April 12, 2004

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609.

Comment to Release Nos. 33-8358; 34-49148; IC-26341; File No. S7-06-04, via e-mail

Dear Mr. Katz,

Thank you for accepting comment on the above-captioned release (the "proposal"). I am an investor and work as a journalist who covers the retail securities trade. I have no financial stake in this issue.

I generally support the idea of enhanced point-of-sale and confirmation disclosures, but only if done correctly. The proposal comes up short in several areas, as specified below.

As an initial matter, the SEC needs to take a broader look at mutual fund reform, including full deregulation of mutual fund sales loads via repeal of section 22(d) of the Investment Company Act, as well as consider a more comprehensive regime of disclosure and elimination of profound conflicts. A piecemeal and politically charged approach to fixing the mutual fund industry (and other problems) is bound to be less effective than considered, integrated rulemaking.

Commission Neglects to Address Deregulation of Fund Sales Loads

One issue that should be debated now in light of the concerns over mutual fund costs and missed breakpoints is mutual fund deregulation. Under Section 22(d) of the Investment Company Act, mutual funds are required to charge fixed sales charges. Discounting off the charges published in the prospectus is illegal. Investors have no bargaining power.

In addition, full deregulation whereby consumers and brokers agree on a price, as happens now with trades in individual equities, would likely simplify disclosure at the broker-dealer level and make the implementation of disclosures recommended in this proposal more practical.

Repeal of section 22(d) has long been advocated by the Commission. In 1966, in the SEC report " Public Policy Implications of Investment

Company Growth," (PPI), the SEC noted that, "In 1940, the Commission was of the opinion that the sales load question should be left 'for the present at least ... to competition among the different distributors.'" (Page 221, PPI). "The growth and size of the industry have now reached the point where a reexamination of this question is necessary. More than a quarter of a century of experience shows that the sort of competition which in fact generally prevails, i.e., competition among principal underwriters for the favor of retail dealers rather than price competition among retail dealers, has had the effect of raising rather than lowering prices to the investor. ... In a freely competitive market the load-raising effects of the vigorous competition among principal underwriters for the favor of dealers and salesmen could be restrained by countervailing downward pressures stemming from price competition among retailers for investor patronage. By precluding price competition at the retail level, section 22(d) suppresses the downward pressures that normal market forces might otherwise exert." (Page 221, PPI) "The Commission has considered achieving this objective by proposing an amendment to the retail price maintenance provisions of section 22(d) so as to remove the barrier to retail price competition in the sale of mutual fund shares. This would enable retail dealers to attract customers by offering lower prices." (Page 222, PPI)

Nearly 30 years later, SEC staff again recommended repeal of section 22(d), and offered further explanation of why price-fixing (or as described by the industry, "retail price maintenance") was no longer needed. In "Protecting Investors: A Half Century of Investment Company Regulation," by the Division of Market Regulation (May 1992), Division staff recommended that "the Commission seek legislation to amend section 22(d) to unfix front-end sales loads. This action would introduce price competition among dealers." (Page 297). Division staff said that "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." (Page 299).

The 1992 staff report says that the original section 22(d) "was drafted after the Senate hearings on the initial bill. Although the legislative history contains little explanation of the purpose of section 22(d), retail price maintenance does not itself appear to have been the purpose of the section." (Pages 299 and 300). "Rather, the legislative history suggests that Congress intended retail price maintenance simply as a means of preventing certain activities that existed in the distribution of mutual fund shares before 1940: riskless trading by insiders and resulting dilution, disruption of distribution systems, and unjust discrimination."

In its 1992 report, Division staff specified that section 22(d) was to "primarily" address riskless trading by insiders and the resulting dilution of fund assets. (Page 300) "Under the system of backward pricing generally used before the Act's passage and for many years thereafter, the price of a mutual fund share was based upon the fund's net asset value per share determined at the close of the market on the previous day. If the market rose, an investor could purchase fund shares near the end of the day at the price based upon the previous day's valuation, knowing that the actual net asset value of the shares was greater than the price he or she was paying. The transaction could be made riskless by redeeming the shares the following day, before a new and possibly lower price reflecting that day's market activity was established." (Page 300)

Payment of loads for most investors made this sort of late trading uneconomic, the 1992 report says, except for insiders and dealers who could avoid the loads.

