Part II

Securities and Exchange Commission

17 CFR Part 270
Prohibition on the Use of Brokerage Commissions To Finance Distribution; Final Rule
I. Background
Funds buy and sell large amounts of securities each year for their portfolios. Fund advisers choose which broker or dealer will effect transactions ("executing broker"), and can use commissions to reward brokers or dealers for promoting the sale of fund shares ("selling brokers"). Brokers are prohibited from conditioning the promotion of fund shares on the receipt of brokerage commissions from a fund. Since 1981, however, fund advisers have been permitted to follow a disclosed policy "of considering sales of shares that the fund issues as a factor in the selection of broker-dealers to execute portfolio transactions, subject to best execution."  

Last year we conducted a review of current brokerage practices. Our staff found that the use of brokerage commissions to facilitate the sale of fund shares is widespread among funds that rely on broker-dealers to sell fund shares. In some cases transactions are directed to selling brokers. In other cases where the selling broker lacks capacity to execute fund securities transactions, fund advisers will cause the fund to enter into "step out" and other types of arrangements under which a portion of the commission is directed to the selling brokers. Fund advisers and selling brokers keep track of the value of directed brokerage, and if an insufficient amount of brokerage is directed to a selling broker, the broker may require compensation from the adviser. If the compensation that a selling broker receives for distributing shares of a fund (or a fund complex) falls below agreed-upon levels, the selling broker may reduce its selling efforts for the funds. 

Pressures to distribute fund shares (or to avoid making payments for distribution out of their own assets) have caused advisers to direct more fund brokerage (or brokerage dollars) to selling brokers. The directed brokerage has been assigned explicit values, recorded, and traded as part of increasingly intricate arrangements by which fund advisers barter fund brokerage for sales efforts. These arrangements are today far from the benign practice that we approved in 1981 when we allowed funds to merely consider sales in allocating brokerage. 

Fund brokerage is an asset of the fund, and its use to pay for distribution expenses implicates rule 12b–1, which regulates the use of fund assets to pay selling brokers or otherwise finance the sale of fund shares. Rule 12b–1 permits funds to use their assets to pay distribution-related costs, subject to certain conditions designed to address concerns about the conflicts of interest arising from allowing funds to finance distribution. In 1981, shortly after we adopted Rule 12b–1, we commented that the rule was intended to protect funds from bearing excessive and unnecessary costs. 

Unless otherwise noted, all references to statutory sections are to the Investment Company Act of 1940, and all references to "rule 12b–1" or any paragraph of the rule will be to 17 CFR 270.12b–1, as amended.

[For further description of these practices, see Proposing Release, supra note, at nn.12–14 and accompanying text. ]

[See supra note 4 and accompanying text. ]

[17 CFR 270.12b–1. Because it is an asset of the fund, fund brokerage must be considered for the fund’s benefit. See Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV, Investment Advisers Act Release No. 1954 (Apr. 5, 2000) (FR 25924 (Apr. 17, 2000)), at text following n.166 ("Client brokerage, however, is an asset of the client—not of the adviser."). See also American Bar Association, Fund Director’s Guidebook, 59 Bus. Law. 201, 243 (2003) ("Brokerage commissions are assets of the fund, and the fund’s directors are ultimately responsible for determining policies governing brokerage practices.").]

[See Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11414 (Oct. 28, 1980) (FR 73898 (Nov. 7, 1980)). In order to rely on rule 12b–1, among other requirements, a fund must adopt “a written plan describing all material aspects of the proposed financing of distribution” that is approved by fund shareholders and fund directors. 17 CFR 270.12b–1(b). We adopted rule 12b–1 pursuant to section 12(b) of the Act, which makes it unlawful for a fund “to act as distributor of securities of which it is the issuer, except through underwriters, in contravention of such rules and regulations” as we prescribe. 15 U.S.C. 80a-12(b). Section 12(b) was intended to protect funds from bearing excessive sales and promotion expenses. Investment Trusts.
adopted rule 12b–1 and in light of its adoption, we concluded that “it is not inappropriate for investment companies to seek to promote the sale of their shares through the placement of brokerage without the incurring of any additional expense.”

