Responding to Mutual Fund Investors' Changing Needs

MUTUAL FUND DISTRIBUTION and SHAREHOLDER SERVICING PRACTICES

WHITE PAPER

SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION[1]

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I. Introduction

Compensation arrangements between fund complexes and broker-dealers support a wide range of services that benefit fund investors and facilitate the enormous diversity in fund products.

Funds,[2] and the broker-dealers that sell them, offer investors an unprecedented range of investment choices. In the 1960s, investors had a relatively small number of funds from which to choose and (with the limited exception of no-load funds) could buy them only by paying an up-front load of approximately 8%. Today, investors may pick from literally thousands of funds and may pay for those investments in a variety of ways.

The Securities and Exchange Commission's (the "SEC" or the "Commission") adoption of Rule 12b-1 under the Investment Company Act of 1940 (the "1940 Act") has been one of the critical events in facilitating diversity in fund products, although that action has both fostered, and been accompanied by, other innovations in fee arrangements. As the number and types of funds, the number of channels through which funds may be purchased, and the demands of clients for more sophisticated advice have increased, broker dealers, third party retirement plan administrators and fund complexes have developed additional fee arrangements to support those broad investment choices, and the distribution, servicing and administrative costs they entail. The developments of these fee arrangements, and the services that they support, have given investors many more choices. Unfortunately, as those fee arrangements have become more diverse, it may have become more difficult for investors to keep track of how these relationships work. This WHITE PAPER seeks to explain those relationships in simple terms. It addresses not

[1] The Securities Industry and Financial Markets Association ("SIFMA") brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

One of SIFMA's predecessor organizations, the Securities Industry Association ("SIA") originally published this WHITE PAPER on May 10, 2004. SIFMA has now revised the WHITE PAPER to reflect legal developments that have occurred in the past three years. Dechert LLP assisted SIA with the preparation of the original WHITE PAPER and has assisted SIFMA with its revision.

[2] We use the term "funds" to refer to mutual funds, unit investment trusts, municipal fund securities, variable annuity contracts and variable life insurance policies.

only Rule 12b-1 fees but also discusses other aspects of the relationships between fund complexes and broker-dealers. SIFMA hopes that this WHITE PAPER will give policy makers a clearer picture from which to make decisions.

SIFMA notes that the developments in the relationships between funds and broker-dealers have outpaced the development of disclosure regulations regarding these relationships. Investors need more information about these marketing and servicing arrangements. Investors should have a good understanding of the fees that they are paying in connection with their investment in mutual funds. At the same time, it is not helpful to bury investors in minutiae about the relationships between funds and broker-dealers.

II. Executive Summary

The development of the relations between broker-dealers and fund complexes is a story of innovation and creating choices for investors.

- The SEC adopted Rule 12b-1 at a time of moribund fund sales and high loads.
- The SEC's adoption of that rule and other revenue sharing arrangements fostered many innovations by the brokerage and fund industries.
- Broker-dealers and fund complexes have developed new approaches to meeting investors' needs. Investors now have a multitude of choices as to the funds that they wish to buy, how they wish to pay for those funds and the services that support those investments.
    - Investors who so choose may buy low cost no-load funds from distributors.
    - But investors may also choose:
        - Professional advice – some investors prefer to buy funds with the assistance of a broker-dealer, who will help them select the fund and consider the fund in the context of a suitable investment strategy and asset allocation plan.
        - Diversity of Fee Arrangements – investors may choose to pay front load, spread load, contingent deferred sales charge, or some combination of these fee arrangements.
        - Variety of Platforms – some investors may choose to buy funds from a broker-dealer that the registered representative recommends. Others may select their own funds or use a financial planner and purchase through a fund supermarket.

- As funds have evolved, so have the shareholder servicing arrangements that support them.
    - Broker-dealers and funds have developed innovations to improve efficiency and service to customers.
    - For example, many funds have chosen to delegate most of their traditional responsibilities, such as recordkeeping, to the broker-dealer. Investors benefit from the efficiencies because they see their entire portfolio on one

statement, which helps them and their registered representative manage the accounts comprehensively.

Service fees facilitate such arrangements and allow the marketplace to develop efficiencies and innovations.

- Fee arrangements between the mutual fund complex and the selling broker-dealer also have become more elaborate. These include revenue sharing or payments for shelf space, in which a fund's adviser or other affiliate pays a fee to the selling broker-dealer.

    - Such payments are a legitimate source of revenue for the broker-dealer.
    - Broker-dealers may use such payments in conjunction with their due diligence and selection process for funds.
    - Fund complexes also may pay for educational and training activities in accordance with NASD Rules.

  Broker-dealers look at these fees holistically and use them to fund the many different services and arrangements associated with providing mutual funds to investors.

  It is entirely legitimate for fund complexes to pay broker-dealers for entering into such distribution arrangements. But broker-dealers and funds must ensure that investors have meaningful disclosure of these arrangements so that investors are able to evaluate the incentives properly.

- Mutual fund boards should be able to approve and evaluate Rule 12b-1 plans in circumstances involving expanding investor choice and offering innovation. Fund boards should not fear "second guessing," provided that the fees serve the needs of investors.

In short, Rule 12b-1 has been a success; curtailing or withdrawing the rule would harm investors and competition in the marketplace. Similarly, other fee arrangements have fostered innovation and supported higher levels of services. It may be appropriate to improve disclosures for the benefit of investors and fund boards, but it would be a major mistake for the SEC to withdraw or substantially curtail Rule 12b-1, or otherwise to restrict the fee arrangements that have fostered innovation, flexibility, and investor choice.

III. **Historical Overview**

Fund sales have always involved shared responsibilities between the fund complex and the broker-dealer. During the past forty years, the fund landscape has changed dramatically. In 1966, the Commission observed in a report to Congress (the "PPI Report") that:

> Some mutual funds – the so-called "no-load funds" -- sell their shares at net asset value without the imposition of a sales load. No-load funds, however, account for only a small share of total mutual fund assets and shareholder accounts. The overwhelming majority of mutual fund shareholders invest in "load" funds.