In a footnote, the Division says, "The Commission would have cured riskless trading by requiring forward pricing [which it did in 1968]. The industry, however, vigorously resisted, and section 22(d) was enacted as the compromise. ..." (Page 301)

Due to fears over whether the Commission had authority to allow negotiation of loads, the agency took no action, the 1992 report says. But staff was clear about the need for Congress to act: "There no longer are any compelling reasons to retain retail price maintenance." (Page 308). ... "The first, and we believe the primary, purpose of section 22(d) has been rendered moot. Riskless trading by fund insiders to the dilution of other shareholders has not been possible since 1968, when the Commission adopted rule 22c-1, requiring "forward" pricing of fund shares. ... Finally, section 22(d) is not needed to prevent 'price discrimination.' Competitive markets generally tend to eliminate discriminatory price differences, i.e., differences unrelated to costs. In addition, competition generally should reduce prices for investors at all levels, even though reductions are likely to be most dramatic for the largest investors." (Page 310). ... "We also considered maintaining the status quo. Opponents of repeal have argued that retail price maintenance has in fact permitted price competition and 'worked well' over the last half century, as evidenced by the great variety of sales charges, the increases in the number of no-load funds and low-load funds. ... Thus, they conclude that section 22(d) need not be amended.

"The Division disagrees. ... the statute today precludes intrabrand competition. The original rationales for section 22(d) no longer exist. ..." (Page 310)

The Commission's current proposal claims that more disclosure is crucial for competition. The proposal professes to improve competitive forces. So why not give investors the chance to negotiate for lower prices? (Existing rules that cap sales loads and protect investors from egregious charges should continue, of course.).

The Commission is negligent in omitting any discussion regarding the repeal of section 22(d). This is a troubling omission, given industry support for the status quo.

The Proposal Neglects to Require Public Disclosure of Key Information

Imagine the poor consumer who goes into an auto dealer's showroom *not* knowing the dealer's cost and incentives on the car. Surely it is to the consumer's advantage to have this information *ahead of time* so that they are already well-informed at the point of sale.

This proposal would leave investors in the same disadvantaged position as the hapless automobile buyer. Currently, few disclosures of directed brokerage and revenue sharing ("payola") are being made in prospectuses or SAIs. To this day, the SEC has shown no inclination to enforce existing rules and law that *require public disclosure*. (See "Who, Us? Follow the Rules?" by Dan Jamieson, *On Wall Street*, August 2003: Public disclosure of payola is not occurring, based on a review of prospectuses and SAIs of selected products from 19 broker-sold fund groups. However, the author subsequently found one online SAI dated May 2003 that did disclose that payments were made, disclosed these in basis points, and listed the top dealers receiving them. See also, "NASD Disclosure Rules Ignored," by Dan Jamieson, *Registered Representative*, Sept. 2000: A review of SAIs from major fund groups found no disclosure of specific amounts of revenue sharing and no broker-dealers named, despite confirmation from the NASD that the payments must be disclosed in the prospectus for dealers to accept them.)

All payola-type payments, whether or not specifically made for shelf-space purposes, must be publicly disclosed, in basis points.

Under this proposal, and assuming continued public disclosure failure, investors will have information on shelf-space payments and differential broker compensation only *after* they agree to buy. Investors need to be armed with this information before they choose a broker or financial planner, and before they make an investment decision. Indeed, in evaluating potential brokerage firms and individual stockbrokers, and before buying any products from the firm, investors should be able to see a full list of all products sold by that firm and all costs and fees, including the payola amounts. This way, investors will know full well what are their firms' and brokers' conflicts. Public disclosure of all the fees, charges and payments lets investors and individual brokers prepare themselves for meaningful discussions of investment suitability and costs. Public disclosure of all the information will allow the media and researchers to track and report the information in formats that will help inform consumers early on in the buying process, thus spurring competition and mitigating conflicts.