After reviewing the current directed brokerage practices described above, in February 2004, we proposed to amend rule 12b–1 to prohibit the use of fund brokerage to compensate brokers for the sale of fund shares. Thirty-three of these commenters supported the proposal, agreeing with our conclusion that the practice of using brokerage to reward sales of fund shares involves substantial conflicts of interest. Seven commenters opposed the proposed ban.

We are adopting the amendments to rule 12b–1 substantially as proposed. We are taking this action because we have concluded that the practice of trading brokerage for sales of fund shares may harm investors in mutual funds in at least four ways:

- **Adverse Impact on Best Execution of Fund Transactions.** The decision to use brokerage commissions to pay for distribution poses significant conflicts. Fund advisers, whose compensation is based on the amount of assets held by the fund, have an incentive to promote the sale of fund shares to increase their advisory fees, and to avoid having to pay brokers out of their own pockets for selling fund shares (“revenue sharing”). Competition among fund advisers to secure a prominent place in selling brokers’ distribution networks (“shelf space”) has created powerful incentives to direct brokerage based on distribution considerations. This can adversely affect decisions on how and where to effect portfolio securities transactions, or how frequently to trade portfolio securities. Because of the practical limitations on the ability of fund directors to actively monitor and evaluate the motivations behind the selection of brokers to effect portfolio securities transactions, we believe that reliance on fund directors to police the use of fund brokerage to promote the sale of fund shares is not sufficient.

- **Circumvention of Limits on Distribution Expenses.** Pursuant to section 22(b) of the Investment Company Act, the NASD prohibits its members (i.e., broker-dealers) from selling shares of funds that impose excessive sales loads and other distribution costs directly or indirectly on shareholders. By using these directed brokerage arrangements, fund advisers and brokers are able to circumvent the NASD rules on excessive sales charges, thus undermining the protections afforded fund shareholders by those rules and by section 22(b) of the Act.

**II. Discussion**

We received thirty-three comment letters in response to our proposal to ban funds’ use of directed brokerage to compensate brokers for the sale of fund shares. Twenty-three of these commenters supported the proposal, agreeing with our conclusion that the practice of using brokerage to reward sales of fund shares involves substantial conflicts of interest. Seven commenters opposed the proposed ban.

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...
These included an approach set forth in the Proposing Release that would reform rule 12b–1 to provide that funds deduct distribution-related costs directly from shareholder accounts rather than from fund assets.\textsuperscript{34} Commenters also addressed concerns regarding revenue sharing. We will take these and other comments we received into consideration as we evaluate whether and how to amend the rule further. We are not adopting any further changes to rule 12b–1 today.

III. Effective and Compliance Dates

The amendments to rule 12b–1 will be effective on October 14, 2004. The compliance date of these rule amendments is December 13, 2004. No later than the compliance date, funds must be in compliance with the ban in paragraph (h)(1) of the rule and funds that use their selling brokers to execute portfolio securities transactions must have in place the policies and procedures prescribed by paragraph (h)(2)(ii) of rule 12b–1. Funds may make corresponding changes to their registration statements at the time of the next regularly scheduled amendment.

IV. Cost-Benefit Analysis

We are sensitive to the costs and benefits that result from our rules. The amendments prohibit the use of brokerage commissions to compensate broker-dealers for the distribution of fund shares. In the Proposing Release, we requested comment and specific data regarding the costs and benefits of the proposed amendments.\textsuperscript{35} We received no comments on the costs and benefits of the proposed amendments.

A. Benefits

The amendments will benefit funds and their shareholders. The practice of directing brokerage for sales involves substantial conflicts of interest that can harm shareholders. Fund advisers control fund brokerage and, as a result of their compensation structures, have incentives to maximize the size of funds they advise, while fund shareholders are interested in maximizing their fund returns by minimizing overall costs, including transaction costs. Fund advisers that overtrade fund portfolio securities in order to generate additional sales of fund shares, or that fail to optimize transactions costs, impose real costs on fund investors, which these rule amendments seek to eliminate. The opaqueness of fund transaction costs makes it impossible for investors to control the conflict or to understand the amount of actual costs incurred for distribution of fund shares.

