



INDEPENDENT DIRECTORS COUNCIL

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November 23, 2005

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934 (File No. S7-09-05)

Dear Mr. Katz:

The Independent Directors Council appreciates the opportunity to comment on the interpretive guidance proposed by the Securities and Exchange Commission regarding client commission practices under Section 28(e) of the Securities Exchange Act of 1934.¹

The Independent Directors Council applauds the efforts of the Commission to clarify the scope of brokerage and research services in the face of evolving technologies and industry practices. Fund directors have an intense interest in this area and we believe the industry needs additional guidance from the Commission. The IDC has studied the issue of soft dollars and, in December 2004, adopted a Statement of Policy Concerning Soft Dollars² in which we supported narrowing the interpretation of the scope of the safe harbor for the use of soft dollars to protect only brokerage services, as described in Section 28(e)(3) of the Securities and Exchange Act of 1934, and the “intellectual content” of research, as defined in the NASD Report of the Mutual Fund Task Force on Soft Dollars and Portfolio Transaction Costs.³ We shared a copy of this Policy Statement with former SEC Chairman Donaldson on December 27, 2004. The IDC believes that funds should limit the use of soft dollars to bona fide research and that the Commission should, in all instances, narrowly interpret the scope of the safe harbor. While the interpretive release aims toward this goal, in our view, it falls short of providing the clarity needed to enable directors to oversee effectively the conflict presented by the use of soft dollars.

As the interpretive release points out, the payment of soft dollars is legally permissible under the safe harbor of Section 28(e). Fund director oversight of the practice is important to ensure that the potential conflict presented by an adviser’s use of

¹ The Independent Directors Council serves the mutual fund independent director community and provides a venue to advance the education, communication, and policy positions of mutual fund independent directors. The IDC’s Governing Council represents 28 fund complexes with \$ 4.5 trillion dollars in assets or 51.7% of industry assets reported to the Investment Company Institute.

² A copy of the IDC Policy Statement is attached.

³ NASD, Report of the Mutual Fund Task Force, “Soft Dollars and Portfolio Transaction Costs” (Nov. 11, 2004), available at http://www.nasd.com/web/groups/rules_regs/documents/rules_regs/nasdw_012356.pdf.

fund commissions paid by shareholders for research services and brokerage is resolved in a manner that benefits fund shareholders. The challenge for fund boards is to balance the benefits a fund obtains with soft dollar commissions against the cost to that fund's shareholders. Under the current system, directors are not being effectively supported in their efforts to do this. As discussed in more detail below, the description of proposed eligible items in the interpretive guidance doesn't help the job of directors because it is unnecessarily broad and would permit payments that are viewed by many as a hidden subsidy to the adviser's overhead. Additionally, the payment of soft dollars is a cost to shareholders that is not transparent. This is counter to the efforts by directors to advance transparency of all costs to shareholders. As part of its forthcoming proposal relating to disclosure of soft dollar practices, we encourage the Commission to require disclosure to the board of the allocation of commission dollars paid between execution and the other benefits received so the board can understand the difference and can take that difference into account at the time the board reviews the management contract.

With respect to the current interpretive release, the IDC strongly encourages the Commission to further narrow the scope of the safe harbor to permit as eligible research items only those items that reflect "intellectual content" or offer true value added to shareholders. While the guidance suggests that eligible research services under Section 28(e) should include advice, analyses and reports that have "substantive content" or the expression of reasoning or knowledge, the list of acceptable items, in our view, includes items that possess none of these attributes. By way of example, mass-marketed newsletters, trade journals, and similar publications do not offer the subjective analysis that advances the objectives of the safe harbor. We are confident that the shareholders we directly represent would not include such items under a common sense definition of "research". Similarly, market data and financial and economic data that are readily available from a variety of sources do not offer unique benefits to shareholders. These basic tools of the trade should be treated as overhead expenses of the adviser and, as such, should not be passed on to fund investors.⁴

The release seeks to qualify the inclusion of these items in the safe harbor by requiring that eligible items also be evaluated to ensure they provide "lawful and appropriate" assistance to the money manager and that each money manager make a good faith determination that the commissions paid for the research services are reasonable in light of the value of the research obtained. We submit that the application of the safe harbor would be easier for directors to monitor if these subjective determinations were

⁴ We are aware that some commentators have suggested that items such as stock price quotation services, subscriptions to magazines covering issues related to the industry and other material relating to basic economic research are within the safe harbor of Section 28(e). We encourage the Commission to avoid advancing this notion and instead seek to narrow that interpretation of eligible research. We view the position of the FSA that price feeds or historical price data that have not been analyzed or manipulated should not meet the requirements of research as the correct one. *See* Securities Exchange Act Release No. 52635 (October 19, 2005) at note 89 available at <http://www.sec.gov/rules/interp/34-52635.pdf>.

replaced with a list of eligible research items that excluded items lacking the expression of reasoning or knowledge articulated in the release. This interpretation would avoid misuse of the rule and facilitate the already difficult task faced by fund directors.