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> The purchase price of a load fund share consists of two elements — its net asset value and a sales load. The sales load is by far the most significant charge paid by mutual fund investors. Rarely is the basic load less than 7.5 percent of the total price that the investor pays and it has not exceeded 9 percent. An 8.5 percent sales load is most common.[3]

The PPI Report stated that mutual funds also supported sales efforts through the use of fund brokerage.[4]

Even in the 1960s, mutual fund sales were not as simple as sales of other investments. Two authors noted in a 1964 Article that:

> [T]he execution of fund share orders was not as easy to handle as executions involving other securities because of the variety of plans, withdrawal privileges, letters of intent, and other options being offered by the funds. A significant percentage of orders were said to require a telephone call to the fund's principal underwriter to clarify or verify the terms of the purchase.... [and] the bookkeeping operations needed to serve a fund-owning client were generally more time consuming than required for servicing a "regular" customer account.[5]

The 1964 Article also noted that it takes broker-dealers and funds more time to sell a mutual fund share than it does to sell a share of common stock.

Compare the situation of the mid-1960s to the choices available to fund investors today. The fund and securities industries developed a host of innovations and new choices that they made available to mutual fund investors. Working within the statutory framework, the SEC and NASD have fostered an environment open to innovation. The private sector welcomed that opportunity and developed new products and choices to meet a broader range of investors' needs. Some examples include:

- **Expansion of "No Load" Funds --** No load funds do not impose an initial sales charge on investors (although they do have other types of fees and expenses). By the mid-1970s, no-load mutual funds had become very popular with investors,[6] and such popularity further increased with the development of fund supermarkets in the 1990's.

- **Development of Rule 12b-1 --** In 1980, the SEC adopted Rule 12b-1 under the 1940 Act, which permits mutual funds to use their assets to pay for distribution, as

3 Report of the SEC on the Public Policy Implications of Investment Company Growth[3] ("PPI Report") H.R. REP. No. 2337, 89th Cong., 2d Sess. (issued December 2, 1966), at 204.

4 During 1965, larger mutual funds and fund complexes allocated about 53% of their combined brokerage commissions to compensate dealers who sold their shares, 13% to pay for supplementary advisory, pricing, wire and other services, and the remainder was allocated on the basis of a broker's ability to execute transactions. *Id*., at 166. *See* discussion below regarding this practice.

5 Lehr, Dennis J. and Meyer Eisenberg, MUTUAL FUND RETAILING: ASPECTS OF MARKET STRUCTURE AND DEALER OPERATIONS, at ch. 2 (June 1964) ("1964 Article").

6 SEC DIVISION OF INVESTMENT MANAGEMENT, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION, at 321 (1992) ("Protecting Investors Study"), *citing* SEC DIVISION OF INVESTMENT MANAGEMENT REGULATION, MUTUAL FUND DISTRIBUTION AND SECTION 22(D) OF THE INVESTMENT COMPANY ACT OF 1940, at 19, 20-22 (1974).

long as the fees are disclosed to shareholders and scrutinized by the mutual funds' boards of directors.[7] Since Rule 12b-1 was adopted, more than half of all mutual funds have adopted Rule 12b-1 plans, using these charges, alone or with sales loads, as the primary means of financing distribution.[8] Other mutual funds have added a relatively modest Rule 12b-1 fee to pay for some sales commissions, printing prospectuses and sales literature, advertising, and similar expenses.[9] Although the SEC adopted Rule 12b-1 to assist no-load mutual funds to finance their distribution expenses, the vast majority of *load* mutual funds have adopted Rule 12b-1 plans as a complement to, or a substitute for, a front-end sales load. Such plans have also made it economically viable for fund supermarkets to more broadly offer no-load funds. Mutual fund front end sales loads have declined substantially since the adoption of Rule 12b-1.[10]

- **Development of Multiple Class Structures --** Funds began to adopt multiple class structures in 1985. Fund complexes tailor different classes to differing needs of investors. Some multiple class funds enter into arrangements whereby particular classes of fund shares are sold to specific institutional investors, such as banks acting in a fiduciary, advisory, agency, custodial, or similar capacity on behalf of customer accounts, insurance companies, investment counselors, brokers, or other financial institutions.[11] These funds use a combination of 12b-1 fees and contingent deferred sales charges ("CDSCs"), to finance distribution of certain share classes, in lieu of front-end loads.

    - Each class of a multiple class fund must have a different arrangement for shareholder services or distribution or both, and must pay all of the expenses of that arrangement.

    - Multiple class funds may also permit investors to select the method of financing distribution best suited to their investment horizon and the size of their investment.[12] Some investors may wish to pay a front-end sales load, whereas others may wish to avoid paying a front-end sales load to enable 100% of the proceeds to be invested, and are willing to pay a Rule 12b-1 fee and potential CDSC instead.[13]

As the type and level of mutual fund charges began to change, the NASD revised its rules governing the level of mutual fund sales loads and distribution fees. NASD Conduct Rule

[7] *Id*., at 322.
[8] *Id*., at 320.
[9] *Id.*
[10] *See* FUNDAMENTALS: INVESTMENT COMPANY INSTITUTE RESEARCH IN BRIEF, vol. 11, no. 4 (Sept. 2002), *available at* http://www.ici.org/pdf/fm-v11n4.pdf.
[11] *See id*., at 330.
[12] *Id.*, at 331.
[13] However, the NASD has taken enforcement actions against broker-dealers who have sold B shares to individuals in instances in which A shares would have been an economically superior investment. *See, e.g.*, McLaughlin, Piven, Vogel Securities, Inc. (MPV) (press release available at http://www.nasdr.com/news/pr2003/release_03_027.html). Most broker-dealers and their customers consider the results of the NASD Expense Analyzer in conjunction with a recommendation to buy B shares. *See* NASD Expense Analyzer Homepage, http://apps.nasd.com/investor_Information/ea/nasd/mfetf.aspx.