The elimination of the practice of directing fund brokerage for distribution also may yield secondary benefits to funds if it leads to lower institutional brokerage rates, lower portfolio turnover rates, and better transparency of distribution costs. The Commission has no way of quantifying these benefits.

B. Costs

The amendments may decrease the commissions received by broker-dealers who may seek to make up for any shortfall from other sources. In response, fund advisers may seek to increase sales loads paid by investors, or to increase the amount of payments to broker-dealers deducted from fund assets under rule 12b–1 plan. The ability of advisers to obtain these funds is, however, subject to NASD limits, and by the requirement that fund shareholders approve increases to fees deducted pursuant to a rule 12b–1 plan. Alternatively, advisers may be required to increase the payments that they make to broker-dealers or their own assets, which are likely to cause advisers’ costs to rise.\textsuperscript{36} Advisers may resist making these payments because of uncertainty that they may be recouped.

We assume that a great many, if not all, funds are likely to find that, for some portfolio transactions, the broker-dealer who can provide best execution also distributes the fund’s shares. These funds will incur costs in order to comply with the requirement for policies and procedures contained in the amendments.\textsuperscript{37} Specifically, these funds or their advisers would be required to institute policies and procedures reasonably designed to prevent: (i) The persons responsible for selecting broker-dealers to effect transactions in fund portfolio securities from taking broker-dealers’ promotional or sales efforts into account in making those decisions; and (ii) the fund, its adviser or principal underwriter, from entering into any agreement under which the fund directs brokerage transactions or revenue generated by those transactions to a broker-dealer to pay for distribution of the fund’s shares. We do not anticipate that drafting or implementing these policies and procedures will be costly.

By narrowing the options for financing distribution of fund shares, the proposed amendments could impose costs on funds and their advisers. If the remaining methods of financing distribution are not adequate, funds may not grow as quickly as they otherwise would have. Advisers, whose compensation is generally tied to net assets, may experience slower growth in their advisory fees, and fund shareholders may not benefit from the economies of scale that accompany asset growth.\textsuperscript{38}

V. Consideration of Promotion of Efficiency, Competition, and Capital Formation

Section 2(c) of the Investment Company Act mandates the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.\textsuperscript{39} As discussed above, the amendments prohibit funds from compensating selling brokers with commissions generated from fund portfolio securities transactions. This new prohibition could promote efficiency by eliminating brokers’ selling efforts, which are not indicative of their execution capabilities, as a factor that fund advisers use in selecting an executing broker. Efficiency also will be enhanced because, if commissions are not used to finance the distribution of a fund’s shares, lower commission rates may be available or the fund may be able to obtain other services more directly beneficial to it and its shareholders.

We do not anticipate that these amendments will harm competition; they are, in fact, intended to enhance competition. All funds are precluded from using this form of compensation. In addition, the amendments should reduce incentives that broker-dealers currently have to base their fund recommendations to customers on payment for distribution. The amendments also could foster greater competition in brokerage commission rates by unbundling distribution from execution.

\textsuperscript{34} See Proposing Release, supra note 5, at nn. 63–67 and accompanying text.

\textsuperscript{35} See Proposing Release, supra note 5, at section V.C.

\textsuperscript{36} Advisers may seek to increase their management fees to offset increased payments to broker-dealers. Any increase in management fees would have to be approved by the fund’s shareholders. See 15 U.S.C. 80a–15(a).

\textsuperscript{37} We assume that a great majority of, if not all, funds are likely to find that, for some portfolio transactions, the broker-dealer who can provide best execution also distributes the fund’s shares.

\textsuperscript{38} Historically, however, fund shareholders have not always enjoyed lower expenses as a result of increased assets (the absence of lower expenses can result from a number of causes, including that advisers are failing to pass on scale economies to shareholders or that advisers are not themselves earning scale economies).