We recognize that individual boards have the ability to limit or prohibit the use of soft dollars by their fund, and some firms have taken this step. However, the economic reality is that a fund's adviser that does not receive soft dollars may find that it is competitively disadvantaged. Further, the amount paid for execution may or may not be reduced so that those advisers, in effect, may be passing up research that is on the table. Directors are in a difficult spot. The practice of paying soft dollars is permissible and may advantage the management company and, arguably, shareholders. Yet, the actions of regulators in recent settlement actions strongly suggest that soft dollar payments should not be allowed. The Commission now has the opportunity to send a clear message to the industry. In the absence of Congressional action to eliminate soft dollars, we urge the Commission to advance a narrow interpretation of eligible research services under the safe harbor of Section 28(e). To the extent a firm engages in soft dollar arrangements, the interpretive release should make clear that the safe harbor extends only to items that, on their face, reflect true intellectual content. Clearer guidance from the Commission in this area will greatly enhance the ability of directors to oversee soft dollar practices and to better protect shareholder interests.

We look forward to guidance from the Commission regarding additional disclosure requirements and the concept of "unbundling." This would address our second concern outlined above – that these additional costs to shareholders are not transparent. As noted in the attached Policy Statement, we recognize the challenges posed by mandating unbundling. However, we feel strongly that it is important that directors be provided the information necessary to understand the amount paid for execution separately from the other benefits received with commission dollars. We believe this required disclosure should apply to third party as well as proprietary research to facilitate director oversight of a fund adviser's soft dollar practices. We urge the Commission to require enhanced disclosure on these matters so that directors are better able to serve the interests of our shareholders.

We appreciate the opportunity to submit comments on this guidance.

Sincerely,

/s/

James H. Bodurtha
Chairman
Independent Directors Council

Attachment

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cc: The Honorable Christopher Cox, Chairman
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
The Honorable Annette L. Nazareth, Commissioner

Meyer Eisenberg, Acting Director, Division of Investment Management

INDEPENDENT DIRECTORS COUNCIL

Statement of Policy Concerning Soft Dollars

The Independent Directors Council (IDC) supports increased transparency and simplified disclosure to mutual fund shareholders about the use of soft dollars. It believes that the current system whereby mutual funds pay commissions that include charges for execution as well as research and other services without separately stating the cost for each service is potentially adverse to the interests of mutual fund shareholders and unnecessarily complicates the oversight responsibilities of fund directors.

The IDC has examined several options for addressing potential conflicts of interest presented by the use of soft dollars including:

1. Unbundling of execution and research costs;
2. Requiring additional disclosure that would add transparency to the practice of paying soft dollars;
3. Narrowing the definition of permitted research; and
4. Eliminating the use of soft dollars entirely.

Concerns have been raised within the industry that some of these approaches could have unforeseen adverse implications for certain segments of the industry. Some are concerned there would be a negative impact on shareholders who benefit from the research that soft dollars provide. The IDC recognizes that some are concerned that the termination of all soft dollar practices may have an adverse impact on activities such as independent research. Ultimately, however, we believe the best research quality will come about as a result of full and open competition for fund research dollars.

Accordingly, the IDC adopts today the following policy statement concerning soft dollars:

1. The IDC supports narrowing the interpretation of the scope of the safe harbor for the use of soft dollars to protect only brokerage services, as described in Section 28(e)(3) of the Securities Exchange Act of 1934, and the “intellectual content” of research, as defined in the NASD Report of the Mutual Fund Task Force on Soft Dollars and Portfolio Transaction Costs (the “NASD Report”)¹. The IDC believes that funds should limit the use of soft dollars to bona fide research and that the scope of the safe harbor should in all instances be narrowly interpreted.

¹ The NASD Report proposes that the SEC define “intellectual content” as “any investment formula, idea, analysis or strategy that is communicated in writing, orally or electronically and that has been developed, authored, provided or applied by the broker-dealer or third-party research provider (other than magazines, periodicals or other publications in general circulation).” According to the report, the definition of research services would not extend to the means by which the intellectual content is delivered or provided.

2. The IDC supports greater disclosure to both fund directors and investors concerning payment of soft dollars. The IDC believes that the recommendation in the NASD Report concerning additional disclosure regarding soft dollar practices² is too limited and recommends extending the disclosure to proprietary as well as third party research.
3. To achieve this goal, the IDC asks the Securities and Exchange Commission to require, through rule change, that all brokers executing a transaction separately state or “unbundle” the costs charged to the fund for research and brokerage services. The IDC does not believe that the investment adviser is in a position to provide “unbundled” information without the assistance of the broker and, for this reason, the SEC should require the broker to supply it. Fund directors receiving unbundled execution cost data will be better informed and able to make better decisions about the use of fund assets, to the ultimate benefit of fund shareholders.

The Independent Directors Council serves the mutual fund independent director community and provides a venue to advance the education, communication, and policy positions of mutual fund independent directors. The Council's members represent 28 fund complexes with \$2.956 trillion dollars in assets, or 39% of the industry assets. For more information about the Council, contact the Council's Managing Director, Marguerite Bateman, at 202-326-5813 or bateman@ici.org.

² The NASD Report calls for disclosure of, among other items, the amount of third party research benefits obtained with fund commissions expressed in dollars and in basis points.