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NASD ISSUES MUTUAL FUND TASK FORCE REPORT

[18195] November 18, 2004 TO: SEC RULES MEMBERS No. 164-04 EQUITY MARKETS ADVISORY COMMITTEE No. 46-04 CLOSED-END INVESTMENT COMPANY MEMBERS No. 74-04 BOARD OF GOVERNORS No. 76-04 COMPLIANCE ADVISORY COMMITTEE No. 111-04 CHIEF COMPLIANCE OFFICER COMMITTEE No. 26-04 INVESTMENT ADVISER MEMBERS No. 24-04 RE: NASD ISSUES MUTUAL FUND TASK FORCE REPORT The NASD has issued the report of its Mutual Fund Task Force, which was formed in May 2004 to consider ways to improve the transparency of mutual fund portfolio transaction costs and distribution arrangements.1 The Report contains recommendations on methods to improve the existing regulation of soft dollars and the disclosure of transaction costs. The most significant aspects of the Report are summarized below. I. Recommendations Concerning Soft Dollars A. Scope of Safe Harbor The Task Force unanimously agreed that the soft dollar safe harbor set forth in Section 28(e) of the Securities Exchange Act of 1934 should be preserved. The Task Force, however, recommends that the SEC narrow its interpretation of the scope of the safe harbor to protect only brokerage services as described in Section 28(e)(3) and the "intellectual content" of research. The Task Force proposes that the SEC define "intellectual content" as "any investment formula, idea, analysis or strategy that is communicated in writing, orally or electronically and that has been developed, authored, provided or applied by the broker-dealer or third-party research provider (other than magazines, periodicals or other publications in general circulation)." The Report states that under this definition of "research services," the safe harbor would not protect the means by which such content is provided.2 1 The Task Force report ("Report") can be found on the NASD's website at http://www.nasd.com/stellent/groups/rules_regs/documents/rules_regs/nasdw_012356.pdf. 2 In particular, the Report states that the proposed definition of research services would not protect such benefits as: computer hardware and software, unrelated to any research content or analytical tool; phone lines and data transmission lines; terminals and similar facilities (as distinct from any research content or analytical tool); 2 B. Disclosure to Fund Boards The Task Force recommends that the SEC mandate expanded disclosure to fund boards about soft dollar practices to ensure that every fund board understands the types of information that should be reviewed in exercising effective oversight over an adviser's soft dollar practices. Specifically, the Task Force recommends that the SEC mandate that a fund's adviser provide the board of directors with, at a minimum, the following information for each fund: portfolio turnover rate; list of brokers used and total commissions3 paid to each broker; the aggregate average commission rate per share and the average commission rate per share by broker; the average commission rate paid to brokers that provide soft dollar services to the fund's adviser versus the average rate paid to brokers that do not provide such benefits; list of brokers from which the fund adviser obtains soft dollar products and services; the conversion ratio or price of research offered by each

broker through which the adviser obtains third-party research benefits; and the amount of third-party research benefits obtained with fund commissions.4 C. Disclosure to Investors The Task Force recommends that the SEC mandate expanded disclosure to fund investors about soft dollar practices. Specifically, the Task Force recommends that the SEC expand current disclosure requirements5 to require that a fund state whether it obtains third- party research through soft dollars and whether it obtains proprietary research through soft dollars. The Report states that Task Force members generally agreed that this additional disclosure should be included in the fund prospectus and not be relegated to the SAI. D. Application of Section 28(e) to All Discretionary Advisers The Task Force recommends that the SEC consider making compliance with Section 28(e) mandatory for all discretionary investment advisers, whether or not registered with the SEC, and that the SEC recommend to the Department of Labor and the federal banking regulators that they require all other discretionary investment managers not subject to SEC jurisdiction to comply with the standards of the safe harbor. The Report notes that mutual fund and pension fund managers are the only managers that currently must meet the safe harbor, due to the self-dealing limitations under the 1940 Act and ERISA. Other managers, such as hedge fund managers, may engage in soft dollar practices that do not fall within the scope of Section 28(e). The Report states that the same types of conflicts that may arise in the use of soft dollar arrangements by investment companies also may occur when other fund managers magazines/newspapers/journals/on-line news services; portfolio accounting services; proxy voting services unrelated to issuer research; and travel expenses incurred in company visits. 3 For purposes of the Report, the term “commission” refers to traditional commissions, commission equivalents, and any other remuneration eligible for the Section 28(e) safe harbor. 4 The Task Force also considered whether it is possible for an adviser to provide the board with a good faith estimate of the total dollar amount of proprietary research obtained with fund brokerage commissions. The Report states that the Task Force was unable to reach a consensus on this point. 5 Currently, mutual funds disclose in their SAIs how the fund selects brokers and, if a fund considers the receipt of research services in selecting brokers, the nature of the services. 3 obtain soft dollar benefits and that research obtained by a money manager can serve multiple advisory clients, such as mutual funds and hedge funds. Applying one set of rules with regard to mutual fund-related soft dollar transactions and another set of rules with regard to non-fund or mixed transactions therefore may be difficult for that money manager, and may cause compliance challenges. II. Recommendations Concerning Portfolio Transaction Costs A. Disclosure to Fund Boards The Task Force recommends that the SEC explicitly require disclosure about transaction costs to fund boards. At a minimum, the Task Force recommends that the adviser supply fund boards with its policies and procedures for monitoring transaction costs and brokerage allocation as well as information concerning the reasonableness of all transaction costs. The Report states that the board would be expected to use this information to determine whether the adviser is sufficiently ensuring that the fund does not pay excessive transaction costs and is adequately monitoring the execution quality of the fund’s transactions. B. Disclosure to Investors The Task Force recommends that the SEC require enhanced disclosure about transaction costs to shareholders. Specifically, the Task Force recommends that funds include a brief narrative description in their prospectus of the various types of trading costs incurred by the fund, including commissions, markups and markdowns, market impact costs, and opportunity costs; the fund’s portfolio turnover rate; the percentage of the total dollar value of all transactions that were executed on a commission basis; the average commission paid per share; the total commissions paid as a percentage of total net asset value; and disclosure that the fund’s performance numbers, but not the fee table, reflect these trading costs. The Task Force also recommends that the SEC move the existing disclosure concerning total commissions from the SAI to the

prospectus to accompany such additional information and that this data be presented in chart form covering a five-year period. Ari Burstein Associate Counsel

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