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SEC AND NASD PROPOSE TO PROHIBIT USE OF BROKERAGE COMMISSIONS TO FINANCE DISTRIBUTION; SEC SEEKS COMMENT ON REFORM OF RULE 12B-1

[17172] March 3, 2004 TO: OPERATIONS COMMITTEE No. 3-04 BROKER/DEALER ADVISORY COMMITTEE No. 7-04 BANK AND TRUST ADVISORY COMMITTEE No. 4-04 TRANSFER AGENT ADVISORY COMMITTEE No. 24-04 RE: SEC AND NASD PROPOSE TO PROHIBIT USE OF BROKERAGE COMMISSIONS TO FINANCE DISTRIBUTION; SEC SEEKS COMMENT ON REFORM OF RULE 12B-1 The Securities and Exchange Commission has proposed amendments to Rule 12b-1 under the Investment Company Act of 1940 that would prohibit mutual funds from compensating their selling broker-dealers through the use of directed brokerage arrangements.1 The Release also seeks comment on whether Rule 12b-1 should be amended further, including whether it should be rescinded. In addition, the NASD has filed with the SEC a proposed change to NASD Rule 2830(k) that would prohibit a broker-dealer from selling any mutual fund if the broker has reason to know of any agreement or understanding to direct the fund's portfolio transactions in exchange for the promotion or sale of the fund's shares.2 Both proposals are summarized below. I. CURRENT REGULATION OF DIRECTED BROKERAGE ARRANGEMENTS SEC Rule 12b-1 and NASD Rule 2830(k) govern the use of fund brokerage to pay selling brokers or otherwise finance the sale of fund shares (i.e., directed brokerage). In particular, Rule 12b-1 permits funds to use their assets to pay distribution-related costs provided certain conditions are met.3 NASD Rule 2830(k) prohibits broker-dealers from conditioning their efforts in distributing a fund's shares on the receipt of the fund's brokerage commissions. An exception in the NASD rule, however, allows a broker-dealer to sell shares of any fund that follows a policy, disclosed in its prospectus, of considering sales of its shares as a factor in the 1 See Prohibition on the Use of Brokerage Commissions to Finance Distribution, SEC Release No. IC-26356 (Feb. 24, 2004) ("Release"), available on the SEC's website at http://www.sec.gov/rules/proposed/ic-26356.htm. 2 See Proposed Amendment to Rule Relating to Execution of Investment Company Portfolio Transactions, File No. SR-NASD-2004-027 (Feb. 10, 2004), available on the NASD's website at http://www.nasdr.com/pdf-text/rf04_27.pdf. 3 These conditions include the fund adopting "a written plan describing all material aspects of the proposed financing of distribution" that is approved by fund shareholders and directors and including additional information regarding its 12b-1 plan in its prospectus fee table and statement of additional information. 2 selection of broker-dealers to execute portfolio transactions, subject to the requirements of best execution. II. SEC PROPOSAL A. Ban on Directed Brokerage The proposal would amend Rule 12b-1 to prohibit a mutual fund from compensating a broker-dealer for promoting or

selling its shares by directing brokerage transactions to that broker.4 The amended rule also would prohibit the use of step-out and similar arrangements designed to compensate selling brokers for their sales efforts.5 According to the Release, the SEC believes that the way brokerage has been used to pay for distribution involves "unmanageable conflicts of interest" and is not consistent with the SEC's rationale for approving the exception in NASD Rule 2830(k). In particular, the use of multiple broker-dealers for execution, step-outs and the other arrangements described in the Release "explicitly quantify the value of the distribution component of fund brokerage commissions" and "bear all the hallmarks of barter arrangements" in which advisers trade fund brokerage for sales efforts. The Release states that the use of fund brokerage to finance distribution is a "real and meaningful cost to fund shareholders" because it means foregoing the opportunity to seek lower commission rates, to use brokerage to pay other fund expenses, or to obtain any available cash rebates. The Release also notes the SEC's concern that directed brokerage arrangements: (1) create incentives for brokers to recommend funds providing the best compensation rather than funds meeting the customer's investment needs; (2) have not been transparent to customers; and (3) may permit brokers to circumvent the NASD's sales charge rules. The Release seeks comment on, among other things, whether: (1) the SEC's concerns about the use of brokerage for sales are justified; (2) there are alternative measures to address this practice; and (3) there would be greater competition in commission rates if the practice were eliminated. The Release also seeks comment on whether the primary effect of banning directed brokerage arrangements would be to increase brokers' demands for revenue sharing payments from advisers. It asks whether the SEC is "correct in [its] assumption that properly disclosed revenue sharing payments present more manageable conflicts for funds and broker- dealers" and, if that assumption is incorrect, whether the SEC should take additional steps to address revenue sharing concerns. The Release also seeks comment on whether the problems with directed brokerage arrangements could be adequately addressed through disclosure changes. The Release states that the SEC considered such an approach but is concerned that: (1) it might not be effective in 4 In December, the Institute sent a letter to SEC Chairman Donaldson urging that the SEC and/or NASD adopt rules to prohibit funds from taking sales of fund shares into account when allocating fund brokerage. See Institute Memorandum to Accounting/Treasurers Members No. 60-03, Board of Governors No. 76-03, Closed-End Investment Company Members No. 113-03, Federal Legislation Members No. 33-03, Investment Adviser Members No. 43-03, Investment Company Directors No. 27-03, Operations Members No. 44-03, Pension Members No. 56-03, Primary Contacts – Member Complex No. 113-03, SEC Rules Members No. 191-03, and Small Funds Members No. 88-03 [16889], dated Dec. 17, 2003. 5 Section I.A of the Release describes the operation of step-out and various other directed brokerage arrangements. 3 preventing funds and fund shareholders from being harmed by the conflicts of interest involved in directed brokerage arrangements; and (2) the complicated nature of such arrangements may be difficult for investors to comprehend and to compare across different funds. Nevertheless, the Release asks, among other things, whether: (1) the SEC should revise the disclosure requirements and ban only certain types of directed brokerage arrangements; (2) the SEC should increase or revise the disclosure requirements concerning directed brokerage; (3) such disclosures should be quantitative or qualitative; and (4) the disclosures would enable shareholders – directly or through assessments by investment analysts – to choose among funds with directed brokerage arrangements. B. Policies and Procedures The proposal would further amend Rule 12b-1 to provide that a mutual fund may not direct portfolio transactions to a selling broker-dealer unless it (or its adviser) has implemented policies and procedures reasonably designed to ensure that the fund's selection of broker- dealers is not influenced by considerations about the sale of fund shares. In particular, the

