapture and step-outs are even less common. The SEC has proposed to ban directed brokerage arrangements for sales. Release No. IC-26356 states that the SEC is:

> proposing amendments to rule 12b-1 under the [Investment Company] Act [of 1940] to prohibit funds from compensating a broker-dealer for promoting or selling fund shares by directing brokerage transactions to that broker. The rule would also prohibit step-out and similar arrangements designed to compensate selling brokers for selling fund shares.

http://www.sec.gov/rules/proposed/ic-26356.htm. The deadline for comments is May 10, 2004.

[27] As noted above, Section 28(e) of the Exchange Act specifically allows for such payments.

wirehouse. The amount of payments made and the particular activities undertaken may depend upon whether fund shares are sold to retail investors, IRAs, 401(k) plans, other qualified retirement plans, qualified tuition programs or to insurance company separate accounts supporting variable insurance contracts.

Broker dealers utilize the various revenue streams to support distribution activities, as well as a broad array of shareholder services are described above.

V **Observations**

When one examines current fund distribution, shareholder servicing and research practices, it is important to note that:

- The number of funds offered to investors over the past 20 years has increased dramatically. Consequently, broker-dealers need to familiarize themselves with an exponentially greater number of funds than those that were previously available (as well as the various share classes and breakpoint levels), and thus the costs of offering so many funds (and fund classes) is higher;

- Not only has the number of funds increased, but the types of different funds and the different plans and programs through which investors may purchase funds has also increased. This change requires a greater level of training and education of broker-dealers, and generates longer term broker-dealer servicing and investment guidance.

- Many of the costs and expenses assumed by broker-dealers are ones previously assumed by funds and paid out of fund assets. The market has determined that it is more cost efficient for broker-dealers to perform these services than it is for the funds themselves to undertake the expense of assuring that these services are performed. (*e.g.*, sub-transfer agency; recordkeeping);

- Regulatory and compliance costs have increased;

- Broker-dealers, in large part, do not distinguish between fees paid by funds out of fund assets and fees paid by affiliates in terms of the services provided (however, shareholder servicing payments are typically made from 12b-1 streams and sub-transfer agency payments, as opposed to revenue sharing payments or sales loads). They tend to view payments as an aggregate sum needed to provide the level of service they deem appropriate to serve their customers;

- The developments in mutual fund distribution and shareholder servicing practices have led to tangible benefits for investors, such as:

    - lower distribution costs;
    - availability of a broader array of mutual funds;
    - consolidated statements and other records for investors; and

- consolidated tax information.

SIA believes that in light of current fund distribution and shareholder servicing practices, providing information to investors about broker-dealer compensation, without also providing information to investors about services provided, may be misleading because, among other things:

- while a broker-dealer may receive payments from some fund complexes but not from others, a registered representative's compensation typically does not depend upon whether or not the broker-dealer receives revenue sharing payments, nor is the registered representative generally aware of the nature of such payments consequently, the registered representative may not have an inappropriate conflict of interest; and

- a registered representative who is educated on the specifics of a limited group of mutual funds, including fund holdings, investment strategy, performance and risk profile, is in a much better position to make suitable recommendations to clients.

SIA believes that restricting revenue sharing and other compensation arrangements between broker-dealers and fund complexes would be anti-competitive and would reduce investor choices. The current environment fosters the creation of many funds offered through many distribution channels and has resulted in increased investor choice.

VI. Conclusions and Recommendations

In light of current fund distribution, shareholder servicing and research practices, SIA's conclusions and recommendations are as follows:

A. In the interest of investor protection, it recommends that disclosure and structural reform efforts be focused on ensuring that:

- Fund shareholders can readily access easily understandable information about the various types of payments and the nature of the services being provided[28];

- Competitive forces, not government fiat, set appropriate levels of compensation, whether through fund payments, sales loads or revenue sharing;

- Broker-dealers recommend suitable fund investments;

- Investors have the broadest possible array of fund choices; and

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[28] SIA strongly endorses SEC rulemaking to require meaningful disclosures, after the appropriate notice and comment process, rather than by imposing such a requirement either in conjunction with the inspection program or as a consequence of enforcement actions.

