

**MEMO# 16876**

December 15, 2003

## **ICI BOARD ACTIONS ON SOFT DOLLARS AND DIRECTED BROKERAGE**

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TO: ACCOUNTING/TREASURERS MEMBERS No. 57-03 BOARD OF GOVERNORS No. 74-03 CEOS  
CLOSED-END INVESTMENT COMPANY MEMBERS No. 109-03 FEDERAL LEGISLATION  
MEMBERS No. 31-03 INVESTMENT COMPANY DIRECTORS No. 24-03 OPERATIONS MEMBERS  
No. 43-03 PENSION MEMBERS No. 55-03 PRIMARY CONTACTS - MEMBER COMPLEX No.  
111-03 PUBLIC INFORMATION COMMITTEE No. 48-03 SEC RULES MEMBERS No.  
184-03 SHAREHOLDER COMMUNICATIONS COMMITTEE No. 18-03 SMALL FUNDS MEMBERS  
No. 83-03 UNIT INVESTMENT TRUST MEMBERS No. 53-03 RE: ICI BOARD ACTIONS ON  
SOFT DOLLARS AND DIRECTED BROKERAGE

At a special meeting on December 12th, the ICI's Board of Governors recommended regulatory changes in two significant areas – the use of brokerage commissions for research (commonly referred to as “soft dollars”) and the ability of fund advisers to take into account sales of fund shares in allocating fund portfolio brokerage (often referred to as “directed brokerage”).

Soft dollars. With respect to soft dollars, the ICI's Board is urging the Securities and Exchange Commission to adopt an interpretation that would exclude various types of products and services from the scope of the safe harbor under current law. These products and services would include: (1) computer hardware and software, and other electronic communications facilities, used in connection with trading or investment decision-making, (2) publications, including books, periodicals, newspapers and electronic publications, that are available to the general public, and (3) third-party research services.

The ICI's Board concluded that, while all these products and services may be valuable to funds and their shareholders, it would be more appropriate for them to be paid

for directly by fund advisers.

In connection with this recommendation, the Board is also recommending that all investment advisers – not just fund advisers – be prohibited from using commissions for products and services outside the safe harbor.

Directed brokerage. With respect to directed brokerage, the ICI's Board is urging the SEC and NASD to adopt rules that would prohibit fund advisers from taking into account sales of fund shares in allocating fund brokerage. While current NASD rules strictly regulate this practice, the Board concluded that, in order to avoid the appearance of conflicts of interest, as well as the potential for actual conflicts, it would be preferable if it were prohibited.

In connection with this recommendation, the Board is also recommending that the SEC adopt a rule that would clarify that the mere use of a broker that sells fund shares to execute fund portfolio trades would not subject a fund to liability, provided that the fund has adopted policies designed to prevent sales from being taken into account in allocating brokerage.

Attached are copies of the ICI's press release announcing the Board's action, as well as an editorial on the subject, authored by ICI Chairman Paul Haaga, that appeared in today's Wall Street Journal.

Matthew P. Fink  
President

Attachments

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## **Mutual Fund Leaders Take Hard Stand on Soft Dollars**

### **ICI Asks SEC to Dramatically Curtail Soft Dollars & Ban Directed Brokerage**

Washington, DC, December 15, 2003 – Following decisions by the Investment Company Institute's Board of Governors, ICI Chairman Paul Haaga announced that the ICI would urge the Securities and Exchange Commission to dramatically curtail the use of soft dollars by all investment advisers, including mutual fund managers, and to ban mutual funds' use of "directed brokerage." Haaga said the ICI is seeking "major structural reforms to change mutual funds' relationships with firms who execute their portfolio transactions and market and sell their funds." ICI President Matthew Fink said the actions reinforce mutual funds' "commitment to putting the interests of fund investors above everything else." According to Fink, "the ICI Board has been concerned about how these practices were evolving and whether existing regulations remained adequate."

#### **Restrict the Use of Soft Dollars**

The ICI took two actions with respect to soft dollars. First, the Institute called on the SEC to significantly curtail the research that can be acquired with soft dollars. The ICI proposed that virtually all products and services that are otherwise available in the marketplace be eliminated from the SEC's definition of permitted research. "The current definition is overly expansive," Fink said, "and thus has been susceptible to abuse. For example, soft dollars can currently be used for routine expenses like computers, software and investment publications. The ICI is convinced a much narrower definition will help eliminate the potential abuses most often associated with the questionable use of soft dollars."

#### **Eliminate Soft Dollars for Third Party Research**

In addition, the Institute urged the SEC to prohibit all investment advisers, including fund managers, from using soft dollars to acquire any research products and services from third parties. Eliminating this outlet for soft dollars would forcefully address an area that some believe has been most prone to problematic conflicts. While a special 1998 SEC inspection sweep found no soft dollar abuses by mutual funds in this area, Haaga pointed out that "questions about the appropriateness of using soft dollars for third party research have cast a pall over all investment advisers, no matter what they actually do in practice."

The Institute urged the SEC to limit the use of soft dollars to the narrow category of

proprietary research that reflects unique intellectual content. Haaga said the ICI is not questioning the value of third party research, just the manner in which it is paid for. "The ICI Board acted to make sure that most research is paid for directly by investment managers from their management fees, not from shareholder assets."

## **Ban Directed Brokerage**

The ICI also called on the SEC to end the practice of "directed brokerage." While this practice is subject to strict regulations, the rules permit fund companies to consider the fact that a brokerage sells their mutual funds when choosing a broker to execute their portfolio trades.

