

Mr. Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-0609

Re: File No. S7-09-04

Proposed Rule: *Prohibition on the Use of Brokerage Commissions to Finance Distribution*

Dear Mr. Katz:

Morningstar, Inc. ("Morningstar") is pleased to provide comments on the Securities and Exchange Commission's (the "Commission") proposed rule, *Prohibition on the Use of Brokerage Commissions to Finance Distribution* (the "proposal"). The proposal would amend the 12b-1 rule under the Investment Company Act of 1940 to prohibit funds from using brokerage commissions to pay for fund distribution.

We wholeheartedly support the proposed rule.

Thank you again for the opportunity to express our views regarding this proposal. We offer the following specific comments in response to your questions:

Proposed Ban on Directed Brokerage

1. *Are our concerns about this practice justified?*

Morningstar believes the Commission's concerns about directed brokerage, specifically that the practice "is fraught with conflicts of interest and may be harmful to funds and fund shareholders," are warranted.

As Morningstar managing director Don Phillips testified before the U.S. Senate in February 2004, it is imperative that mutual funds operate on a fair and level playing field. In fact, investors expect that this is the case, which is one reason that the mutual-fund industry enjoys the immense level of public trust that it does. Directed brokerage, however, compromises that confidence. Fund investors should be able to reasonably expect that funds are offered based on their investment merit and suitability for their portfolios, and not based on which investment companies are paying the most, or extra, in trading commissions. As long as mutual funds are allowed to potentially influence brokers and other financial intermediaries to sell their funds for reasons other than their clients' best interests, fund shareholders are being harmed.

We also believe that directed brokerage is harmful to funds. Bundling distribution fees with trading commissions makes costs associated with trade execution much less transparent and thus heightens the possibility that funds overpay for trade execution. This creates unnecessary costs for funds, and these costs erode investor returns. Further, to the extent that fund companies set target commission levels with broker-dealers, portfolio managers could end up trading unnecessarily. Portfolio managers should trade only when they believe the investment calls for it.

2. *Are there alternative measures that we could take to address the use of brokerage commissions to finance distribution?*

Morningstar believes that using brokerage commissions to finance distribution should be banned. We don't see other alternative measures that would give the same, desirable result: eliminating any conflict of interest or potential for abuse.

3. *Would brokerage commissions be reduced by eliminating the use of commissions to pay for distribution? Would there be greater competition in commission rates?*

We do believe that brokerage commissions would be reduced by eliminating the use of commissions to pay for distribution and that there would be greater competition in commission rates. We believe that unbundling costs, including other soft-dollar expenses as well as directed-brokerage payments, from trading commissions would lead fund companies to more regularly look for best execution in other places, including electronic communication networks (ECNs) and lower-cost brokerages, in part because trading costs would be easier to compare. To the extent that alternative trading outfits are used more often and take market share from traditional broker-dealers, we believe that these broker-dealers will respond by lowering commission rates to take back share.

4. *If we ban this practice, would the primary effect be to increase brokers' demands on advisers to make payments out of their assets, i.e., revenue sharing? Are we correct in our assumption that properly disclosed revenue sharing payments present more manageable conflicts for funds and broker-dealers?*

While we cannot be sure that broker-dealers would look for alternative sources of revenue once directed-brokerage revenue dries up, we believe that broker-dealers would indeed look for ways to replace this revenue. Broker-dealers asking for more revenue sharing seems a likely consequence. Morningstar is certainly no fan of revenue sharing--while the practice is less harmful to funds, it shares the same conflicts of interest with directed brokerage when it comes to investors--we do believe that revenue sharing, if thoroughly, prevalently, and blatantly disclosed, is a more manageable conflict.

5. *If our assumption is incorrect, should we take additional steps to address revenue sharing concerns? If so, what steps should we take?*

Morningstar believes that the Commission should ultimately ban revenue sharing. In order for investors to safely assume that mutual funds operate on a fair and level playing field, broker-dealers and other financial intermediaries must offer their clients funds based solely on their investment merit and suitability for investors' portfolios.

6. *Should we increase or revise the disclosure requirements concerning the use of brokerage commissions to pay brokers for selling fund shares? Instead of banning directed brokerage, is there a disclosure-based alternative that would adequately address the concerns discussed above? If so, what should be the format of these disclosures? Where should these disclosures be located--in the prospectus, the SAI, or the annual reports?*

Morningstar generally believes that funds should do a better job of disclosing a variety of information and practices. We think that the current disclosure regarding directed brokerage is weak. The current disclosure is generally found in a fund's SAI--a document, sadly, that isn't typically studied by mutual-fund investors, largely because it is often written in a confusing or legalistic manner. Further, the language used to discuss directed brokerage has become boilerplate, giving investors little basis for comparison, and vague, giving investors little insight into its meaning. This disclosure should be more meaningful--perhaps under the heading "Potential Conflicts of Interest for [this fund]," which might include other conflicts--and appear in a place that investors are most likely to examine, both the prospectus and annual report, for instance.

