Consumer Federation of America

Fund Democracy
The Mutual Fund Shareholder's Advocate

November 23, 2005

BY ELECTRONIC MAIL

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

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

Dear Secretary Katz:

We are writing on behalf of the Consumer Federation of America and Fund Democracy in response to the Commission's proposed clarification regarding brokerage and research services that can be paid for with soft dollars under the safe harbor provided in section 28(e) of the Securities Exchange Act of 1934.

Because their use drives up portfolio transaction costs, makes a mockery of the expense ratio as an accurate reflection of mutual fund costs, creates significant conflicts of interest between funds and their shareholders, and interferes with the functioning of the free market, our organizations have supported a ban on the use of soft dollars to pay for any goods or services, including research, that could readily be purchased with hard dollars. We recognize, however, that a total ban cannot be accomplished through Commission rulemaking and instead would require congressional action.

Absent such a ban, the Commission can and should significantly narrow the existing interpretation of the safe harbor. The Commission's interpretation the safe harbor in its recent release ("Release"), however, is directly at odds with this position. As a result, we urge the Commission to substantially revise its position to ensure that the safe harbor covers the narrowest scope of soft dollar arrangements consistent with the terms of section 28(e).

I. Background

When Congress deregulated brokerage commissions in 1975, it introduced a welcome whiff of market competition into the nation's securities markets. Brokers, who had become accustomed to competing based on such factors as their research, however, were understandably

concerned about how they would adapt if they "could no longer be compensated in commissions for their work product." One can argue in hindsight that Congress should have trusted the market, confident that, if the research had value, money managers would have been willing to pay for it with hard dollars. Instead, however, Congress adopted the safe harbor in Section 28(e) to ease the transition to a non-fixed-commission environment. Over the years, instead of acknowledging that the safe harbor was no longer needed or justified in an era when brokers had fully adjusted to deregulated commissions, the Commission has repeatedly and inexplicably expanded the safe harbor.

While the Commission notes in its current Release that its new interpretation is intended to recognize "changing market conditions," it continues to offer a broad interpretation of the safe harbor, as if nothing at hall had changed over the past 30 years. In fact, the interpretation in the current Release is effectively broader than the interpretation put forward by the Commission in 1976, when the argument for a broad interpretation had at least some credibility as a response to an abrupt end to fixed commissions. In short, instead of adopting a pro-investor approach by ensuring that soft dollar arrangements protected by the safe harbor are as limited as reasonably possible, the Commission appears in this Release to be far more concerned that it do as little as possible to upset existing soft dollar arrangements.

II. The Release Ignores Significant Problems Associated with Soft Dollars

In developing the case for its approach to the soft dollar safe harbor, the Commission presents a very limited view of the potential harms to investors posed by soft dollars. These include not just the risk that money managers will use client commissions to benefit themselves, which the Commission does cite, but also the risks that money managers will use one client's trades to benefit another client and that they will use soft dollars to hide expenses from their clients. These problems are ignored in the Release.

As the Commission notes, the most significant potential abuse associated with soft dollars is the risk that money managers will use client commissions to benefit themselves. Soft dollars are commonly used for brokerage and research services that money managers would otherwise pay for themselves. Money managers are paid advisory fees that compensate them for the costs of providing portfolio management and certain execution services. Soft dollar arrangements enable money managers to cause their clients to pay twice for these services – once through the advisory fee and once through the trading commissions. Because the safe harbor permits this kind of cost shifting from managers to shareholders, every soft dollar spent by the client is potentially a dollar in additional profits to the money manager.

While the Release acknowledges this problem, it does not even mention the problem of money managers' using soft dollars to hide expenses from their clients. Mutual fund expense ratios exclude portfolio transaction costs, and the Statement of Additional Information (a rarely read document) requires only that the total amount of soft dollar commissions be disclosed. Other money managers are not required to disclose even this information under Form ADV and common law rules. This disclosure loophole creates a powerful incentive for money managers to reduce their posted fees by shifting expenses to soft dollar arrangements. Money managers who

can simultaneously shift costs onto shareholders and hide those costs from view have little incentive to negotiate the lowest price. As a result, the ability of the market to discipline costs is seriously impeded.

