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ICI Urges SEC Rulemaking on Soft Dollars, Directed Brokerage, December 2003

December 16, 2003

The Honorable William H. Donaldson
Chairman
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Donaldson:

The Investment Company Institute[1] is writing to urge the Commission 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").

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First, with respect to soft dollars, the Institute believes that the Commission should 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:

- Computer hardware and software, and other electronic communications facilities, used in connection with trading or investment decision-making;
- Publications, including books, periodicals, newspapers and electronic publications, that are available to the general public; and
- Third-party research services.

The purposes of such an interpretation would be to (1) ensure that the payment through commissions for products and services that have the attributes of traditional overhead and more routine expenditures of investment managers would fall outside of the safe harbor, and (2) limit the scope of the safe harbor to those research-related products and services that are produced by and provided directly by the broker-dealer receiving the commissions. We believe that this 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 we believe 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.[2]

We further recommend 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.[3] Such a step 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.

Second, with respect to directed brokerage, the Institute believes that the SEC and NASD should 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. While the ability of fund advisers to take sales into account in allocating brokerage is strictly regulated under existing NASD rules, we believe that, in order to avoid both the appearance of conflicts of interest and the potential for actual conflicts, it would be appropriate to further tighten regulation in this area.

At the same time, we recommend that the Commission 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. Such a rule should provide a safe harbor for the use of such a broker in those cases where a fund has adopted policies and procedures reasonably designed to prevent sales from being considered in connection with brokerage allocation.

Our recommendations are discussed further below.

Background

Section 28(e) was enacted by Congress in 1975. The section was enacted in response to concerns that, with the unfixing of commissions, money managers might be held liable if they paid more than the lowest possible commission rate. Accordingly, Section 28(e) created a safe harbor that permits money managers to pay for brokerage and research services with commissions, subject to various conditions.

In 1976, the SEC issued an interpretive release on Section 28(e).[4] That release took the position that the safe harbor did not apply to products and services that were readily and customarily available and offered to the general public on a commercial basis. The 1976 Release listed several types of products and services that the Commission felt did not fall within the safe harbor; these included "newspapers, magazines and periodicals, directories, computer facilities and software, government publications, electronic calculators, quotation equipment, office equipment, airline tickets, office furniture and business supplies."[5]

In 1986, the Commission reinterpreted the scope of the safe harbor in a manner that broadened it substantially. In particular, it dropped the limitation on products and services offered to the public on a commercial basis. Instead, the SEC stated that whether or not a product or service constitutes "research" for purposes of the safe harbor depends upon "whether it provides lawful and appropriate assistance to the money manager in carrying out his investment decision-making responsibilities."[6] The release further noted that, in the case of products and services that related to both research and non-research functions ("mixed-use" products and services), the investment adviser should reasonably allocate their cost and pay for the latter directly (i.e., through "hard dollars"). The Commission recognized in the release that it can be difficult to allocate these costs in a precise manner, and stated that it would be sufficient if investment advisers make a good faith attempt to do so.

In addition, while Section 28(e), by its terms, refers to brokerage and research services that are "provided by" the broker that receives the commissions, the Commission consistently has interpreted this as encompassing certain services produced by third parties.[7] In particular, such services may fall within the safe harbor if the broker, as opposed to the investment adviser, is the entity obligated to pay the third party.

In 1998, the Commission's Office of Compliance Inspections and Examinations issued an inspection report on soft dollar practices.[8] Although the report noted several instances of questionable practices, it did not report any significant shortcomings on the part of mutual fund advisers.

Discussion

Scope of the Safe Harbor. The ICI believes that the SEC should issue a new interpretive release that, for purposes of Section 28(e), excludes from the definition of "brokerage and research services" the following: (1) computer hardware and software, and other electronic communications facilities, used in connection with trading or investment decision-making; (2) publications, including books, periodicals, newspapers and electronic publications, that are available to the general public; and (3) third-party research services, i.e., services provided or produced by a party other than the broker receiving the commissions.

It is important to note that paying for the products and services listed above with commissions is clearly permissible under current SEC interpretations of Section 28(e), subject to appropriate disclosure. Thus, we are not suggesting that any investment adviser that has purchased such products and services in this manner and has made appropriate disclosure was not entitled to rely on the safe

harbor for this activity or has otherwise has done anything unlawful or improper. Nevertheless, we believe that the Commission should reinterpret existing standards and tighten them on a going-forward basis.