2830(d):

- imposes aggregate limits on the front-end, deferred and asset-based sales charges paid by a fund distributed through an NASD member; and

- limits the annual amount of "service fees" that such a fund may pay, and prohibits a fund from describing itself as "no-load" if the fund's total asset-based sales charges and/or service fees exceed 0.25% of the fund's average annual net assets.

There also seems to be some confusion as to whether funds and broker-dealers are using Rule 12b-1 fees in ways in which the SEC did not intend. That theory is inconsistent with the history of the rule and the SEC's oversight. First, the text of Rule 12b-1(a)(2) provides that permissible activities include, but are not necessarily limited to, "advertising, compensation of underwriters, dealers, and sales personnel, the printing and mailing of prospectuses to other than current shareholders, and the printing and mailing of sales literature." Second, the Commission and the staff approved various steps in the evolution of the use of Rule 12b-1 fees. For example, the Commission adopted Rule 18f-3 under the 1940 Act to facilitate multiple class companies. The fund and brokerage industries have developed innovative approaches to the structure and fee arrangements for funds since the SEC adopted Rule 12b-1. The SEC and its Staff were very much engaged in this evolutionary process, and it would be inaccurate, and even unfair, to suggest otherwise.

The 1990s witnessed an historic transition of administrative and shareholder servicing responsibilities from fund complexes to broker-dealers, which introduced still more complexities and broker-dealers began to replace funds as the provider of various administrative services to customers. This increased broker-dealer servicing responsibility, coupled with substantially declining sales loads and regulatory caps on 12b-1 fees engendered the need for additional revenue sources, but also engendered some transparency shortcomings that need to be addressed. We discuss these arrangements in more detail below.

Similar changes occurred with respect to payments for research. At the time that the PPI Report was issued, broker-dealers charged fixed commission rates and provided a variety of services over and above transaction execution, including research. In 1975, Congress and the SEC abolished fixed commission rates. Congress also enacted a safe harbor under Section 28(e) of the Securities Exchange Act of 1934 (the "Exchange Act") to protect advisers from claims that they had breached their fiduciary duties by causing clients to pay more than the lowest available commission rates in exchange for research and execution.

Since 1975, the use of soft dollars has grown, as has the number of firms that provide research and other products and services in exchange for soft dollars. An SEC staff study found that almost all investment advisers obtain products and services (both proprietary and third-party) other than pure execution from broker-dealers and use client commissions to pay for those products and services.[14] The total value of third-party research purchased annually with soft

[14] SEC OFFICE OF COMPLIANCE, INSPECTIONS AND EXAMINATIONS, INSPECTION REPORT ON THE SOFT DOLLAR PRACTICES OF BROKER-DEALERS, INVESTMENT ADVISERS AND MUTUAL FUNDS (September 22, 1998), at Section I.

dollars is estimated to exceed $1 billion.[15] The SEC continues to scrutinize soft dollar practices, as it has done on a recurring basis since 1975.[16]

Finally, the types of products currently available far exceed what was available when the SEC originally examined mutual fund distribution practices. Investors may now purchase mutual funds through IRAs, 401(k)s and other retirement plans. Mutual funds also offer shares to qualified education plans. These types of plans and programs did not exist in the 1960s. Investors may also purchase variable annuity contracts and variable life insurance policies – these products were in their infancy in the 1960s.

IV. **Services Provided**

Revenue sharing and other payments described in Section IV. support a broad variety of marketing distribution and shareholder servicing activities that broker-dealers provide. Some payments support administrative and recordkeeping services, including services that were previously viewed as "fund" responsibilities. Payments support training and education of a broker-dealer's registered representatives. Broker-dealers may also apply payments to defray the cost of educating retirement plan participants about the various investment options available to them. Still other payments are made in exchange for research provided by the broker-dealer. We discuss these practices in more detail below.

A. *Marketing Support Services*

1. Shelf space.

Mutual funds advisers typically pay wirehouses or clearing firms for "shelf space." Introducing firms typically make available to their customers those funds carried by their clearing firms; consequently, introducing firms typically do not receive payments from the fund complexes for shelf space.

One concern about payments for shelf space is that a broker-dealer may tend to recommend one fund over another solely because the fund or the registered representative receives a greater incentive to sell that fund. However, broker-dealers typically perform initial due diligence before adding a fund or fund complex to its menu of options, and will perform continuing due diligence on the fund complex and its funds. Many broker-dealers also perform quantitative analytics with respect to funds in order to generate a list of recommended funds.[17] SIFMA notes several trends:

[15] *Id.*

[16] The Commission has issued a series of interpretive releases to provide money managers and broker-dealers with compliance guidance. The most recent example is Exchange Act Release No. 54165 (July 18, 2006); 71 FR 41978 (July 24, 2006). SEC Chairman Christopher Cox has called for Congress to "consider legislation that would repeal or substantially revise Section 28(e) of the Securities Exchange Act of 1934, which provides a safe harbor for certain "soft dollar" arrangements between broker-dealers and money managers." Letter from the Honorable Christopher Cox, Chairman, U.S. Securities and Exchange Commission, to the Honorable Christopher Dodd, Chairman, Committee on Housing and Urban Affairs, U.S. Senate, May 17, 2007.

[17] Some broker-dealers will screen only funds offered through complexes making revenue sharing payments. Other broker-dealers will screen funds, regardless of whether the fund complex makes revenue sharing payments and offer those funds even if they provide no revenue sharing payments. Still other broker-dealers will screen funds, and attempt to enter into revenue sharing arrangements with only those fund complexes whose funds "pass" the screens.

