MEMO# 16816

November 25, 2003

DECEMBER 12, 2003 MEETINGS OF THE BOARD OF GOVERNORS AND THE SUCCESSION PLANNING COMMITTEE

[16816] November 25, 2003 TO: BOARD OF GOVERNORS No. 66-03 SUCCESSION PLANNING COMMITTEE RE: DECEMBER 12, 2003 MEETINGS OF THE BOARD OF GOVERNORS AND THE SUCCESSION PLANNING COMMITTEE At its November 20th meeting, the Executive Committee decided to call a special meeting of the Board of Governors to be held on Friday, December 12, 2003 beginning at 9:30 a.m. to discuss the Institute taking policy positions on the use of soft dollars for research and on directed brokerage for sales of mutual fund shares. The meeting will be held in the David Silver Conference Room at the Institute’s offices. I expect the meeting will conclude by 11:30 a.m. In contrast to the Board's regular practice, Governors may attend this meeting by conference call. However, in light of the importance of these issues and the need for active discussion and debate among the Board, the Executive Committee has requested that Governors try to attend the meeting in-person. If you will be joining by conference call, please dial 888-381-5770. You will be asked to provide the moderator’s name, Matthew Fink, and the passcode, Fink. If a substitute will be participating by phone on your behalf, please provide that person’s name on the response form so that the conference operator will allow that person to join the call. Enclosed is a memo describing the issues that will be discussed. I encourage you to review these issues with colleagues in your organization so that the Board can have the full benefit of your firm's views. As usual, please keep Board matters confidential. Following the Board meeting, the Succession Planning Committee will meet from 11:45 until 1:30 p.m. If you will be joining by conference call, please dial 888-396-9923. You will be asked to provide the moderator’s name, Matthew Fink, and the passcode, Succession. For your convenience, we are holding a block of rooms at: Sofitel Lafayette Square 806 15th Street, NW Washington, DC 20005 Phone: 202-730-8800 Fax: 202-730-8500 2 Standard rooms are available for $199.00 per night plus tax. To make reservations, please call the Sofitel at 202-730-8800 by December 5th. Be sure to mention that you are calling as part of the ICI room block in order to get the group rate. To avoid a penalty, reservations at the Sofitel must be cancelled 48 hours prior to the scheduled arrival date. Please use the attached response form to indicate whether or not you will be attending the December meeting. I look forward to seeing you next month. Attachments Matthew P. Fink President RESPONSE FORM Board of Governors Meeting December 12, 2003 Name (Please print. If substitute, please also list name of Governor you will be participating on behalf of.) Board of Governors Meeting – 9:30 a.m. – 11:30 a.m. WILL ATTEND IN PERSON WILL PARTICIPATE BY PHONE* WILL NOT ATTEND * Dial-in: 888-381-5770 / Moderator: Matthew Fink / Passcode: Fink Succession Planning Committee Meeting – 11:45 a.m. - 1:30 p.m. (Executive Committee & Dow, Driscoll, Meyer, Osborne, Papesh, Putnam, Shames) WILL ATTEND IN PERSON WILL