As the Commission has recognized, traditional overhead expenses of an investment adviser are not within the safe harbor. Yet the products and services listed above in categories (1) and (2), while not traditional overhead expenses, nevertheless may have attributes of overhead expenses because they encompass the types of expenses that any investment adviser may need to incur in carrying out its responsibilities. In fact, it is our understanding that many investment advisers already pay for much or all of these expenses directly. Removing these items from the safe harbor would assist investors in comparing the fees and expenses of different investment advisory firms. It also would reduce significantly the need to allocate "mixed use" expenditures, which, as noted above, can be difficult to do in a precise manner.[9]

Our recommendation with respect to third-party research does not represent, in any way, a judgment that proprietary research is somehow "better" than third-party research. It is, rather, based on our conclusion that there is no inherent reason why research provided by one firm should be bundled with execution services provided by a different firm. In contrast, where both types of services are provided by the same entity, allocating costs between the two can be difficult, particularly since brokerage firms do not typically break out such costs.[10]

Investment Advisers Act Rulemaking. We further recommend that the SEC adopt a rule under Section 206(4) of the Investment Advisers Act that would prohibit an investment adviser from using client commissions to pay for any products or services used by the adviser that fall outside the safe harbor with commissions.[11]

Because Section 28(e) is a safe harbor, failure to comply with its terms does not, in and of itself, violate any provision of law. For certain investment advisers, however, using commissions outside of the safe harbor raises serious issues under federal law. These include advisers to mutual funds and to pension plans under ERISA.[12] In contrast, advisers to other types of accounts are not subject to similar substantive limitations. Instead, such advisers are only required to provide disclosure about their use of soft dollars in Form ADV.[13]

We believe that similar standards should be applicable to all investment advisers. It can be difficult for all but the most sophisticated investors to understand and effectively monitor an adviser's use of soft dollars outside the safe harbor, and to understand their impact on the adviser's expenses and trading activity. Moreover, the 1998 OCIE Report noted that disclosure by advisers concerning their use of soft dollars was not very effective; less than half of the advisers examined provided disclosure "with sufficient specificity to enable clients or prospective clients to understand what was being obtained." Even more importantly, OCIE found that, of those advisers who purchased products or services outside the safe harbor, none provided sufficient disclosure.[14]

The SEC has proposed revisions to the disclosure requirements of Form ADV that would enhance disclosure of soft dollar arrangements. While these amendments, if adopted, may result in more meaningful disclosure being provided to investors, we believe that there is little justification for treating certain investment advisory clients differently than others with regard to permissible uses of their commissions. Consequently, we urge the Commission to adopt a rule that would extend the protections afforded to mutual funds and ERISA accounts to all investment advisory clients.

2. Brokerage for Sales

Background

The ability of a mutual fund adviser to take into account sales of fund shares in allocating brokerage is currently governed by NASD Conduct Rule 2830(k). Rule 2830(k) permits this practice, but only subject to various conditions. Among other things, (1) the policy must be described in the fund's prospectus, (2) no broker may favor or disfavor the sale of fund shares based on commissions it receives, (3) no broker may demand commissions as a condition for selling shares of a fund, and, perhaps most importantly, (4) the broker must provide best execution.

Put another way, NASD rules only permit sales of fund shares to be taken into account "after the fact" and only where the broker is providing best execution (i.e., a fund cannot "pay up" for distribution-related services).

Discussion

Despite the strict nature of the restrictions noted above, the Institute has come to the conclusion that a further tightening of regulation in this area is warranted. In particular, we recommend that the SEC and/or NASD adopt new rules that would prohibit funds from taking into account sales of fund shares in allocating fund brokerage. At the same time, in order to ensure that such a strict rule does not inadvertently call into question legitimate brokerage allocations, we recommend that the SEC adopt a narrow safe harbor for funds that use brokers that also sell shares of the fund.

Prohibition on Taking Sales Into Account. Under our recommendation, distribution considerations could play no role in the allocation

of brokerage, even in the limited circumstances permitted under current law. The Institute has concluded that such a change is warranted because this practice can give rise to the appearance of a conflict of interest, as well as the potential for actual conflicts, given the fact-specific nature of the best execution determination.

We understand that the Commission may consider soon the issuance of an interpretive release on the use of brokerage for sales. Among other things, the release may require funds to treat, in certain circumstances, a portion of their brokerage commissions as distribution costs (which would, in turn, require that portion of commissions to be made pursuant to a Rule 12b-1 plan).

We believe that prohibiting the allocation of brokerage based on sales considerations—rather than seeking to regulate the practice under Rule 12b-1—would be far more effective in addressing conflicts and restoring investor confidence. Accordingly, we urge the Commission to consider and act upon our recommendation as soon as possible.

In order to implement this recommendation, NASD Rule 2830(k) would have to be amended. It also may be advisable for the SEC to adopt its own rule under the Investment Company Act, as funds and fund advisers are not regulated by the NASD, and the issue of fund brokerage is more properly regulated under the Investment Company Act.

