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COMMENT LETTER

February 9, 2007

ICI Comment Letter to the Committee of European Securities Regulators on Inducements Under MiFID (pdf)

February 9, 2007 Fabrice Demarigny The Committee of European Securities Regulators 11-13 avenue de Friedland 75008 Paris FRANCE Re: Public Consultation CESR/06-687 – Inducements under MiFID Dear Mr. Demarigny, The Investment Company Institute1 is writing to encourage the Committee of European Securities Regulators ("CESR") to recognize that soft commission and bundled brokerage arrangements can be effectively managed and that continuing to allow investment managers the flexibility to employ these arrangements is consistent with the requirements of Article 26 of the MiFID Level 2 Implementing Directive. We also encourage CESR to consider a harmonized EU approach to limiting the types of services that can be obtained with soft commissions, although we caution that any such approach should be narrowly tailored and recognize market developments in the use of soft commissions and bundled brokerage. We express these views in connection with CESR's public consultation on Inducements under MiFID (the "Consultation Paper"). Institute members, with more than US $10 trillion in assets under management, are keenly interested in the effective and appropriate use of trading commissions, and especially in assuring that the regulatory framework governing commission practices operates in the interests of investors. As recognized by current European law and regulations, soft commission arrangements, when used appropriately, can provide valuable benefits to investors by facilitating investment managers' access to research and other services that enhance managers' investment decisions. As explained below, we are concerned that the statements by CESR in the Consultation Paper regarding bundled brokerage and soft commission arrangements suggest a presumption that these arrangements contain inherent and insurmountable conflicts. We disagree: legal and fiduciary obligations, prudent regulatory approaches, and market mechanisms can effectively address potential conflicts. We are also concerned that the statements in the Consultation Paper suggest that CESR may be considering requiring that investment managers provide "unbundled" disclosure of bundled commissions. We urge CESR not to adopt this approach. 1 The Investment Company Institute is the national association of the U.S. investment company industry. More information about the Institute is available at the end of this letter. Mr. Fabrice Demarigny February 9, 2007 Page 2 of 5 Managing Potential Conflicts in Soft Commission Arrangements As described in the Consultation Paper, a "bundled" commission is one in which a broker charges a single commission for providing both trade execution and other goods and services to an investment manager. The Consultation Paper asserts that these "arrangements could lead to overtrading (to gain commission credits to buy new services), poorer execution than otherwise, and to the over-

consumption of non-execution services . . . which would result in higher costs for investors." The Consultation Paper also states that bundled brokerage arrangements provide "no transparency over the costs of the soft commission arrangements and therefore limited opportunity for the investment manager to ensure value for money." A number of factors address these concerns and help ensure that investment managers make appropriate use of soft commissions. For example: • Investment managers are—or soon will be under MiFID—subject to a legal obligation to obtain best execution for client transactions and a fiduciary duty to otherwise act in the best interests of their clients. As a result of these obligations, managers may not trade portfolio securities in client accounts in a manner that would benefit the manager at the expense of the client.2 • Specific regulations limiting the types of services that may be obtained with soft commissions help ensure that use of soft commissions is consistent with an investment manager's duty to act in the best interests of clients. For example, regulators in the United Kingdom, France, Canada, and the United States have all taken steps in recent years to limit the uses of soft commissions to those that could reasonably be expected to enhance the quality of services provided to an investment manager's clients.3 • Investment managers have a powerful incentive to pursue the best possible performance. This acts as a natural check against CESR's concerns about overtrading, acceptance of poor 2 Best execution requirements and fiduciary obligations are reinforced in the context of managers of U.S. mutual funds with the requirement that U.S. fund managers adopt internal compliance procedures that provide additional controls to ensure that soft commission arrangements are not being misused. An additional control mechanism in the United States is the oversight of soft commission arrangements by fund boards, which are required to review a manager's use of soft commissions as part of the annual determination whether to renew a fund management contract. 3 In the United States, the Institute supported the SEC's recent interpretive guidance on soft commission arrangements that effectively narrowed the scope of soft commission products and services available to fund managers. Among other things, the SEC's interpretive guidance required that research services obtained with soft commissions contain substantive content involving the expression of reasoning or knowledge. The SEC guidance also made clear that an investment manager may not rely on statutory protections if using soft commissions for the payment of operational overhead expenses (for example, membership dues, office equipment and furniture, or travel, entertainment, and meals associated with attending seminars and meetings with corporate executives or analysts). Mr. Fabrice Demarigny February 9, 2007 Page 3 of 5 execution quality, and overconsumption of non-execution services because all of these would negatively affect performance to the long-term detriment of the investment manager. This combination of legal and fiduciary obligations, prudent regulatory controls, and existing market mechanisms provides an effective framework for managing soft commission arrangements. As a result, we believe that continuing to allow investment managers the flexibility to use soft commission arrangements and bundled brokerage is consistent with the requirements of Article 26 of the MiFID Level 2 Implementing Directive.4 As reflected in the second bullet point above, we believe that a common European approach to limiting the types of services that can be obtained with soft commissions would be appropriate and beneficial to investment managers and their clients by establishing clear guidelines and simplifying regulatory compliance for managers operating in multiple European countries. "Unbundled" Disclosure The Consultation Paper notes that it is possible to use commissions to pay for non-execution goods and services without commission charges being bundled. The Consultation Paper also asserts that bundled brokerage arrangements provide "no transparency over the costs of the soft commission arrangements and therefore limited opportunity for the investment manager to ensure value for money." We are concerned that these statements suggest that CESR may be considering mandating that investment

managers provide “unbundled” disclosure of bundled commission charges. We have previously expressed concern to European regulators regarding approaches that mandate unbundled disclosure by investment managers without also requiring brokers to provide unbundled information to the managers.5 An “unbundled” disclosure obligation placed only on investment managers, without a corresponding obligation on the brokers who provide and price commission services, will generate inconsistent disclosure of limited benefit to clients and may create the potential for client and market confusion rather than desired improvements in market efficiency and competition. For these reasons, we believe that CESR should not adopt this approach. * * * * 4 Specifically, Article 26(b)(ii) of Level 2 Implementing Directive 2006/73/EC, which states that “the provision of the non- monetary benefit must be designed to enhance the quality of the relevant service to the client and not impair compliance with the firm’s duty to act in the best interests of the client.” 5 We expressed our views on unbundled disclosure more fully in a comment letter to the UK Financial Services Authority in response to its consultation on bundled brokerage and soft commission arrangements for retail investment funds. See Letter from Elizabeth Krentzman, General Counsel, Investment Company Institute, to Mr. Mark Glibbery, UK Financial Services Authority, dated Jan. 5, 2006 (CP05/13), available at http://www.ici.org/statements/cmltr/06_eu_soft_dollar_com.html. Mr. Fabrice Demarigny February 9, 2007 Page 4 of 5 We appreciate the opportunity to express our views on this important topic. If you have any questions about our comments or would like any additional information, please contact me at +1 202- 371-5430, or Glen Guymon at +1 202-326-5837. Sincerely, /s/ Robert C. Grohowski Robert C. Grohowski Senior Counsel Mr. Fabrice Demarigny February 9, 2007 Page 5 of 5 About the Investment Company Institute The Investment Company Institute seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Institute members include 8,795 open-end investment companies (mutual funds), 658 closed-end investment companies, 325 exchange-traded funds, and 4 sponsors of unit investment trusts. Mutual fund members of the Institute have total assets of approximately $10.279 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 93.9 million shareholders in more than 53.8 million households.