- Many broker-dealers have essentially the same payment arrangements with all of the different mutual fund complexes whose funds they offer or recommend, thereby minimizing the incentive to sell one fund on the recommended list over another.
- Broker-dealers typically equalize compensation to their registered representatives for selling funds of the same type, thus reducing the point-of-sale incentive to sell one fund over another.
- While broker-dealers may have dealer-agreements with a large number of fund complexes, they tend to have revenue sharing arrangements with only some complexes and may only feature or recommend a small number of funds with which they have such arrangements. This is attributable to the fact that even large broker-dealers and their registered representatives cannot effectively master the features of thousands of different funds, and revenue sharing arrangements assist them in performing due diligence and training with respect to a manageable number of the funds.

Regardless of shelf space incentives, broker-dealers and their registered representatives have suitability obligations to their customers.[18] Broker-dealers and their registered representatives have powerful economic incentives to select funds that best meet their customers' needs. In an environment that offers thousands of funds on a multitude of platforms, customers have lots of alternatives.

SIFMA supports efforts to provide investors with additional disclosure about shelf space and other revenue sharing arrangements. But SIFMA does not believe that ending such arrangements would be in investors' best interests.

2. Training and Education

Payments for training and education may encompass enabling a fund's distributor to participate in, and present at, training conferences, defraying the cost of training and education intended to ensure that registered representatives are knowledgeable about funds being offered and can make suitable recommendations; and providing support and marketing concerning funds to registered representatives through internal sources (such as Internet web sites and mailings).

Such programs enhance the ability of registered representatives to help investors select funds that meet their needs. SIFMA believes it is entirely reasonable for the fund complex offering such products to defray some of the expenses associated with educating registered representatives about those products. NASD Conduct Rule 2830(1)(5)(C) specifically permits broker-dealers to accept such payments.[19] SIFMA believes such programs benefit investors and should continue.

B. *Administrative Services*

As noted above, broker-dealers provide various administrative, recordkeeping and

[18] *See e.g.* NASD Conduct Rule 2310.

[19] *See also* NASD Conduct Rule 2820(g)(4)(C), which also authorizes payments for training of associated persons with respect to the sale and distribution of variable contracts.

transfer agency services on behalf of funds. These services include:

- sub-accounting;
- shareholder account set up and maintenance;
- shareholder assistance;
- transaction processing and settlement;
- preparation and distribution of account statements and transaction confirmations;
- payment of fund distributions;
- distribution of prospectuses; and
- clearing and custodial services.[20]

These services have proven to be particularly important in connection with qualified retirement plans and qualified tuition programs. Broker-dealers have invested heavily in infrastructure to support sales of mutual fund shares.

Networking provides a concrete example of how revenue streams from fund complexes to broker-dealers may be beneficial to investors. Although there are a variety of such arrangements, let us examine a basic form of networking. Fund complexes (including their transfer agents) need to keep accurate records of which investors own their funds. The fund complex may choose to delegate this task to the broker-dealers that sell their funds (*i.e.*, with whom they have dealer agreements). Instead of incurring the recordkeeping expenses itself, the fund complex pays the broker-dealers to keep the shareholder records for its customers. Broker-dealers keep detailed records of purchases and sales in those mutual funds.

Networking offers advantages that go beyond a simple delegation of responsibility from one entity to another. Networking permits broker-dealers to provide investors with a single account statement detailing all of their mutual funds and other securities holdings, even if the investors have purchased shares of several different funds. In addition, investors will receive tax-related information from a single source. Consolidation of this information improves the quality of service to investors and may help them manage their accounts more effectively. For example, by consolidating all of this information, investors and their financial advisers can allocate assets and diversify their portfolios with greater ease than if they had to keep track of multiple statements from different fund complexes. In short, the flow of revenue from the fund complex to the broker-dealer to pay for networking offers clear advantages to investors.[21]

Another example of such services is when a broker-dealer provides telephone support to shareholders and hires staff dedicated to answering questions of registered representatives regarding the funds. These arrangements afford customers with an extensive range of choices; an investor may have access to more than 10,000 different mutual funds and

[20] When an investor invests in a fund directly, the fund typically pays its service providers for providing these administrative services to the customers. *Investment Company Institute* (SEC No-action Letter) (pub. avail. Oct. 30, 1998).

[21] SIFMA does not mean to suggest that broker-dealers that do not enter into networking arrangements do not provide good service; we simply note that when fund complexes pay revenue to broker-dealers, they are paying for a service that the fund complex would otherwise have to provide and that investors may benefit as a consequence of the arrangement. It belies the notion that all payments from fund complexes to broker-dealers are somehow nefarious.

share classes through a single broker-dealer.

V. Sources of Revenue

Broker-dealers receive payments in connection with sales of funds and the servicing of fund shareholders from a variety of sources including individual fund shareholders, fund assets and third parties including investment advisers, fund distributors or other affiliates.

These payments may take a variety of forms, including among others:

- Payments from fund distributors, either from front-end sales charges or from the distributors' assets (subsequently repaid through a deferred sales load);
- 12b-1 distribution and servicing payments from fund assets;
- Sub-transfer agent and other servicing fees and operating expense reimbursements from fund assets or fund affiliates; and
- Revenue sharing payments from management fees received from fund advisers or from fund affiliates.

In addition, broker-dealers may receive compensation from mutual fund complexes through soft dollar[22] arrangements in the form of commissions for effecting fund portfolio transactions. However, the SEC and NASD have banned certain reciprocal brokerage arrangements, sometimes also called "directed brokerage."[23]

Fund affiliates typically make hard dollar payments to broker-dealers. Some payments involve continuous revenue streams, which may be paid as a percentage of sales, as a percentage of net assets attributable to the broker-dealer's accounts, or as a combination of both. Fund

[22] As noted above, Section 28(e) of the Exchange Act specifically allows for such payments.

[23] The SEC amended Rule 12b-1 to prohibit "funds from paying for the distribution of their shares with brokerage commissions." Release No. IC-26591 (Sept. 2, 2004). The Commission added subsection (h) to the rule to prohibit a registered open-end investment company ("company") from, among other things, compensating a broker-dealer for selling its shares by directing to that broker-dealer the company's portfolio transactions. The amendment does permit a company to direct brokerage to a broker-dealer that sells shares issued by the company, provided that the company has implemented procedures reasonably designed to prevent informal arrangements in violation of the rule. The SEC's adopting release notes that the amendments are not intended to compromise best execution. *See id* at 54730.