Likewise, individual brokers should know that consumers are armed with this information. Brokers will therefore be more likely to offer services for fees that are competitive. Brokers would also know which products are paying their employers for preferential shelf space—critical information they need prior to recommending any products. Without this knowledge, broker/employees are vulnerable to being manipulated by the brokerage firms they work for. Any final rule should ensure that all registered representatives get from their firms routine disclosure of all vendor payments, whether the data is public or not.

Public disclosure of product payola would also ensure that individual reps would be able to compare potential broker-dealer employers as to the amount of payola deals and conflicts. Careful choice of broker-dealers by associated persons is a critical dynamic in investor protection.

If the SEC continues to allow non-disclosure of payola amounts, at the very minimum the Commission must ensure that customers and their individual brokers or service personnel at the brokerage firm can give the investor a full rundown on all the payola amounts from all the vendors *prior* to making an investment.

But full public disclosure would be easy. Why not require it? As noted, one fund company already provides details in at least some SAIs. Many other entity-to-entity details are already put in SAIs and prospectuses, including various custody arrangements with specific broker-dealers. Industry claims that such specific disclosure is not possible are contradicted by actual experience.

The Proposal Could Weaken Existing Public Disclosure Requirements

The perverse result of this proposal could be to *weaken existing public disclosure requirements of payola.*

As noted, public disclosure of such payments should be happening now. It is not. As the proposal indicates, SEC policy has been that disclosures made in fund prospectuses can substitute for confirmation disclosure. For years, with approval from the Commission, broker-dealers and brokers relied on prospectus disclosure to meet their obligations under Rule 10b-10.

Yet the proposal potentially takes a first step backward by reducing or ignoring reliance on public, before-the-sale prospectus disclosure, and instead focusing on private communications (oral disclosures at point of sale and confirms to customers only). Although the proposal is helpful in possibly expanding when disclosures are made, it will hurt consumers if it gives the fund and brokerage industries a helping hand to obtain what they have long sought—elimination of requirements to *publicly* disclose payola through. The industry's agenda can be seen in efforts to eliminate NASD Conduct Rule 2830(l)(4), for example.

Strangely, the proposal is silent on NASD Conduct Rule 2830(l)(4). The rule directly addresses revenue-sharing payments. It reads:

"No [brokerage firm] shall accept any cash compensation from [a mutual fund] unless such compensation is described in a current prospectus of the investment company. When special cash compensation arrangements are made available by [a mutual fund] to a [brokerage firm], which arrangements are not made available on the same terms to all members who distribute the [fund's shares] a [brokerage firm] shall not enter into such arrangements unless the ***name of the [brokerage firm] and the details of the arrangements*** *are disclosed in the prospectus. ..."* (bold-face added)

While the proposal says that the proposed confirmation disclosures would not "preempt or otherwise negate other provisions of law," it is unclear what will happen with NASD Conduct Rule 2830(l)(4). This is a valid concern, as industry interests have repeatedly tried to eliminate this particular rule even though they have been allowed to ignore it.

In its notice to members 03-54, the NASD itself asked whether "the current requirements of Rule 2830(l)(4) be eliminated in light of the disclosure that would be required by the proposed [NASD] amendments" in NTM 03-54. The NASD floated this idea of eliminating the rule despite the fact that NTM 03-54 proposed a weaker point-of-sale disclosure than the SEC now puts forth. The NASD proposed only that dealers maintain a web page or provide a phone number through which customers could see a list of funds that have paid payola to the dealer—but without any requirement to disclose any amounts.

The Investment Company Institute has long sought to eliminate Rule 2830(l)(4). In a letter to the NASD dated Oct. 15, 1997, Craig S. Tyle, General Counsel, ICI, advocated a point-of-sale disclosure regime for revenue sharing, and argued that specific prospectus disclosure would be "irrelevant" to investors and would "engender severe practical problems. …" (Letter to Ms. Joan Conley, Office of the Corporate Secretary, NASD Regulation, Inc., as cited in an Oct. 17, 2003, ICI letter to the NASD, see below.) In a letter sent to the SEC in the year 2000, the ICI reiterated that disclosure of revenue sharing should only be made in “general terms” at or before the time of sale, and told a reporter that disclosure of the payments in basis points would not be meaningful to investors. (“Fund Industry Opposes Disclosure of Shelf-Space Fees,” by Dan Jamieson, *Registered Representative*, May 2001.)