PARTICIPATE BY PHONE* WILL NOT ATTEND * Dial-in: 888-396-9923 / Moderator: Matthew Fink / Passcode: Succession If you would like us to schedule transportation to the airport or train station at the conclusion of the meeting, please complete the section below: I will need transportation to Reagan National airport. I will need transportation to Dulles airport. I will need transportation to Union Station. Depart ICI at: Flight/train departure: I plan to make my own transportation arrangements. Please fax the completed form to Jane Forsythe at the Institute – 202/326-5986 November 25, 2003 TO: Board of Governors FR: Matthew Fink RE: Special Meeting on Soft Dollars and Directed Brokerage At its meeting on December 12th, the Board of Governors will consider whether the ICI should recommend changes to the law and rules governing the ability of fund advisers (1) to pay “soft dollars” (i.e., to use commissions for research and related services) and (2) to take fund distribution into account when allocating brokerage. This follows a discussion of these topics at the October meeting of the Board of Governors. At that meeting, we discussed presenting recommendations to the Board at the January 2004 meeting; however, in light of recent developments, the Executive Committee decided that we should attempt to develop and make public industry positions before year-end. Current Standards (1) Soft dollars. Under Section 28(e) of the Securities Exchange Act, a money manager may pay for both execution and research services with commissions, subject to various conditions. Since 1986, the SEC has interpreted Section 28(e) as applying to a broad range of products and services. These include all products and services that provide “lawful and appropriate assistance to the money manager in carrying out his investment decision decision- making responsibilities.” As a result, money managers have used commissions to pay for research services provided by parties other than the broker-dealer executing the trade (“third party research”), publications, electronic communications facilities, computers, etc. Advisers to mutual funds generally can only use commissions to pay for services that fall within the safe harbor (or that directly benefit the fund). Many other advisers, however, can use commissions to pay for services outside the safe harbor, if they provide disclosure about their soft dollar practices in Form ADV. (2) Brokerage for sales. NASD Conduct Rule 2830(k) permits, subject to limitations, a fund adviser to take into account distribution in allocating brokerage. Among other things, the rule requires this practice to be disclosed in the fund’s prospectus, and requires that the broker provide best execution. The rule also prohibits a broker from conditioning the sale of fund shares on the receipt of brokerage allocations. Put another way, under the rule, advisers are only supposed to take into account the sale of fund shares “after the fact” when allocating brokerage. 2 Recommendations of the Executive Committee At its meeting on November 20th, the Executive Committee had an extensive discussion on soft dollars and directed brokerage. The Committee concluded that the following recommendations should be presented to the Board. 1. The ICI should request that the SEC significantly narrow the types of research and other services that qualify under the safe harbor for use of commission dollars. In particular, the following types of services should be excluded from the scope of the safe harbor: (i) computer hardware and software, and other electronic communications facilities; (ii) publications, both paper-based and electronic, that are available to the general public; and (iii) all other third party research and execution services. Under this proposal, the only types of research services that an adviser could take into account in allocating brokerage would be research provided by the broker to whom the commissions are paid. (This would be one among a variety of factors that an adviser could take into account in deciding how to allocate brokerage; others would include execution capabilities, willingness to commit capital, commission rates, etc.) In addition, only products and services that directly involve the intellectual resources and professional abilities of the firm would be considered “research.” While other types of products and services (e.g., computer hardware and software) may be valuable, the Committee believes that they should be paid for directly by the adviser. 2. The ICI should call upon the SEC to adopt a rule under which all investment advisers would be prohibited from using commissions for products and services outside the statutory safe harbor. This would, in effect, subject all investment advisers to the same standards applicable to advisers to mutual funds. 3. The ICI should call for the adoption of rules that would prohibit fund advisers from taking into account fund distribution in allocating brokerage. The Committee believes that a stricter standard than the one under current NASD rules is warranted, under which distribution considerations would play no role in allocation of brokerage. 4. The ICI should ask the SEC to adopt a safe harbor rule, under which using a broker that sells fund shares for portfolio trades would not be deemed to be in violation of the rule noted above, provided that the fund has adopted procedures designed to prevent sales from being considered as part of brokerage allocation. This is intended to prevent a fund from being “second-guessed” whenever it uses a broker that sells fund shares for a portfolio trade. Discussion (1) Soft dollars. One advantage of the recommended approach is that it could probably be implemented by the SEC, as opposed to requiring legislation. Should the ICI go further, however, and recommend a prohibition on any use of commissions for research-related services? (This would require legislation.) Alternatively, does the recommendation go too far? For example, should some types of third-party research still be permitted? What about computer hardware and software, and publications? 3 (2) Brokerage for sales. The Committee felt that a prohibition on taking into account distribution considerations in all cases was preferable to alternative approaches, such as only restricting “step-out” arrangements (i.e., arrangements in which the executing broker-dealer “steps out” of a portion of the transaction, allowing a second broker-dealer to clear and settle the trade, and receive a portion of the commission), or attempting to categorize a portion of commissions as distribution expenses subject to Rule 12b-1. The safe harbor rule is intended to address possible concerns with this approach. Does the Board agree with these recommendations? I look forward to your participation on December 12th.