Safe Harbor Rule. While we strongly believe that the SEC should prohibit, going forward, 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. This could result, in some cases, in funds not using the brokerage firm that would be best suited for executing a trade.

In order to address this concern, we believe the SEC should promulgate a safe harbor rule that would expressly permit the use of such a brokerage firm in certain circumstances. In particular, we would recommend that such a rule state that a fund would not be deemed to violate the prohibition on taking sales into account in allocating brokerage if its board has adopted policies and procedures that are reasonably designed to ensure that sales considerations do not affect the fund's brokerage allocation practices. These policies and procedures could include, for example, (1) placing brokerage allocation determinations under the control of trading and investment personnel, (2) affirmatively prohibiting marketing personnel from playing any role in brokerage allocation, and (3) periodic review by fund boards.[15]

* * *

We appreciate your consideration of our recommendations, and would be pleased to discuss them further with you, other members of the Commission, or the members of the Commission staff.

Very truly yours,

Matthew P. Fink
President

cc: The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid

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ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,928 open-end investment companies ("mutual funds"), 499 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.898 trillion, accounting for approximately 95 percent of total

industry assets, and over 88.6 million individual shareholders.

[2] Some have suggested that Section 28(e) be repealed altogether. We agree that this is an issue that may warrant further study and consideration. In any event, however, repeal of Section 28(e) would require an act of Congress. In contrast, the Commission has ample authority to issue an interpretation along the lines that we suggest, and we urge it to do so.

[3] As the Commission is aware, investment advisers that manage accounts for clients other than those subject to the Investment Company Act of 1940 or ERISA may use client commissions to pay for services or products outside the safe harbor.

[4] Securities Exchange Act Release No. 12251 (March 24, 1976) (the "1976 Release").

[5] Id.

[6] Securities Exchange Act Release No. 23170 (April 23, 1986). The Commission said, however, that the safe harbor did not encompass "obvious overhead expenses such as office space, typewriters, furniture and clerical assistance." Id. at note 10.

[7] See the 1976 Release (" . . . Section 28(e) might, under appropriate circumstances, be applicable to situations where a broker provides a money manager with research produced by third parties . . .").

[8] Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds (September 22, 1998) ("OCIE Report").

[9] In many respects, our recommendation with respect to categories (1) and (2) would be similar to the standard set forth in the 1976 Release. We do not necessarily believe, however, that this is the best standard; we note that one of the reasons the Commission revised its interpretation of Section 28(e) in 1986 was that it believed that the 1976 standard was difficult to apply in practice. Consequently, there may be better ways to narrow the standard than by returning to the 1976 standard, and we urge the Commission to explore possible alternatives.

[10] Under the "Global Settlement" announced on April 28, 2003, ten broker-dealer firms have committed to making available independent, third-party research at no cost to their customers. As the availability of such research is not dependent on the receipt of any particular level of commissions, we would recommend that this research continue to fall within the safe harbor.

[11] Our proposal is not intended to affect traditional directed brokerage arrangements, in which a client directs its adviser to use commissions to obtain products or services that are used by the client. Since the adviser is being directed by the client in these arrangements, the adviser does not need to rely upon Section 28(e).

[12] In the case of advisers to mutual funds and other registered investment companies, such conduct could be in violation of Section 17(e)(1) of the Investment Company Act, which prohibits an adviser to a fund from receiving "any compensation" when purchasing or selling any property as agent for the fund. Similarly, investment advisers to ERISA plans may be exposed to liability for the receipt of products or services outside the safe harbor, since that activity may not be consistent with ERISA's "exclusive benefit" requirement or may otherwise violate ERISA's prohibited transaction rules.

[13] The Commission has taken the position that, for purposes of the federal securities laws, payment for products and services outside the safe harbor by investment advisers (other than advisers to registered funds and ERISA accounts) is permissible if the adviser's client has consented, and that consent can be inferred if the arrangements were disclosed in the adviser's Form ADV. See OCIE Report, supra note 8, at 9.

[14] OCIE Report, supra note 8, at 40. In addition, the Commission has, on a number of occasions, sanctioned advisers who have used soft dollars to pay for products and services outside the safe harbor without making adequate disclosure. See, e.g., Dawson-Samberg Capital Management, Inc., Investment Advisers Release No. 1889 (Aug. 3, 2000); Marvin & Palmer Assoc., Inc., Investment Advisers Release No. 1841 (Sept. 30, 1999); Renaissance Capital Advisors, Inc., Investment Advisers Act Release No. 1688 (Dec. 22, 1997).

[15] If the SEC decides to adopt its own rule on brokerage for sales, the safe harbor could be included as part of that rule.