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The ICI concluded that "directed brokerage" raises questions about whether fund managers' trading decisions are affected by considerations other than shareholders' best interests. If the SEC were to abolish directed brokerage, as the ICI suggests, a significant potential conflict of interest would not just be regulated, it would be eliminated.

"These are substantial reforms," Haaga said. If enacted, they "will benefit fund investors by substantially diminishing potential conflicts of interest and strengthening the operating integrity of mutual funds."

Today's reform proposals build upon initiatives the Institute announced in October to combat recently discovered abuses. To combat late trading, the ICI proposed that all mutual fund trades be reported to the fund company by 4:00 pm to obtain the current day's price. To deter abusive market timing, the ICI urged the SEC to require a minimum mandatory 2 percent redemption fee (payable to the funds' long term shareholders, not fund managers) on sales of shares held for five days or less.

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## Mutual Integrity, Mutual Trust

Op-ed for The Wall Street Journal, Monday, December 15

By Paul Haaga

It is not news that mutual funds experienced remarkable growth over the last 20 years. More than 60% of middle American households now own fund investments. In a 1999 Pew Research survey, Americans said mutual funds were one of the 1990s three "best trends," alongside civil rights and equality for women in the workplace.

But if fund leaders do not act to restore the high standards which led to such widespread confidence in mutual funds—standards which always put fund investors first—we will not see facts and findings like this again. Nor will we deserve to. This is why the Investment Company Institute, the national association of mutual funds, is today calling for major reforms relating to "soft dollars" and "directed brokerage."

The Institute's Board of Governors, which I chair, is today calling on the Securities and Exchange Commission to restrict substantially the use of soft dollars. Soft dollars resemble frequent flier miles. Investment managers receive credits based on the commissions funds pay when buying and selling securities. Managers can use these "soft" credits instead of "hard" dollars to acquire investment research products and services. Concerns have long been expressed that some managers choose higher rather than lower cost brokers because of the opportunity to receive soft dollars.

Although protected by a safe harbor Congress enacted in 1975, this longstanding practice has created many more problems than the practice was originally intended to solve. Most investment research should be paid from management fees, not from shareholders' assets.

Our second proposal addresses the practice whereby some fund managers steer brokerage transactions to reward securities firms that also sell the managers' funds. Mutual funds are among the largest buyers and sellers of securities, and generally execute their trades through broker-dealers. While fund managers are obligated to seek best execution (i.e., best overall value) for their transactions, funds are permitted in some circumstances to "direct" brokerage transactions to securities firms in consideration of the firm's sale of fund shares.

The Institute is calling on the SEC to abolish this form of directed brokerage. While the potential conflicts associated with these arrangements have generally been contained by existing regulations, it is also true that directed brokerage causes some to suspect that fund managers could "pay to play" using shareholders' money.

These are substantial proposals. They build upon initiatives fund leaders proposed in October to combat late trading and abusive market timing.

To stamp out late trading, the Institute said that all trades must be received by a mutual fund before the market closes at 4 p.m. to receive the current day's price. While unpopular among some in the financial services industry, this "hard" close is tough medicine that is undeniably effective.

To strengthen funds' ability to deter abusive market timing, the Institute asked the SEC to impose a minimum mandatory 2% redemption fee (payable to the funds' long-term shareholders, not fund managers) on any sale within five days of the original investment. Redemption fees, coupled with additional SEC guidance about a valuable but subjective technique known as "fair value" pricing, will provide mutual funds with stronger tools to combat abusive market timing.

The significant new policies the fund industry is calling for today will benefit millions of investors by substantially diminishing potential conflicts of interest and strengthening the operating integrity of mutual funds. Fund investors need these new protections. But tough requirements, whether old or new, have to be followed and enforced.

Three weeks ago, Institute President Matthew Fink told Congress that fund executives "who acted willfully against the interest of fund shareholders should be sanctioned severely. Those found to have violated criminal laws should be sent to prison. The law enforcement message should be loud, clear and memorable." Supporting vigorous enforcement is not an empty promise; mutual funds have long endorsed increased funding for the SEC. And we pledge to work hard to ensure the Commission gets the resources it needs to fulfill its mission of protecting investors.

We make no excuses for the behavior of those in our industry who violated the letter or the spirit of the law-because there are no excuses. By substantially reducing conflicts of interest, the proposals we advance today, along with the steps we took in October, reflect our commitment to doing whatever is necessary to restore trust and confidence in mutual funds, upon which tens of millions of Americans depend.

We know that integrity is not demonstrated, and trust not earned, by adopting a new strategy or issuing a press release. Integrity and trust are the products of a culture that honors fiduciary principles, unshakeable ethics, broad vision and a profound commitment to those you ultimately serve. We ask only that we be judged by our actions.

Today, some question whether integrity and trust are genuinely valued by mutual-fund companies that provide the public with vital financial services. It is our responsibility-and ours alone-to answer that question decisively and unambiguously. If we fail, it will not matter if regulators are smart, prosecutors tough and legislators far-sighted. If we fail, we will have endangered the historic accomplishments that mutual funds have come to represent for more than 92 million Americans and their families.

Despite the current tumult, many experts believe mutual funds remain the best way for Americans to invest for the future. We are convinced of this as well. For most of us-and most of our history-our words and our deeds have been fully aligned. The result is that mutual funds democratized our financial markets and energized the capital formation process. In the wake of recently discovered abuses, we are moving swiftly to offer tough, practical solutions, and will continue to call for changes to address broader concerns. Everything remains on the table to ensure that the interests of mutual-fund investors are, and always will be, served above everything else.