In an Oct. 17, 2003, letter to the NASD, a comment letter to NTM 03-54, the ICI said: “ We recommend deleting the existing cash compensation prospectus disclosure requirement from Rule 2830 because it would provide little additional benefit once the other elements of NASD's proposal are implemented. ...”

(The ICI now uses its early support of point-of-sale disclosure of revenue sharing as an example of its investor-friendliness. The ICI fails to note, of course, that this stance was part of its agenda to eliminate public disclosure requirements.)

Another Oct. 17, 2003, comment letter to NTM 03-54, from the SIA's Investment Company Committee, said: “The NASD may wish to consider whether disclosure is necessary regarding 'revenue sharing arrangements'” where the payments were not for preferential shelf-space or used to create differential payouts to individual brokers.

The industry's agenda is clear: The removal of current requirements in Rule 2830 that the name of the brokerage firm and the “details” of the payola arrangements be disclosed in the prospectus.

Perhaps the SEC will make clear that prospectus disclosure under Rule 2830 must, now, also occur along with the new point-of-sale and confirmation disclosures. But the proposal never mentions Rule 2830(l)(4) or any other rule or law that requires public disclosure. Can investors count on the SEC and NASD to enforce current rules on prospectus disclosure? Perhaps not. Both regulators are, and always have been, silent on this ongoing industry-wide disclosure violation. The failure has been an embarrassment, but so far has received no coverage in major media. So it would not be surprising if, after the new point-of-sale/confirmation disclosure regime is approved, Rule 2830(l)(4) was labeled “redundant” with the new and improved disclosures and eliminated with little fuss.

Thus, the proposal needs to make clear that all payments that could cause conflicts, including all payola payments, are publicly disclosed in fund prospectus filings. The Commission must clearly and publicly reject the industry's push to remove public disclosure requirements.

<u>The Proposal Neglects to Inform Investors of Proprietary Products</u>

Perhaps no conflict is as profound as a firm or broker selling an internal or “house brand” product, that is, a proprietary mutual fund, UIT or annuity. Proprietary products are manufactured by the brokerage firm or an affiliate of the firm, and are more profitable for the brokerage firm. After the 1995 Tully committee report, the industry moved away from paying individual brokers more for proprietary products, but the conflicts at the firm level still exist. These conflicts are so troublesome, in fact, that the SEC is now proposing that brokers disclose to customers when they get paid more on proprietary products. This is a good idea, but the proposal omits to ensure that investors will be informed when they are buying a proprietary product *for which the broker gets no extra compensation*—the typical case. The result will be that firms will be free to continue pushing their broker-employees to sell proprietary products, often under different brand names of affiliates or subadvisors, and clients will never know or be told of the conflict.

The SEC must clearly and fairly define proprietary products, and investors must be told whenever a proprietary product is recommended to them. Ideally, the manufacture and sale of proprietary products should be completely separated from a brokerage firm's retail operation, as the conflict is too profound to effectively regulate.

Other Payola Not Covered in the Proposal—Possibly Far More than Revenue Sharing and Directed Brokerage

The proposal neglects to address the issue of other undisclosed payola or pay-to-play fees.

For example, as the Commission knows, large financial institutions perform "subaccounting" services for their mutual fund investors, and charge fund companies for this service. Such "omnibus" accounting is problematic in its own right. On Nov. 18, 2003, SEC Chairman William Donaldson told a Senate Committee that: "In the breakpoint context, omnibus accounts make it difficult for funds to track information about the underlying shareholder that might have entitled the shareholder to breakpoint discounts. In the market timing context, funds are not able to assess redemption fees, limit exchanges or even kick out a shareholder who is market timing through an omnibus account because they don't know the identity of that shareholder."