\textsuperscript{39} 15 U.S.C. 80a–2(c).
Although we do not anticipate that these amendments will adversely affect all funds in the same manner. Certain types of portfolio managers, for instance, might rely more heavily on directed brokerage to ensure adequate shelf space for the funds they advise than other advisers, which could result in an increase in some funds’ costs. The ban on directed brokerage to pay for distribution also could lead to an increase in costs for some funds if the amendments compel the fund to modify the way it distributes its shares. This potential differential impact on funds could affect competition.

The amendments prohibit a fund from relying on its selling brokers to effect fund portfolio securities transactions unless the fund has policies and procedures in place designed to ensure the active monitoring of brokerage allocation decisions when executing brokers also distribute the fund’s shares. Thus, funds will not be unnecessarily limited in their choice of executing brokers, and the amendments will not have adverse effects on competition in the provision of brokerage services. We do not anticipate that the amendments will affect capital formation.

VI. Paperwork Reduction Act

As explained in the Proposing Release, the amendments contain a “collection of information” requirement within the meaning of the Paperwork Reduction Act of 1995 (“PRA”). We published notice soliciting comments on the collection of information requirements in the Proposing Release and submitted these requirements to the Office of Management and Budget (“OMB”) for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for the collection of information requirements associated with the proposed amendments is “Rule 12b–1 under the Investment Company Act, ‘Distribution of Shares by Registered Open-End Management Investment Company.’” An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. The OMB control number for rule 12b–1 is 3235–0212.

Rule 12b–1 permits funds to use their assets to pay distribution-related costs. In order to rely on rule 12b–1, a fund must adopt “a written plan describing all material aspects of the proposed financing of distribution” that is approved by fund shareholders and fund directors. Any material amendments to the rule 12b–1 plan similarly must be approved by fund directors, and any material increase in the amount to be spent under the plan must be approved by fund shareholders. In considering a rule 12b–1 plan, the fund board must request and evaluate information reasonably necessary to make an informed decision. Rule 12b–1 also requires the fund to preserve for six years copies of the plan, any related agreements and reports, as well as minutes of board meetings that describe the factors considered and the basis for implementing or continuing a rule 12b–1 plan.

As discussed above, today we are adopting amendments to rule 12b–1 substantially as proposed. To eliminate a practice that poses significant conflicts of interest and may be harmful to funds and fund shareholders, we are amending rule 12b–1 to prohibit funds from paying for the distribution of their shares with brokerage commissions. Funds that use their selling brokers to execute securities transactions will be required to implement, and their boards of directors (including a majority of independent directors) to approve, policies and procedures. The policies and procedures must be reasonably designed to prevent: (i) The persons responsible for selecting broker-dealers to effect transactions in fund portfolio securities from taking broker-dealers’ promotional or sales efforts into account in making those decisions; and (ii) the fund, its adviser or principal underwriter, from entering into any agreement under which the fund directs brokerage transactions or revenue generated by those transactions to a broker-dealer to pay for distribution of the fund’s shares. This requirement includes the following new information collections: (i) A fund’s documentation of its policies and procedures, and (ii) the approval by the board of directors of those policies and procedures. The new information collection requirements are mandatory. Responses provided to the Commission in the context of its examination and oversight program are generally kept confidential. None of the commenters addressed the PRA burden associated with these amendments. OMB approved the information collection requirements.

This Final Regulatory Flexibility Analysis has been prepared in accordance with 5 U.S.C. 604. It relates to the amendments to rule 12b–1, which governs the use of fund assets to finance the distribution of fund shares. The Initial Regulatory Flexibility Analysis (“IRFA”), which was prepared in accordance with 5 U.S.C. 603, was published in the Proposing Release.

A. Reasons for the Proposed Action

As described more fully in Section I of this Release, the amendments are necessary to address the practice of directing brokerage commissions to particular broker-dealers in order to compensate them for selling fund shares, a practice we believe poses significant conflicts of interests and may be harmful to funds and fund shareholders.