- The prominence of fund fee disclosure is not so skewed as to deflect attention away from other critical investment factors such as a fund's risk profile, performance and investment objectives, strategies, policies and methods.

B. SIA opposes prohibitions or restrictions upon revenue sharing and Rule 12b-1 fees are likely to be counterproductive and harm fund investors. In particular, SIA believes that a prohibition on these practices may result in fewer investment options being made available to investors, which in turn, may lead to investment options that are less suitable to investors.

C. SIA supports enhanced disclosure to fund investors, but respectfully disagrees with certain aspects of the point of sale and confirmation proposal,[29] and makes the following points with respect to such proposal:

- There should be enhanced disclosure of mutual fund economics as well as all other material aspects of mutual fund investing, such as investment objectives, performance and risk.

- SIA agrees with the SEC on the basic types of information that need to be disclosed, but not on the specific proposed methodology or content of disclosure.

- SIA is concerned that in its current form, the SEC's proposal will have significant adverse unintended consequences, for both the securities industry and the investors that it serves.

- SIA suggests that in place of the proposed point-of-sale disclosure, brokerage firms should be required to maintain website disclosure concerning their relationships with mutual funds or mutual fund families available for purchase through that brokerage firm.

- SIA recommends that its disclosure alternative, together with the SEC's proposed approach (and perhaps alternative approaches that other commenters might suggest) be tested with investor focus groups to determine which approach is the most useful and cost-effective. SIA stands ready to participate with the SEC and others in designing

[29] SIA filed an extensive comment letter on the SEC's proposed Rules 15c-2 (confirmation) and 15c2-3 (point of sale). Letter from George R. Kramer, Vice President and Acting General Counsel, to Jonathan G. Katz, Secretary, SEC, re: Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, File No. S7-06-04, available at http://www.sia.com/2004_comment_letters/

and implementing such market research,[30] or to undertake such effort independently.

D. Because fund distribution practices, shareholder services practices and research practices have evolved over time, and can be expected to further evolve, SIA believes that disclosure practices should likewise evolve. Such disclosure requirements should be flexible enough to assure that investors receive clear, concise and meaningful disclosure about the various types of payments broker-dealers may receive at any time from both funds and fund affiliates.

* * * * *

The explosion of new fund products and fee arrangements have brought greater choice and lower costs to investors. But as choices have increased, so has the complexity of arrangements between broker-dealers and fund complexes. Complexity isn't bad -- it just means we need to ensure that investors have meaningful information and can make informed investment decisions. Although such complexity has made fee arrangements less transparent - and that needs to be fixed it - would be wrong to conclude that those fees are not being appropriately utilized to fund the broad array of investment and other important services which broker-dealers provide to the vast majority of America's 95 million mutual fund shareholders.

SIA welcomes the opportunity to present its views on arrangements between fund complexes and broker-dealers. We hope to work with all interested parties to assure that customers have relevant information and are able to make intelligent investment decisions from a multitude of choices.

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[30] SEC Chairman William Donaldson noted that the Commission has a task force examining the SEC's entire disclosure system. Remarks Before the Investment Counsel Association of America, April 22, 2004, http://www.sec.gov/news/speech/spch042204whd.htm. Paul Roye, Director of the SEC's Division of Investment Management noted that the task force will be examining the disclosure of fund fees, expenses and costs. It will examine the layering of information in the prospectus, statement of additional information and quarterly disclosures. The task force also will "ask what kind of information investors should have when their making an investment decision." *Ignites*, April 27, 2004. SIA supports such a systematic review and would welcome the opportunity to participate in it.

Glossary of Mutual Fund Terms (Exhibit A)

Exhibit A
Glossary

Many mutual fund terms do not have hard and fast definitions, but below are commonly understood definitions of important terms.

