

MEMO# 16889

December 17, 2003

ICI LETTER URGING SEC TO RESTRICT THE USE OF SOFT DOLLARS AND BAN BROKERAGE FOR SALES OF FUND SHARES

[16889] December 17, 2003 TO: ACCOUNTING/TREASURERS MEMBERS No. 60-03 BOARD OF GOVERNORS No. 76-03 CEOS 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 SMALL FUNDS MEMBERS No. 88-03 RE: ICI LETTER URGING SEC TO RESTRICT THE USE OF SOFT DOLLARS AND BAN BROKERAGE FOR SALES OF FUND SHARES The Institute has submitted a letter to SEC Chairman Donaldson urging the SEC to issue interpretive guidance and to adopt rules with respect to two related matters: the use of brokerage commissions for research products and services (commonly referred to as "soft dollars") and the ability of mutual fund investment advisers to take into account sales of fund shares in selecting a broker-dealer to execute transactions in portfolio securities (often referred to as "directed brokerage"). The Institute's recommendations are summarized below.

Soft Dollars. The Institute recommended that the SEC adopt a revised interpretation under Section 28(e) of the Securities Exchange Act that would exclude certain products and services from the scope of the safe harbor under Section 28(e). These products and services would include the following: (1) computer hardware and software, and other electronic communications facilities; (2) publications, both paper-based and electronic, that are available to the general public; and (3) third-party research services. The letter states that this change would be beneficial for investors because it would clarify application of the safe harbor in areas where guidance is needed; would make it easier for investors to understand the costs of various investment advisory products, including mutual funds; would reduce incentives for money managers to engage in unnecessary trading; and would interpret Section 28(e) in a manner that more closely reflects its original purpose – a narrowly tailored provision that allows a money manager to take into account the intellectual resources, as well as the execution capabilities, of a brokerage firm in determining how to allocate trades.

Investment Advisers Act Rule. The Institute recommended that the Commission adopt a rule under Section 206(4) of the Investment Advisers Act that would prohibit both registered and unregistered investment advisers from using client commissions to pay for services or products that fall outside of the safe harbor under Section 28(e) of the Exchange Act. The letter states that such a rule would provide greater transparency in adviser compensation and would ensure that all investors are treated equitably by all investment advisers in connection with the adviser's use of

brokerage. Directed Brokerage. The Institute recommended that the SEC and NASD adopt new rules and amend existing rules to prohibit fund advisers from taking into account the sale of fund shares when selecting brokers to execute trades in securities held or to be acquired by the fund. The letter states that, while the ability of fund advisers to take sales into account in allocating brokerage is strictly regulated under existing NASD rules, the Institute believes that in order to avoid both the appearance of a conflict of interest and the potential for actual conflicts, it would be appropriate to further tighten regulation in this area. Safe Harbor Rule. The letter states that if the SEC were to adopt our recommendation and prohibit the allocation of brokerage based on sales, it should be recognized that such a rule could have the potential to improperly discourage funds from using brokers that sell fund shares for portfolio transactions, for fear of being second-guessed. The letter notes that this could result, in some cases, in funds not using the brokerage firm that would be best suited for executing a trade. To address this concern, the Institute recommended that the SEC adopt a rule that would ensure that the use of a broker that sells shares of a fund to execute trades in that fund's portfolio securities would not, by itself, subject the fund to potential liability if its board has adopted policies and procedures reasonably designed to prevent sales from being considered in connection with brokerage allocation. Amy B.R. Lancellotta Senior Counsel Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (<http://members.ici.org>) and search for memo 16889, or call the ICI Library at (202) 326-8304 and request the attachment for memo 16889. Attachment (in .pdf format)

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