B. Significant Issues Raised by Public Comment

When the Commission proposed the rule amendments that it is now adopting, it requested comment with respect to the proposal and the accompanying IRFA. We received no comments on the IRFA. Twenty-three commenters supported the Commission’s proposal to ban the use of directed brokerage to finance distribution. Commenters noted that the practice gives rise to conflicts of interest, causes shareholders to be treated inequitably, may lead to portfolio churning in order to generate brokerage commissions, facilitates circumvention of the NASD’s limits on sales charges, may result in inappropriate recommendations by brokers to their customers, and increases execution costs for funds.

Seven commenters opposed the ban on the use of brokerage commissions to pay for distribution. They argued that the proposed ban is unnecessary to protect investors and would inhibit the ability of funds to obtain best execution, increase commission rates by concentrating the brokerage business among fewer brokers, and eliminate a method of compensating broker-dealers for processing fund transactions and maintaining customer accounts.

Opposing commenters offered the following alternatives to the proposed ban: (i) Enhanced disclosure of directed brokerage arrangements; (ii) Commission guidance about improper

41 See section 31(c) of the Investment Company Act (15 U.S.C. 80a–30(c)).

42 In the Proposing Release, we estimated that the aggregate burden for all funds in the first year after adoption would be 649,500 hours. We further estimated that the average weighted annual burden for all funds over the three-year period for which we requested approval of the information collection burden would be approximately 628,833 hours. See Proposing Release, supra note 5, at section VII.
arrangements; (iii) requiring funds to adopt policies and procedures governing brokerage allocation practices; (iv) as with other fund assets, prohibiting the use of brokerage commissions for distribution unless they are used in accordance with a rule 12b–1 plan; and (v) enhanced review and enforcement efforts with respect to existing restrictions on the use of directed brokerage.

C. Small Entities Subject to the Rule

A small business or small organization (collectively, “small entity”), for purposes of the Regulatory Flexibility Act, is a fund that, together with other funds in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year. Of approximately 5,124 registered investment companies, approximately 204 are small entities. As discussed above, the amendments prohibit all funds, regardless of size, from using portfolio brokerage commissions to finance distribution. All funds that use selling brokers to execute portfolio transactions must implement policies and procedures. While we have no reason to expect that small entities will be disproportionately affected by the amendments, it is possible that a larger portion of smaller funds secure shelf space through the use of directed brokerage than is the case with larger funds. If true, smaller funds could incur some unanticipated costs as they adapt to these amendments.

D. Reporting, Recordkeeping, and Other Compliance Requirements

The amendments do not include any new reporting or recordkeeping requirements. The amendments introduce a new prohibition, applicable to all funds, including small entities, on the use of fund brokerage commissions to compensate selling brokers. In addition, all funds, including small entities, are prohibited from using selling brokers to execute portfolio transactions unless they have implemented policies and procedures reasonably designed to prevent: (i) The persons responsible for selecting broker-dealers to effect transactions in fund portfolio securities from taking broker-dealers’ promotional or sales efforts into account in making those decisions; and (ii) the fund, its adviser or principal underwriter, from entering into any agreement under which the fund directs brokerage transactions or revenue generated by those transactions to a broker-dealer to pay for distribution of the fund’s shares. The board of directors must approve these policies and procedures.

E. Commission Action To Minimize Effect on Small Entities

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. Alternatives in this category would include: (i) Establishing different compliance or reporting standards that take into account the resources available to small entities; (ii) clarifying, consolidating, or simplifying the compliance requirements under the rule for small entities; (iii) using performance rather than design standards; and (iv) exempting small entities from coverage of the rule, or any part of the rule.

Establishing different standards for small entities is not feasible because we believe that a complete ban on the use of brokerage commissions to finance distribution is necessary in light of the intensity of the conflicts of interest that surround the practice. It would be inappropriate to apply a different standard for small entities, whose advisers may face even greater pressure than advisers to larger funds to take all measures to enhance distribution. Shareholders of small funds should receive the same protection as shareholders in large funds.

We do not believe that clarification, consolidation, or simplification of the compliance requirements is feasible. The amendments contain a straightforward ban on the use of brokerage commissions to finance distribution. The special requirements applicable to a fund that uses a selling broker to execute its portfolio securities transactions are likewise clear.