However, Morningstar stresses that it would rather see directed brokerage banned outright. Banning the practice would eliminate any potential conflicts of interest and opportunity for abuse.

7. *Should the disclosures be quantitative (e.g., discuss the amount of brokerage commissions) or qualitative (e.g., discuss the nature of the arrangements and the potential conflicts of interest), or both? Could a single quantitative measure accurately disclose the costs under the many different arrangements through which brokerage commissions are used to pay for distribution?*

Morningstar generally believes that more disclosure, if provided in a meaningful and understandable way, is best for investors, so both a quantitative and qualitative assessment would be appropriate. If directed-brokerage disclosure included a quantitative analysis, however, we think it would be necessary for fund companies to provide context. For example, if amounts of brokerage commissions were provided and broken down, fund companies should also give some indication of clearly appropriate industry and/or historical norms. A qualitative analysis should be thorough and candid, divulging all potential conflicts of interest and additional costs to funds.

However, as previously stated, we would much rather see the Commission ban directed brokerage, making such disclosure unnecessary.

8. *Would the disclosures enable shareholders, either directly or based on assessments by investment analysts, to choose between funds that engage in these types of arrangements?*

Morningstar believes that directed brokerage should be eliminated, for reasons discussed above. However, for disclosure to enable investors and investment analysts to better choose among funds that engage in these types of arrangements, it must be uniform and comprehensive.

9. *What costs would a fund likely incur in making these disclosures?*

We cannot say for sure, but we do not doubt fund companies would pass any cost on to shareholders, if allowed. These additional costs to fund shareholders give another reason to merely ban directed-brokerage practices, which would make any costly disclosures unnecessary.

10. *Should we revise the disclosure requirements and ban the use of brokerage commissions in the manner described above? Should we revise the disclosure requirements and ban only certain types of arrangements under which brokerage commissions are used to finance distribution?*

Morningstar believes that all forms of directed brokerage should be banned. We think that any arrangement that targets commission levels, whether precisely or in "ball-park" figures, undermines a fund's ability to choose freely among trading entities and could encourage fund managers to trade excessively. Worse, paying for distribution with trading commissions, a fund asset, hurts investors who expect that funds are offered based on investment merit (as they should be).

#### Policies and Procedures

1. *Is it appropriate to require funds that execute transactions through their selling brokers to implement policies and procedures to ensure that distribution considerations do not affect execution decisions?*

Even if directed brokerage is banned, there will be numerous occasions when funds will execute transactions through their selling brokers. To avoid any potential conflict of interest, or the appearance of conflicts, or other abuse, Morningstar believes that funds should adopt policies and procedures to ensure that distribution considerations do not affect execution decisions.

2. *Is the scope of the proposed policies and procedures appropriate? Should we include different or additional objectives?*

We agree with the Commission that policies and procedures should be designed to ensure that funds' selection of executing brokers is not influenced by fund sales and that fund companies do not enter into directed-brokerage agreements to compensate selling brokers.

We also think the Commission should consider a third objective: ensuring that funds' turnover is not influenced by sale of fund shares. More specifically, a fund's principal underwriter should not be permitted to pressure investment personnel to increase trading activity in a fund as a reward for any selling broker; thus, we believe that fund companies should not be allowed to "target" commission levels, whether in precise or approximate figures. We believe that communication between a fund's distributor and its investment staff should thus be restricted: A Chinese wall could keep the investment staff from learning which selling brokers are most important to the distributor and keep the distributor from knowing how the investment staff distributes transactions among executing brokers.

3. *Would these policies and procedures be effective in preventing funds and broker-dealers from circumventing the ban on paying distribution-related expenses with brokerage commissions?*

We cannot say that we think these policies and procedures would be 100% effective; there could always be some rule-breakers. We do believe that the policies and procedures would be most effective if they allow for accountability to the fund board and fund shareholders. These policies and procedures should thus be fully disclosed. We can say that we think these policies and procedures will make it harder for funds to pay distribution-related expenses with brokerage commissions.

4. *Should we adopt other measures to help the fund monitor the use of fund brokerage? The rule would require the board of directors to approve the policies and procedures. Should we also require the board of directors to monitor the fund's adherence to the policies and procedures, or to approve the allocation of brokerage? Should we require the fund's adviser to report to the board on its decisions regarding brokerage allocation? Are there other measures we should require the board to take to ensure that brokerage decisions are not influenced by brokers' distribution efforts?*

Morningstar believes that funds should be required to monitor their brokerage transactions on an ongoing basis, and, to keep funds accountable, that the board and fund shareholders should be provided with a semiannual or annual report of brokerage allocation. If this report shows that any one executing broker was favored, the fund should describe how that broker provided best execution and whether or not that broker is an important selling broker. We do not believe that the board should be required to approve brokerage allocation; however, we do think the board should be permitted to adopt that task, if it proves necessary.