In addition, the NASD amended its Rule 2830(k), the anti-reciprocal rule, to strengthen its prohibitions. New subparagraph (2) provides that

> No member shall sell shares of, or act as underwriter for, an investment company, if the member knows or has reason to know that such investment company, or an investment adviser or principal underwriter of the company, has a written or oral agreement or understanding under which the company directs or is expected to direct portfolio securities transactions (or any commission, markup or other remuneration resulting from any such transaction) to a broker or a dealer in consideration for the promotion or sale of shares issued by the company or any other registered investment company.

The amendments deleted paragraph (k)(7)(B) from the rules "Accordingly, a member may not sell the shares of, or act as an underwriter for, a fund that follows a policy of considering sales of shares of the fund as a factor in selecting broker-dealers to execute portfolio transactions." NASD *Notice to Members 05-04* (Jan. 2005), at 2.

affiliates may also make episodic payments – these payments usually support particular activities, rather than continuing activities. Both the form and amount of payments and the types of services provided in exchange for payments may depend upon whether the recipient is an introducing broker, a clearing broker, or a wirehouse. The amount of payments made and the particular activities undertaken may depend upon whether fund shares are sold to retail investors, IRAs, 401(k) plans, other qualified retirement plans, qualified tuition programs or to insurance company separate accounts supporting variable insurance contracts.

Broker-dealers use the various revenue streams to support distribution activities, as well as a broad array of shareholder services that are described above.

In the wake of a number of SEC, SRO, and state enforcement cases, broker-dealers and fund complexes have sought to expand substantially the disclosure provided to investors regarding these arrangements. The SEC proposed rules to expand confirmation disclosure and to institute a point of sale requirement.[24] Although the SEC has not adopted final rules, broker-dealers have enhanced disclosure regarding revenue sharing arrangements, based on the terms of the settlements in these enforcement cases. Brokerage industry practices vary, but they often include:

- Extensive revenue sharing information disclosed on websites and provided to customers in printed form. These disclosures provide information about which mutual fund complex is paying the broker-dealer and the amount it is paying. Broker-dealers often provide this information to customers at the time of account opening and periodically thereafter.

- Information on confirmations regarding revenue sharing. In the absence of an SEC rule, practices vary, but broker-dealers may include revenue sharing notifications on confirms. Such notices may direct customers to more extensive information on websites or elsewhere.

- Point of sale disclosure. Again, in the absence of an SEC rule, practices vary. Some firms may use, or have sought to develop, point of sale disclosures. Practical limitations and other factors have presented challenges.

- Generic compensation brochures. Some broker-dealers have prepared extensive descriptions of how their compensation systems work in general terms.

Broker-dealers also recognize that it may not be sufficient to rely on the disclosures in fund prospectuses or other documents, since those materials only describe what one fund

[24] Release 33-8358 (Jan. 29, 2004); 69 FR 6438 (Feb. 10, 2004). The release proposed Rule 15c2-2 (confirmation) and Rule 15c2-3 (point of sale). The proposal was designed to "improve investor access to martiral information about investments in open-end management investment company securities, unit investment trust interests, and municipal fund securities used for education savings." *Id* at 6438 For example, Rule 15c2-2(c)(5) would require "disclosure of information related to revenue sharing payments and portfolio securities transaction commissions received by the broker, dealer or municipal securities dealer." *Id* at 6450. The Commission subsequently reopened the comment period and proposed changes to the confirmation and point of sale requirements. The Commission has not adopted these rules. *See also* New York Stock Exchange *Information Memo,* No. 05-54, (Aug. 11, 2005) regarding revenue sharing and point of sale disclosure.

complex pays to selling broker-dealers. Only the broker-dealer can describe the payments it receives and indicate whether it receives more revenue from one fund complex than from another. The disclosure mechanisms described above are the means by which broker-dealers provide this information to customers.[25]

VI. **Observations**

When one examines current fund distribution, shareholder servicing and research practices, it is important to note that:

- The number of funds offered to investors over the past 20 years has increased dramatically. Consequently, broker-dealers need to familiarize themselves with an exponentially greater number of funds than those that were previously available (as well as the various share classes and breakpoint levels), and thus the costs of offering so many funds (and fund classes) are higher.

- Not only has the number of funds increased, but the types of different funds and the different plans and programs through which investors may purchase funds have also increased. This change requires a greater level of training and education of broker-dealers, and generates longer term broker-dealer servicing and investment guidance.

- Many of the costs and expenses assumed by broker-dealers are ones previously assumed by funds and paid out of fund assets. The market has determined that it is more cost-efficient for broker-dealers to perform these services than it is for the funds themselves to undertake the expense of assuring that these services are performed (*e.g.*, sub-transfer agency; recordkeeping).

- Regulatory and compliance costs have increased.

- Broker-dealers, in large part, do not distinguish between fees paid by funds out of fund assets and fees paid by affiliates in terms of the services provided (however, shareholder servicing payments are typically made from 12b-1 streams and sub-transfer agency payments, as opposed to revenue sharing payments or sales loads). They tend to view payments as an aggregate sum needed to provide the level of service they deem appropriate to serve their customers.

- The developments in mutual fund distribution and shareholder servicing practices have led to tangible benefits for investors, such as:

    - lower distribution costs;

    - availability of a broader array of mutual funds;

[25] Because as noted, the Commission has not adopted specific rules for fund disclosure, broker-dealer must develop policies and procedures based on enforcement cases and then try to apply those settlements to their own situations. Because situations vary and the SEC has not adopted rules, broker-dealers use varying approaches to meet their responsibilities. But broker-dealers provide substantial disclosures to investors regarding the various revenue arrangements. *See* comment at note 28.