Types of Funds -- There are many different types of mutual funds designed to meet the needs of different investors. As disclosed in the investment policy of the fund, the fund manager may purchase only certain types of portfolio securities. For example:

- Equity or Stock Funds -- common stocks. Some examples include:
    - Growth funds -- focus on stocks that may not pay a regular dividend but have the potential for growth.
    - Index funds -- aim to achieve the same return as a particular market index, such as the S&P 500 Composite Stock Price Index, by investing in all — or perhaps a representative sample — of the companies included in an index.
    - Sector funds -- may specialize in a particular industry segment, such as technology or consumer products stocks.
- Blue Chip -- securities of well-established companies with seasoned management or large market share. A fund might be a blue chip growth fund, which focuses on companies with long-term growth prospects, but does not pay dividends.
- Small Cap -- securities of smaller, typically newer companies. A fund might be a small cap (for "capitalization") growth fund or a value fund, in which the fund will buy stocks of companies whose current stock prices do not appear adequately to reflect their underlying value as measured by assets, earnings, cash flow, or business franchises.
- Debt Funds -- bonds and other debt instruments. Quality of the bonds may vary from U.S. Treasury securities or highly rated corporate bonds, to more risky "higher yielding" bonds. Some funds invest only in tax-exempt securities.

Differential Compensation -- Broker-dealers and/or their registered representatives receive higher incentive payments for promoting certain funds (*e.g.*, in-house funds or funds with which the broker-dealer has a revenue sharing arrangement).

Directed Brokerage -- many people use this term to describe different things.

Under one definition, directed brokerage is an arrangement under which an account manager directs trades to a specific broker-dealer. In return, the broker-dealer agrees to pay certain fund expenses. Fund prospectuses disclose these arrangements, often as a fee table footnote. These arrangements do not ordinarily raise conflict of interest issues

because the fund directly benefits from the arrangement. For example, Fund A directs trades to Broker-Dealer X and that broker-dealer pays custody expenses for Fund A. A conflict of interest may arise if the fund's investment adviser has previously agreed to cap the fund's expenses at a particular level, and the arrangement allows the adviser to assume less of the fund's expenses.

Under another definition, sometimes called "brokerage for sales," a fund manager or distributor directs fund brokerage to broker-dealers that sell shares of the fund.

There are limitations on a broker-dealer's ability to seek brokerage commissions in exchange for selling shares of a mutual fund. For example, NASD Rule 2830(k) provides, in part:

> (1) No member [*i.e., broker-dealer*] shall, directly or indirectly, favor or disfavor the sale or distribution of shares of any particular investment company or group of investment companies on the basis of brokerage commissions received or expected by such member from any source, including such investment company, or any covered account.

However, there are exceptions to these and other prohibitions. NASD Rule 2830(k) further states:

> (7) Provided that the member does not violate any of the specific provisions of this paragraph (k), nothing herein shall be deemed to prohibit:
> (B) a member from selling shares of, or acting as underwriter for, an investment company which follows a policy, disclosed in its prospectus, of considering sales of shares of the investment company as a factor in the selection of broker-dealers to execute portfolio transactions, subject to the requirements of best execution;

On February 24, 2004, the SEC proposed a rule that would prohibit funds from paying for the distribution of their shares with brokerage commissions. The SEC says that the proposed changes are designed to end a practice that is fraught with conflicts of interest and may be harmful to funds and fund shareholders. Release No. IC-26356, http://www.sec.gov/rules/proposed/ic-26356.htm.

<u>Fee Arrangements for Mutual Funds</u> -- There are many different types of fee arrangements for funds.

- <u>Front-End Sales Charge (or Front-End Load)</u> - a sales charge deducted at the time of purchase from the purchase price for fund shares. It is expressed as a percentage of the total purchase or offering price of the fund's shares. The individual investor pays this charge directly.

- <u>Breakpoints</u> -- Fund front-end sales charges may contain breakpoints that provide reduced sales charges for larger purchases. Funds disclose breakpoints in their prospectuses. They also disclose conditions for waivers of sales charges and for

aggregating purchases or signing letters of intent that would result in lower sales charges.

- Contingent Deferred Sales Charge ("CDSC") -- a sales charge deducted upon redemption of fund shares. This charge is assessed against the individual investor. The CDSC generally declines over a period of five or six years, so that a redemption within one year of purchase is subject to the maximum CDSC while the CDSC is reduced for redemptions in later years and disappears for redemptions more than five or six years from the date of purchase.