procedures must be reasonably designed to prevent: (1) the persons responsible for selecting broker-dealers from taking broker-dealers' promotional or sales efforts into account as part of the selection process; and (2) the fund, its adviser, or its distributor from entering into an agreement under which the fund directs brokerage transactions (or revenue generated by those transactions) to a broker-dealer to pay for distribution of the fund's shares. The policies and procedures would have to be approved by the fund's board of directors, including a majority of its independent directors. According to the Release, the policies and procedures would have to be more specific than those required by the new fund and adviser compliance rules.6 The Release does not provide a date by which funds and their advisers would be expected to comply with this requirement. The Release seeks comment on, among other things, whether: (1) it is appropriate to require funds to implement such policies and procedures; (2) such policies and procedures would be effective in preventing funds and broker-dealers from circumventing the ban on directed brokerage arrangements; (3) the SEC should adopt other measures to help funds monitor the use of fund brokerage (e.g., require board approval of brokerage allocations, require adviser to report its allocation decisions to fund board); (4) an officer of the fund (or the adviser) should have to certify periodically that brokers were selected without taking into account their promotion or sale of the fund's shares or those of any other fund; and (5) the rule should include a safe harbor for funds executing portfolio transactions with a selling broker, and whether the absence of a safe harbor would affect their ability to obtain best execution.7 C. Request for Further Comment on Rule 12b-1 The Release seeks comment – particularly from fund shareholders and fund directors – on whether the SEC should propose additional changes to Rule 12b-1. It notes that the rule's provisions may not address a number of matters facing funds today (e.g., the use of 12b-1 fees as 6 Rule 38a-1 under the Investment Company Act and Rule 206(4)-7 under the Investment Advisers Act of 1940. 7 The Institute's letter to Chairman Donaldson, discussed in footnote 4 above, recommended that the SEC adopt a narrow safe harbor in order to ensure that the ban on directed brokerage does not inadvertently call into question a fund's legitimate brokerage allocations to brokers that also sell the fund's shares. 4 a sales load substitute). The Release states that the SEC would particularly like to receive comment on whether it should require funds to deduct distribution-related costs directly from shareholder accounts rather than from fund assets, noting that such an approach may have a number of advantages over current arrangements.8 The Release also asks whether the SEC should rescind Rule 12b-1. It notes that critics of the rule often argue that it no longer serves the purposes for which it was intended, while others contend that rescinding the rule would harm funds and fund shareholders. The Release requests comment on, among other things: (1) the consequences of rescinding the rule for funds, shareholders, advisers, and selling brokers; (2) the alternate methods of financing distribution that funds and advisers would use; (3) whether there are certain distribution expenses that should be paid with fund assets; (4) whether the SEC should also impose restrictions on other asset-based fees (e.g., shareholder servicing) to ensure that distribution expenses are not improperly characterized; (5) whether particular types of funds would be disproportionately disadvantaged; and (6) if Rule 12b-1 is rescinded, whether the SEC should propose a new rule prohibiting the use of fund assets to pay for sales and distribution expenses. II. NASD PROPOSAL Last month, the NASD filed a proposal with the SEC to eliminate the exception in Rule 2830(k) that currently allows a broker-dealer to sell shares of a fund that considers the sale of its shares as a factor in selecting broker-dealers to execute its portfolio transactions.9 The NASD explained that it is seeking elimination of the exception due to concerns that the exception undermines the purpose of Rule 2830(k), which is to prevent quid pro quo arrangements in which brokerage commissions are used to compensate broker-dealers for selling fund shares. The proposed rule change also includes language

prohibiting any NASD member from selling a fund’s shares if the member knows or has reason to know that the fund (or its adviser or principal underwriter) has entered into a written or oral agreement or understanding under which the fund is expected to direct its portfolio transactions (or commissions or markups from such transactions) to a broker or dealer in consideration for promotion or sale of the fund’s shares. Rachel H. Graham Assistant Counsel 8 According to the Release, these possible advantages include: (1) the amounts charged and their effect on shareholder value would be completely transparent to fund shareholders; (2) existing shareholders would not pay the costs of selling to new shareholders; (3) long-term shareholders would not pay amounts that exceed their fair share of distribution costs; (4) this approach would help eliminate the substantial conflicts of interest presented by the use of fund assets to pay for distribution; (5) fund directors would have more time to address other significant matters; (6) legal and compliance costs associated with Rule 12b-1 and the NASD sales charge rule would be reduced; and (7) this approach would simplify mutual fund investment by (a) eliminating the need for separate share classes based on 12b-1 fees, as well as sales practice abuses associated with the existence of those classes and (b) making fund prospectuses shorter and more understandable. 9 Written comments on the proposal were neither solicited nor received by the NASD prior to the filing with the SEC.