- consolidated statements and other records for investors; and
- consolidated tax information.

SIFMA believes that in light of current fund distribution and shareholder servicing practices, providing information to investors about broker-dealer compensation, without also providing information to investors about services provided, may be misleading because, among other things:

- while a broker-dealer may receive payments from some fund complexes but not from others, a registered representative's compensation typically does not depend upon whether the broker-dealer receives revenue sharing payments, nor is the registered representative generally aware of the nature of such payments consequently, the registered representative may not have an inappropriate conflict of interest; and

- a registered representative who is educated on the specifics of a limited group of mutual funds, including fund holdings, investment strategy, performance and risk profile, is in a much better position to make suitable recommendations to clients.

SIFMA believes that restricting revenue sharing and other compensation arrangements between broker-dealers and fund complexes would be anti-competitive and would reduce investor choices. The current environment fosters the creation of many funds offered through many distribution channels and has resulted in increased investor choice.[26]

SIFMA also recognizes that some have called into question the "factors" that fund boards consider when evaluating Rule 12b-1 plans.[27] SIFMA believes it is appropriate to ensure that boards have practical guideposts to consider when exercising their approval and review processes for Rule 12b-1 plans. Although SIFMA is not taking a position at this time as to whether the SEC should revise the factors, it welcomes a reconsideration of the issue generally.

SIFMA does not believe that boards should have to fear approving a Rule 12b-1 plan in appropriate circumstances when the fees are used to further innovation and investor choice. Any change in SEC guidance should not have the effect of making boards too timid to consider useful innovations and improvements.

VII. Conclusions and Recommendations

In light of current fund distribution, shareholder servicing and research practices, SIFMA's conclusions and recommendations are as follows:

A. In the interest of investor protection, it recommends that disclosure and structural reform efforts be focused on ensuring that:

[26] *Cf.* Sections 3(f) and 23(a) of the Exchange Act.
[27] SEC Release No. IC -11414 (Nov., 7 1980).

- Fund shareholders can readily access easily understandable information about the various types of payments and the nature of the services being provided;[28]

- Competitive forces, not government fiat, set appropriate levels of compensation, whether through fund payments, sales loads or revenue sharing;

- Broker-dealers recommend suitable fund investments;

- Investors have the broadest possible array of fund choices; and

- The prominence of fund fee disclosure is not so skewed as to deflect attention away from other critical investment factors such as a fund's risk profile, performance and investment objectives, strategies, policies and methods.

B. SIFMA opposes prohibitions or restrictions upon revenue sharing and Rule 12b-1 fees which are likely to be counterproductive and harm fund investors. In particular, SIFMA believes that a prohibition on these practices may result in fewer investment options being made available to investors, which in turn, may lead to investment options that are less suitable to investors.

C. SIFMA supports efforts to enhance disclosure to ensure that fund investors are able to make intelligent investment decisions (either on their own, or with the assistance of professional advice). For example, the SEC and NASD have made significant efforts to develop investor disclosure mechanisms that satisfy legal requirements and are accessible to investors.[29] We believe that any disclosure system should provide the following:

- Investors should be able to obtain information in the level of detail that suits their interests and needs. For example, creating websites that allow investors to read summary information, but with the ability to provide more detailed information with links, is one solution.

- Fee disclosure should be clear, organized, and understandable. It should permit easy comparison shopping.[30]

- Disclosure should be balanced and should not focus predominantly on fees. Investors need to be able to obtain a complete picture of the proposed investment – such as investment objectives, performance, and risk. A consumer wouldn't buy an article of clothing if it was an unsuitable size or style, even if the price was low.

[28] SIFMA strongly endorses SEC rulemaking to require meaningful disclosures, after the appropriate notice and comment process, rather than by imposing such a requirement either in conjunction with the inspection program or as a consequence of enforcement actions.

[29] *See e.g*. NASD "Profile Plus" recommendation, http://www.nasd.com/PressRoom/NewsReleases/2005NewsReleases/NASDW_013727

[30] *Cf.* NASD Rule 2210(d)(3) (text box requirement).

- Investor choice should drive the disclosure model, not the reverse. Investors should be able to make informed choices from an expanding menu of investment alternatives. The regulatory system should not present obstacles to innovation.

- The disclosure system should make investors aware of material conflicts of interest, such as that a firm may have a greater incentive to sell one product over another. But the disclosure system should not overwhelm investors with minutiae about the operations of the brokerage and fund businesses. Efforts to force investors to receive excessively detailed information will cause investors to lose interest. Again, a layered approach may be the most effective.

- There should be a greater effort to integrate the mutual fund disclosure system as investors see it. We recognize that different entities have different commercial interests and legal responsibilities and that different policy makers have varying responsibilities for the various rules. But the disclosure system should work as an integrated whole to benefit investors.

- SIFMA stands ready to participate with the SEC and others in designing and implementing such market research, or to undertake such effort independently.

Chairman Cox gave a speech entitled "*Giving Investors the Information They Need, In a Form They Can Use*."[31] Andrew ("Buddy") J. Donohue, Director of the SEC's Division of Investment Management, echoed those comments in the context of mutual fund disclosure.[32] We recognize that policymakers, the brokerage and fund industries, and other groups have not reached consensus on a new disclosure format and we do not endorse any specific recommendations. Nonetheless, we applaud the notion that in cooperation with regulators, funds and broker-dealers should "give investors the information they need in a form they can use." Because we believe that all interested parties share the same objectives, we believe that there is reason to be optimistic about the future of broker-dealer and fund disclosure.

D. Because fund distribution practices, shareholder services practices and research practices have evolved over time, and can be expected to further evolve, SIFMA believes that disclosure practices should likewise evolve. Such disclosure requirements should be flexible enough to assure that investors receive clear, concise and meaningful disclosure about the various types of payments broker-dealers may receive at any time from both funds and fund affiliates.