We do not believe that the use of performance rather than design standards is feasible. The amendments prohibit the use of brokerage commissions to finance distribution because the experience of our staff, including a recent staff review of brokerage commission practices, has led us to believe that the conflicts surrounding this practice are largely unmanageable. The requirement that funds that rely on selling brokers to execute transactions must have in place policies and procedures to prevent the persons making brokerage allocation decisions from taking fund sales into account and to prohibit directed brokerage agreements is a performance standard, because it permits funds or their advisers to implement policies and procedures tailored to their organizations.

We believe that it would be impracticable to exempt small entities from the ban. Doing so would deny to small funds and their shareholders the protection that we believe they are due. We also believe that it would be impracticable to exempt small entities that effect fund portfolio transactions through a selling broker from the requirement that they implement policies and procedures.

Statutory Authority

The Commission is proposing amendments to rule 12b–1 under the Investment Company Act pursuant to the authority set forth in sections 12(b) [15 U.S.C. 80a–12(b)] and 38(a) [15 U.S.C. 80a–37(a)] of the Investment Company Act.

List of Subjects in 17 CFR Part 270

Investment companies, Securities.

Text of Rule

For reasons set forth in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended to read as follows:

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. The authority citation for part 270 continues to read in part as follows:

Authority: 15 U.S.C. 80a–1 et seq., 80a–34(d), 80a–37, and 80a–39, unless otherwise noted.

2. Section 270.12b–1 is amended by:

(a) Removing the periods at the end of paragraphs (a)(1) and (a)(2) and adding semi-colons in their places;
(b) Removing the word “and” at the end of paragraphs (b)(2) and (b)(3)(iii);
(c) Removing the comma at the end of the introductory text of paragraph (b)(3)(iv) and adding a colon in its place;
(d) Removing the word “and” at the end of paragraph (b)(3)(iv)(B);
(e) Adding the word “and” at the end of paragraphs (b)(4);
(f) Removing the word “and” at the end of paragraph (e);
(g) Removing the period at the end of paragraph (f) and adding a semi-colon in its place;
(h) Removing the period at the end of paragraph (g) and adding “; and” in its place; and
(i) Adding paragraph (h).

The addition reads as follows.

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44 17 CFR 270.0–10.
45 Some or all of these entities may contain multiple series or portfolios. If a registered investment company is a small entity, the portfolios or series it contains are also small entities.
§ 270.12b-1 Distribution of shares by registered open-end management investment company.

(h) Notwithstanding any other provision of this section, a company may not:

(1) Compensate a broker or dealer for any promotion or sale of shares issued by that company by directing to the broker or dealer:

(i) The company’s portfolio securities transactions; or

(ii) Any remuneration, including but not limited to any commission, mark-up, mark-down, or other fee (or portion thereof) received or to be received from the company’s portfolio transactions effected through any other broker (including a government securities broker) or dealer (including a municipal securities dealer or a government securities dealer); and

(2) Direct its portfolio securities transactions to a broker or dealer that promotes or sells shares issued by the company, unless the company (or its investment adviser):

(i) Is in compliance with the provisions of paragraph (h)(1) of this section with respect to that broker or dealer; and

(ii) Has implemented, and the company’s board of directors (including a majority of directors who are not interested persons of the company) has approved, policies and procedures reasonably designed to prevent:

(A) The persons responsible for selecting brokers and dealers to effect the company’s portfolio securities transactions from taking into account the brokers’ and dealers’ promotion or sale of shares issued by the company or any other registered investment company; and

(B) The company, and any investment adviser and principal underwriter of the company, from entering into any agreement (whether oral or written) or other understanding under which the company directs, or is expected to direct, portfolio securities transactions, or any remuneration described in paragraph (h)(1)(ii) of this section, to a broker (including a government securities broker) or dealer (including a municipal securities dealer or a government securities dealer) in consideration for the promotion or sale of shares issued by the company or any other registered investment company.

By the Commission.


Margaret H. McFarland,
Deputy Secretary.

[FR Doc. 04–20373 Filed 9–8–04; 8:45 am]