- No-Load Funds -- The fund does not charge any type of sales load. But, not every type of shareholder fee is a "sales load." A no-load fund may charge fees that are not sales loads, such as purchase fees, redemption fees, exchange fees, and account fees. No-load funds also have operating expenses.

- Rule 12b-1 Fees -- The SEC adopted Investment Company Act Rule 12b-1 in 1980, which permits fund assets to be used for distribution and shareholder services. NASD Rule 2830 establishes a general limit of 0.75% for distribution, 0.25% for service fees. The fund distributor pays fees from fund assets to broker-dealers and others who sell fund shares and/or provide ongoing services to fund shareholders.

- Class A Shares -- are typically subject to a front-end sales charge. The front-end sales charge often has "breakpoints" for larger size investments. Funds often establish waiver categories, disclosed in their prospectuses, so that particular categories of investors are permitted to purchase shares with a reduced or waived front-end sales charge. Class A shares also may have a Rule 12b-1 fee that generally does not exceed 0.25% of average annual net Class A assets.

- Class B Shares -- typically have no front-end sales charge, a relatively high Rule 12b-1 fee of up to 1.00%, and a contingent deferred sales charge. Because the fund underwriter pays brokers a commission up-front for sales of Class B shares, the Rule 12b-1 fee is designed to pay the underwriter back for these advances. Class B shares typically convert to Class A shares within a year or two after the CDSC disappears.

- Class C Shares -- Class C shares generally have no, or very low, front-end sales charges or CDSC. They may have a Rule 12b-1 fee of up to 1.00%. Class C shares typically do not convert to Class A shares.

4:00 P.M. Pricing -- Investment Company Act Rule 22c-1 requires that fund share orders must be received by the time specified in the fund's prospectus to receive that day's net asset value (NAV) per share price. In other words, if you buy mutual fund shares on Monday, the order must reach the fund by 4:00 p.m. to get Monday's NAV. If you send in your order at 5:00 p.m. on Monday, you should get Tuesday's NAV. Past SEC staff interpretations have permitted orders to be received by intermediaries, such as a broker-

dealer, by 4:00 p.m. for same day NAV. The fund prospectus typically discloses the 4:00 p.m. deadline and who must receive the order by that time. "Late trading" refers to the illegal practice of helping an investor get today's price after 4:00 p.m. For example an investor enters an order to buy a fund's shares on Monday at 5:00 p.m. and gets Monday's NAV.

Revenue Sharing -- A fund adviser or distributor pays additional compensation to a broker-dealer or other financial intermediary. The payments may be for several different purposes. One purpose is to encourage the broker-dealer to provide "shelf space." Shelf space arrangements range from simply making the fund available to investors or more prominently featuring the fund. Payments may also be for administrative or recordkeeping functions, such as keeping track of the fund's shareholder records at the broker-dealer. Disclosure is generally required in the fund prospectus and Statement of Additional Information ("SAI").

"Soft dollars" or "paying up" for research -- Section 28(e) of the Securities Exchange Act of 1934 makes it lawful for an investment manager (who has discretion to trade an account) to pay higher than the minimum commission when the manager also receives brokerage and research services from that broker-dealer. Congress enacted this provision at the time that it unfixed brokerage commissions. Congress wanted to ensure that, in appropriate circumstances, investment managers would be able to pay more than the absolute lowest available commission without breaching their fiduciary duty.

Under Section 28(e), the commissions must be reasonable in light of services received by the investment manager. The broker-dealer that provides brokerage may provide the research services or the broker-dealer may arrange that a third-party provide the research to the investment manager. If the product/service is also used for non-research purpose ("mixed use"), the investment manager must develop and document a reasonable cost allocation. Mutual funds must disclose soft dollar arrangements in a general way in their Statements of Additional Information ("SAI"). Investment advisers must disclose soft dollar practices in their Form ADV Part II. SEC interpretations establish requirements for reliance on 28(e) (e.g., any research obtained must provide "lawful and appropriate assistance" to the account manager in carrying out his responsibilities).

For more information, see http://www.siainvestor.com/index_flash.htm or http://www.sec.gov/investor/pubs/inwsmf.htm.