E. SIFMA strongly believes that fund boards should have complete information about Rule 12b-1 distribution plans, so that they can make fully informed judgments. They

31 Keynote Address to the 39th Annual Securities Regulation Seminar, Los Angeles, California, October 20, 2006 http://www.sec.gov/news/speech/2006/spch102006cc.htm. The Chairman's remarks were in the context of corporate disclosure, not mutual fund disclosures.

32 Mutual Funds in 2006: Getting Back to Basics and Embracing Core Values: Remarks before the ICI 2006 Securities Law Developments Conference, http://www.sec.gov/news/speech/2006/spch120406ajd.htm.

should have extensive information to be sure that the directors fully discharge their responsibilities to the funds' investors and to satisfy the requirements of the 1940 Act and relevant state law.

* * * *

The explosion of new fund products and fee arrangements have brought greater choice and lower costs to investors. But as choices have increased, so has the complexity of arrangements between broker-dealers and fund complexes. Complexity isn't bad -- it just means that we need to ensure that investors have meaningful information and can make informed investment decisions. Fees are being appropriately utilized to fund the broad array of investment and other important services which broker-dealers provide to the vast majority of America's estimated 96 million mutual fund shareholders.[33]

SIFMA welcomes the opportunity to present its views on arrangements between fund complexes and broker-dealers. We hope to work with all interested parties to assure that customers have relevant information and are able to make intelligent investment decisions from a multitude of choices.

[33] ICI, Ownership of Mutual Funds and Use of the Internet, 2006 (Oct. 2006), http://www.ici.org/pdf/fm-v15n6.pdf.

Glossary of Mutual Fund Terms (Exhibit A)

Exhibit A

Glossary

Many mutual fund terms do not have hard and fast definitions, but below are commonly understood definitions of important terms.

Types of Funds -- There are many different types of mutual funds designed to meet the needs of different investors. As disclosed in the investment policy of the fund, the fund manager may purchase only certain types of portfolio securities. For example:

- Equity or Stock Funds -- common stocks. Some examples include:
  - Growth funds -- focus on stocks that may not pay a regular dividend but have the potential for growth.
  - Index funds -- aim to achieve the same return as a particular market index, such as the S&P 500 Composite Stock Price Index, by investing in all — or perhaps a representative sample — of the companies included in an index.
  - Sector funds -- may specialize in a particular industry segment, such as technology or consumer products stocks.
- Blue Chip -- securities of well-established companies with seasoned management or large market share. A fund might be a blue chip growth fund, which focuses on companies with long-term growth prospects, but does not pay dividends.
- Small Cap -- securities of smaller, typically newer companies. A fund might be a small cap (for "capitalization") growth fund or a value fund, in which the fund will buy stocks of companies whose current stock prices do not appear adequately to reflect their underlying value as measured by assets, earnings, cash flow, or business franchises.
- Debt Funds -- bonds and other debt instruments. Quality of the bonds may vary from U.S. Treasury securities or highly rated corporate bonds, to more risky "higher yielding" bonds. Some funds invest only in tax-exempt securities.

Differential Compensation -- Broker-dealers and/or their registered representatives receive higher incentive payments for promoting certain funds (*e.g.*, in-house funds or funds with which the broker-dealer has a revenue sharing arrangement).

Directed Brokerage -- many people use this term to describe different things.

Under one definition, directed brokerage is an arrangement under which an account manager directs trades to a specific broker-dealer. In return, the broker-dealer agrees to pay certain fund expenses. Fund prospectuses disclose these arrangements, often as a fee table footnote. These arrangements do not ordinarily raise conflict of interest issues because the fund directly benefits from the arrangement. For example, Fund A directs trades to Broker-Dealer X and that broker-dealer pays custody expenses for Fund A. A conflict of interest may arise if the fund's investment adviser has previously agreed to cap the fund's expenses at a particular level, and the arrangement allows the adviser to assume less of the fund's expenses.

Under another definition, sometimes called "brokerage for sales," a fund manager or distributor directs fund brokerage to broker-dealers that sell shares of the fund. As noted, SEC and NASD rules now prohibit such *quid pro quo* activity. The restrictions do not permit a portfolio manager for a fund from sending orders to a broker-dealer for execution even if that broker-dealer sells the same fund. However, the portfolio manager must direct those orders in an effort to achieve best execution and not to reward or encourage fund sales. *See also* Rule 12b-1(h)(2).

<u>Fee Arrangements for Mutual Funds</u> -- There are many different types of fee arrangements for funds.

- <u>Front-End Sales Charge (or Front-End Load)</u> - a sales charge deducted at the time of purchase from the purchase price for fund shares. It is expressed as a percentage of the total purchase or offering price of the fund's shares. The individual investor pays this charge directly.

- <u>Breakpoints</u> -- Fund front-end sales charges may contain breakpoints that provide reduced sales charges for larger purchases. Funds disclose breakpoints in their prospectuses. They also disclose conditions for waivers of sales charges and for aggregating purchases or signing letters of intent that would result in lower sales charges.

- <u>Contingent Deferred Sales Charge ("CDSC")</u> -- a sales charge deducted upon redemption of fund shares. This charge is assessed against the individual investor. The CDSC generally declines over a period of five or six years, so that a redemption within one year of purchase is subject to the maximum CDSC while the CDSC is reduced for redemptions in later years and disappears for redemptions more than five or six years from the date of purchase.