The Release also does not mention the problem of money managers' using one client's trades to benefit another client. This is perhaps because the Commission has helped to create this problem by past interpretations that expressly permitted money managers to use one client's assets – its brokerage – to benefit another client. Thus, an index fund manager that generally will have little use for research services has been permitted to use the fund's soft dollars to generate benefits for other clients rather than seeking the lowest possible transaction costs for the benefit of the index fund's shareholders. Similarly, a money manager that operates a mutual fund and hedge fund side-by-side may use soft dollars paid for by the fund shareholders to benefit the hedge fund investors (particularly troubling in light of the fact that money managers typically retain a share of hedge fund profits). The result of these practices is that one set of shareholders is inappropriately disadvantaged for the benefit of others.

III. Problems with the Commission's Interpretation of the Soft Dollar Safe Harbor

The safe harbor, as the Commission concedes, insulates "conduct that may be a breach of fiduciary duty" and that would likely be a per se violation of the Investment Company Act and ERISA for clients covered by those statutes. The Commission also notes that, "[a]s fiduciaries, money managers are obligated to act in the best interest of their clients," but the safe harbor stands for the precisely the opposite principle: that money managers can violate their fiduciary duty with respect to soft dollar arrangements as long as the safe harbor is available to protect them. The Commission itself concedes that because of the effect of the safe harbor it "should be construed in light of its limited purposes." All these factors, as well as the soft dollar problems enumerated above, strongly militate for a narrow interpretation of the scope of the safe harbor. As a result, the relevant question for each service that could potentially be paid for through soft dollars should not be whether it could reasonably be included within the safe harbor, but whether it could reasonably be excluded.

Yet the Commission continues to take an expansive view of the safe harbor that substantially exceeds its plain terms. Examples of this overly broad approach abound. For instance, the research safe harbor covers only "advice, either directly or through publications or writings," "analyses," and "reports." Yet the Commission finds that seminars or conferences would qualify, notwithstanding that neither fits within a reasonable understanding of "advice, either directly or through publications or writings," "analyses," and "reports." Clearly, seminars and conferences could reasonably be interpreted to fall outside of the safe harbor. By including them within the safe harbor, the Commission seems to be adopting a policy objective of permitting the broadest possible reading of the safe harbor, rather than the narrowest. The same problem applies to the Commission's position that these terms cover data services, which again do not qualify (or at least could be reasonably interpreted not to qualify) as "advice, either directly or through publications or writings," "analyses" and "reports."

The Commission's interpretation of incidental brokerage services also appears to attempt to broaden rather than narrow the safe harbor. By taking a "temporal" approach to transactional services, the Commission would permit a broad array of overhead expenses to be treated as incidental to securities transactions. For example, the Commission would permit money managers to treat connectivity services to broker-dealers and custodians as incidental to securities transactions, when in fact they are overhead services that are essential (not incidental) to money management services. Rather than reasonably interpreting the phrase "effects securities transactions" to relate to the particular transaction with respect to which the soft dollar commission is paid, the Commission has opted for an extremely broad interpretation that permits money managers to use fund brokerage to pay for basic overhead expenses that should be paid out of the money manager's own pocket.

The Commission's position that internal order management systems, for example, fall outside of its extra-statutory "temporal standard" is similarly untenable. This position will create an incentive for money managers to outsource such internal transaction services in order to enable the fund to pay for these services with soft dollars, notwithstanding that these services normally could be covered by the money manager's fee. The Commission's position raises the question of whether it would be more efficient to require money managers to disclose not what services soft arrangements cover, but what services they do not cover, in order that their clients can easily identify the limited services that they are actually paying for through the money manager's fee.

IV. Pro-investor Changes to the Interpretation are Needed

In light of these serious short-comings in its approach, we urge the Commission to reverse course and return to its stated policy of interpreting the safe harbor narrowly. Toward that end, we strongly recommend that the Commission take the following steps to protect investors against soft dollar abuses.

First, the definition of research services should be limited to "products or services that reflect the expression of reasoning or knowledge."