Omnibus subaccounting is an important profit center for major dealers. The record-keeping fees paid by funds for omnibus services create additional conflicts. Morgan Stanley charges "partner" funds up to $19 per fund per account, while Wachovia charges up to $22 per fund per account. The median cost industrywide for such record-keeping is around $10 per fund per account. (See "Regulators Fumble Fund Reforms," by Dan Jamieson, *On Wall Street*, April, 2004.)

Record-keeping fees are a form of payola; the Commission neglects to address such fees in this proposal. The omission is puzzling, because in settling with the SEC over mutual fund payola disclosure failure, Morgan Stanley has agreed to make various disclosures of the fees, and includes record-keeping fees as one of three parts of a revenue-sharing program with certain select mutual funds. (Securities Act of 1933 Release No. 8339 / November 17, 2003, Securities Exchange Act of 1934 Release No. 48789 / November 17, 2003, and Administrative Proceedings File No. 3-11335.)

The Commission needs to perform a more comprehensive review of industry pay-to-play practices, identify all the practices, and formulate a broad definition of them so that new but undisclosed forms of payola do not arise.

Comparative Information May Mislead

Comparative information on costs may mislead consumers because of different service levels. Schwab's revenue-sharing payments are reportedly 40 basis points from fund companies, while at the same time it charges no loads. Merrill Lynch may charge loads, but have lower revenue-sharing payments. Other providers providing various degrees of advice and record-keeping services could charge varying amounts. Is it fair to compare E*Trade to Schwab to Merrill Lynch?

Another problem could occur if more of the payola was paid in forms such as "record-keeping" fees or other permutations that would not be disclosed under the proposal. The firms most skilled at burying more of these fees would then appear to be less conflicted when in fact they were not.

Also, if revenue sharing and directed brokerage are not publicly disclosed, private outfits will not be able to obtain this comparative information and the SEC will be unable to find private vendors to supply the data.

Point of Sale Disclosures Could be Burdensome

Complying with this proposal could be burdensome for small broker-dealers, who often use the "check and app[lication]" system for mutual funds—that is, buying directly from the fund rather than through the broker-dealer's system. This process may benefit consumers in that the consumer can be seen by the fund for breakpoint purposes, unlike with omnibus accounting systems. But check-and-app processing does not require the BD to send confirms—the fund itself does this. Under this proposal, the BD would have to create an entirely new system to produce check-and-app confirms.

All firms regardless of size would need a database of up-to-date data on hundreds of funds' load schedules and payola deals in order to produce the disclosures. The more fund choices the BD gives the customer, the more it would have to track a multitude of loads, 12b-1 and payola deals to put on confirms. This could be burdensome and counterproductive because firms may then offer less choice to investors.

An alternative may be to simply require public disclosure of payola, say, on a BD's website as well as in prospectuses, so that anyone can see what the BD receives from all vendors (individual brokers generally do not share in these fees). Costs directly paid by investors should be on confirms.

Rulemaking Needs Broader Context

As securities regulation guru Professor Joel Seligman said in a February 2004 "Fireside chat" at the SEC Historical Society:

" ... I'm concerned with a very major change in style, which has occurred with the SEC over time. During the '30s, this was an agency that focused on learning the fundamental facts of an industry, publishing detailed reports, holding public hearings, trying to articulate alternative approaches to problems. It was a much more self-consciously engaged effort to look at whichever industry they were addressing in a fundamental way. In more recent decades, under SEC Chairs of both parties, there has been much more a sense of firefighting. There's been more a sense, 'If the immediate issue is revenue sharing on the part of investment companies, we'll try to adopt a rule there.' But much less a sense of, 'How did we get to a point where this became the issue?' What does it tell us more broadly about the way investment companies are regulated or the way in which oversight of investment companies is addressed by the SEC and the by the industry."

I second Prof. Seligman's thoughts. The SEC should prepare another in-depth report on the state of the mutual fund industry, and work with Congress in a studious fashion to craft fundamental reform in the investment company industry. As noted, much of the proposal would be simpler to implement if the SEC achieved its long-held desire to repeal section 22(d). Also as noted, various key elements of mutual fund disclosure have been overlooked in this proposal. There are no doubt important issues not raised in this letter and in the proposal that a broader and more in-depth review would reveal.

Sincerely,

Dan Jamieson