- <u>No-Load Funds</u> -- The fund does not charge any type of sales load. But, not every type of shareholder fee is a "sales load." A no-load fund may charge fees that are not sales loads, such as purchase fees, redemption fees, exchange fees, and account fees. No-load funds also have operating expenses.[34]

[34] The SEC's website notes:

> Some funds call themselves "no-load." As the name implies, this means that the fund does not charge any type of sales load. ***[H]owever, not every type of shareholder fee is a "sales load," and a no-load fund may charge fees that are not sales loads. For example, a no-load fund is permitted to charge purchase fees, redemption fees, exchange fees, and account fees, none of which is considered to be a "sales load." In addition, under NASD rules, a fund is permitted to pay its annual operating expenses and still call itself "no-load," unless the combined amount of the fund's 12b-1 fees or separate shareholder service fees exceeds 0.25% of the fund's average annual net assets.

http://www.sec.gov/answers/mffees.htm#distribution

- Rule 12b-1 Fees -- The SEC Rule 12b-1 under the 1940 Act in 1980, which permits fund assets to be used for distribution and shareholder services. NASD Rule 2830 establishes a general limit of 0.75% for distribution, 0.25% for service fees. The fund distributor pays fees from fund assets to broker-dealers and others who sell fund shares and/or provide ongoing services to fund shareholders.

- Class A Shares -- are typically subject to a front-end sales charge. The front-end sales charge often has "breakpoints" for larger size investments. Funds often establish waiver categories, disclosed in their prospectuses, so that particular categories of investors are permitted to purchase shares with a reduced or waived front-end sales charge. Class A shares also may have a Rule 12b-1 fee that generally does not exceed 0.25% of average annual net Class A assets.

- Class B Shares -- typically have no front-end sales charge, a relatively high Rule 12b-1 fee of up to 1.00%, and a CDSC. Because the fund underwriter pays brokers a commission up-front for sales of Class B shares, the Rule 12b-1 fee is designed to pay the underwriter back for these advances. Class B shares typically convert to Class A shares within a year or two after the CDSC disappears.

- Class C Shares -- Class C shares generally have no, or very low, front-end sales charges or CDSC. They may have a Rule 12b-1 fee of up to 1.00%. Class C shares typically do not convert to Class A shares.

4:00 P.M. Pricing -- Rule 22c-1 under the 1940 Act requires that fund share orders must be received by the time specified in the fund's prospectus to receive that day's net asset value (NAV) per share price. In other words, if you buy mutual fund shares on Monday, the order must reach the fund by 4:00 p.m. to get Monday's NAV. If you send in your order at 5:00 p.m. on Monday, you should get Tuesday's NAV. Past SEC staff interpretations have permitted orders to be received by intermediaries, such as a broker-dealer, by 4:00 p.m. for same day NAV. The fund prospectus typically discloses the 4:00 p.m. deadline and who must receive the order by that time. "Late trading" refers to the illegal practice of helping an investor get today's price after 4:00 p.m. For example an investor enters an order to buy a fund's shares on Monday at 5:00 p.m. and gets Monday's NAV.

NASD Conduct Rule 2830(d) – The NASD regulates broker-dealers' sales of mutual funds, including the fees. NASD rules do not regulate the funds directly, but regulate the circumstances under which a broker-dealer may sell a fund. NASD Rule 2830(d) limits the sales charges on funds that broker-dealers may sell. As the SEC explains:

> NASD Conduct Rule 2830(d) prohibits NASD members (i.e., broker-dealers) from selling shares of funds that impose excessive sales charges. The rule deems a sales charge to be excessive if it exceeds the rule's caps. A fund's sales load (whether charged at the time of purchase or redemption) may not exceed 8.5 percent of the offering price if the fund does not charge a rule 12b-1 fee. The aggregate sales charges of a fund with a rule 12b-1 fee may not exceed 7.25 percent of the amount invested, and the amount of the asset-based sales charge (the rule 12b-1 fee) may not exceed 0.75 percent per year of the fund's average

> annual net assets. Under the cap, therefore, an increase in the fund's sales load could reduce the permissible level of payments a selling broker may receive in the form of 12b-1 fees. The NASD designed the rule so that cumulative charges for sales-related expenses, no matter how they are imposed, are subject to equivalent limitations [footnotes omitted].

Release No. IC-26356; (February 24, 2004)(release proposing changes to Rule 12b-1(h) regarding directed brokerage, as discussed in note 23, *supra*).

Redemption Fees – A fee imposed on investors who redeem shares under certain circumstances. Investors who engage in frequent trading of mutual funds can impose costs on long-term investors. To address this concern, the Commission adopted Rule 22c-2 under the 1940 Act, which permits open-end investment companies to impose redemption fees. Under the rule, a fund's board must either impose a redemption fee of up to 2%, or determine that the imposition of a redemption fee is either not necessary or appropriate. Release No. IC 26782 (March 11, 2005); 70 FR 13328 (March 18, 2005).

Revenue Sharing -- A fund adviser or distributor pays additional compensation to a broker-dealer or other financial intermediary. The payments may be for several different purposes. One purpose is to encourage the broker-dealer to provide "shelf space." Shelf space arrangements range from simply making the fund available to investors or more prominently featuring the fund. Payments may also be for administrative or recordkeeping functions, such as keeping track of the fund's shareholder records at the broker-dealer. Disclosure is generally required in the fund prospectus and Statement of Additional Information ("SAI").

"Soft dollars" or "paying up" for research -- Section 28(e) of the Exchange Act makes it lawful for an investment manager (who has discretion to trade an account) to pay higher than the minimum commission when the manager also receives brokerage and research services from that broker-dealer. Congress enacted this provision at the time that it unfixed brokerage commissions. Congress wanted to ensure that, in appropriate circumstances, investment managers would be able to pay more than the absolute lowest available commission without breaching their fiduciary duty.

Under Section 28(e), the commissions must be reasonable in light of services received by the investment manager. The broker-dealer that provides brokerage may provide the research services or the broker-dealer may arrange that a third-party provide the research to the investment manager. If the product/service is also used for non-research purpose ("mixed use"), the investment manager must develop and document a reasonable cost allocation. A mutual fund must provide general disclosure of soft dollar arrangements in its SAI. Investment advisers must disclose soft dollar practices in their Form ADV Part II. SEC interpretations establish requirements for reliance on Section 28(e) (*e.g.*, any research obtained must provide "lawful and appropriate assistance" to the account manager in carrying out his responsibilities). *See* note 16, *supra*.

For more information, see http://www.pathtoinvesting.org/dictionary/words.htm