In 1976, the Commission correctly interpreted that the safe harbor for research should be limited to "products or services that reflect the expression of reasoning or knowledge." However, it now applies that interpretation to include seminars and conferences which arguably do not meet that restriction. The Commission should reevaluate what services qualify for the research service safe harbor using the approach we have advocated above, in which any service that can reasonably be excluded from the safe harbor is excluded.

Second, the safe harbor should not be available to "products and services which are readily and customarily available and offered to the general public on a commercial basis."

We agree with the Commission's 1976 position that the safe harbor should not cover "products and services which are readily and customarily available and offered to the general

public on a commercial basis." Furthermore, the burden should rest on those who use soft dollars to purchase goods and services to demonstrate that they could not have been purchased using hard dollars. (We would offer one exception to this standard, and that is for third-party research. Until Wall Street firms are required to unbundle their commissions and sell their research separately, independent research firms should also qualify for this "bundled" treatment, even though their research may be "readily and commercially available and offered to the general public on a commercial basis.)

Third, the safe harbor should be available only the extent that the client who pays the commissions receives some benefit from all of the research and brokerage services provided.

As noted above, soft dollars permit cost-shifting from one set of shareholders to another. The fiduciary duty not to use one client's brokerage solely to benefit another client without the express authorization of the first client is not the fiduciary duty for which section 28(e) provides a safe harbor. The Commission should take the express position that the safe harbor does not protect the payment of commissions by one client solely for benefits provided to another client, as such conduct falls outside the express terms of the safe harbor.

Fourth, the safe harbor should be available only with respect to research and brokerage services for which the money manager has determined and fully disclosed the monetary value.

Although the Commission indicates that this Release is intended to address changing market conditions, one change in market conditions that the Commission has failed to address is the ability of soft dollar providers to quantify the value of soft dollar research and brokerage benefits. If money managers are to be permitted to shift some of their costs back to their clients through the use of soft dollars, then they should be required to disclose to their clients the value of the soft dollar benefits that the money manager might otherwise have had to purchase with its own assets. This is necessary to reduce the market-distorting incentive to use soft dollars in order to conceal the true cost of using a particular money manager. The deal recently struck between Fidelity and Lehman Brothers under which Fidelity will use hard dollars to buy research demonstrates that claims that soft dollar benefits cannot be priced are greatly exaggerated. While a less desirable solution than actual unbundling, providing a detailed accounting of the prices of goods and services paid for with soft dollars would at least help to introduce some cost discipline. Frankly, we cannot see how fund managers and directors could meet their fiduciary obligation to shareholders without at least demanding the detailed accounting we are advocating.

Fifth, Congress could not have intended the term "commission" in section 28(e) to apply to principal transactions.

Finally, the Commission should reverse its position that principal transactions are commissions. It is simply inconceivable that Congress, in an attempt to address the effects of un-fixing commission rates, intended that the term "commission" cover principal transactions. The Commission's completely unauthorized expansion of the safe harbor to principal

transactions best illustrates our skepticism that it truly wishes to interpret the safe harbor narrowly. The term "commission" refers to an agency transaction, not a principal transaction. Mark-ups and mark-downs in principal transactions are not commissions; they are mark-ups and mark-downs. The Commission cannot in good conscience continue to take the position that the safe harbor is available for principal transactions while professing that the safe harbor "should be construed in light of its limited purposes."

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Rather than narrowing the scope of the safe harbor as the brokerage industry has adapted to a non-fixed commission environment, the Commission has continuously expanded it. This expansion has exacerbated the problems created by soft dollar arrangements, some of which are not even acknowledged in the Release. The history and effect of the safe harbor militate for a narrow interpretation of its scope, yet the Commission continues to find ways to protect services that were never intended to be protected. The Commission should reverse course and provide a much narrower interpretation of the safe harbor that truly reflects changing market conditions and puts investor, rather than industry, interests first.

Thank you for your attention to our concerns.

Respectfully submitted,

Barbara Roper
Director of Investor Protection
Consumer Federation of America

Mercer Bullard
President and Founder
Fund Democracy

cc (U.S. mail only):

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