5. *Should we require a fund's chief trading officer (or another official of the fund or its adviser) to certify periodically that the selection of brokers to execute the fund's portfolio securities transactions was made without taking into account the brokers' promotion or sale of shares issued by the fund or any other fund?*

We believe the chief compliance officer, who reports to the board, should certify periodically that brokerage allocation was made without taking the sale of fund shares into account.

6. *Should we include a safe harbor in the rule for funds that execute portfolio securities transactions with a selling broker? If so, what conditions should we include in the safe harbor? Would the absence of a safe harbor affect the ability of funds to obtain best execution?*

Morningstar has no comment, except to say that the Commission should be sure to avoid creating loopholes that would allow funds to circumvent a ban on directed brokerage.

#### Request for Comment on Further Amendments to Rule 12b-1

Morningstar generally believes that the Commission should amend or eliminate rule 12b-1. The rule was intended as a temporary measure to help funds maintain and grow assets; few could argue today that the multitrillion-dollar industry is in jeopardy. Additionally, we cannot say that rule 12b-1 has succeeded in meeting its ultimate goal: to help funds achieve economies of scale, thus lowering costs borne by fund shareholders. Rather, Morningstar has found that funds with 12b-1 fees have actually seen their expense ratios rise more than those without 12b-1 fees.

Further, the rule has evolved beyond its original scope. Today, the biggest portion of 12b-1 fees goes either to selling brokers as compensation for servicing client accounts or to fund supermarkets. While Morningstar believes that these services are valuable to some fund shareholders, we think the fees are more appropriately paid directly by those shareholders to the entity providing such services.

Finally, because rule 12b-1 costs are lumped into a fund's expense ratio, they affect performance, putting portfolio managers of funds with 12b-1 fees at a disadvantage to those that run funds without 12b-1 costs. In the competitive world of mutual funds, this setback could encourage fund managers to take additional risks in an attempt to overcome the higher-expense burden.

1. *Would a shareholder account-based approach make sense?*

We do think that distribution fees are best paid at the shareholder account level, as appropriate if incurred. However, it's imperative that these charges be disclosed at the point of sale to give investors enough information with which to make a purchase decision. Further, to the extent that shareholder accounts would ultimately pay a smaller nominal amount as they age, the risk that the selling broker would trade the account is heightened. The Commission may find a new, or rather, renewed, problem: churning.

2. *If we were to rescind the rule, what would be the consequence for funds, fund shareholders, fund advisers, and brokers that sell fund shares? How would elimination of the rule affect the aggregate amount of shareholder expenses? What alternate methods of financing distribution would funds and advisers use?*

Many financial intermediaries argue that a rescission of rule 12b-1 would result in smaller investors being ignored by financial professionals and that smaller investors would be precluded from owning some funds. If financial intermediaries were not compensated in some way for their ongoing services, we do not doubt that some investors would be ignored. However, we are not suggesting that selling brokers not be paid if and when they provide services to investors. We merely believe that they should be paid directly by investors who are using their services and should not be paid through funds or by investors who are receiving no benefit of a financial intermediary's services. Morningstar believes that financial intermediaries who are being paid directly by investors will continue to service these accounts; we also believe that investors will be smarter about what services they demand from financial intermediaries, as the costs of such services would be more transparent.

3. *Should the fund's adviser or principal underwriter pay all promotional expenses, or are there certain distribution expenses that should be paid with fund assets?*

In general, Morningstar believes that promotional expenses should be borne by the fund's adviser or principal underwriter, as fund company earnings benefit most from asset growth. Fund assets should be used to pay the investment-management fee; however, there should be no loopholes that would allow promotional or distribution expenses to be classified as "investment-management" costs. For other services, including distribution, investors should pay the party that provides the service. For example, investors who buy funds directly from fund companies would pay the least amount of distribution costs, if any; investors who buy from a supermarket, financial planner, or other source would pay a little more. That way, one group of shareholders doesn't end up subsidizing another group.

4. *Funds often pay for administrative services provided by third parties with asset-based fees. If we were to propose to rescind rule 12b-1, should we also propose restrictions on the use of asset-based fees to ensure that distribution expenses are not improperly characterized as, e.g., shareholder account servicing expenses?*

Yes.

5. *If we were to rescind rule 12b-1, would particular types of funds, such as funds with fewer net assets or newer funds, be disproportionately disadvantaged?*

Morningstar does not believe that particular types of funds would be put at a serious, long-term disadvantage if rule 12b-1 is rescinded. There's little inherent disadvantage to investors owning a new fund or fund with low net assets. True, smaller funds may be more costly to operate before meaningful economies of scale can be achieved, and they may thus have a higher expense ratio. However, we believe the merits of a good fund will ultimately overcome these higher costs. Indeed, the no-load world of mutual funds is full of examples of funds that have assessed moderate fees from their inception; many of these funds flourished. One example includes Dodge & Cox International, which was launched in May 2001 with a moderate expense ratio and no 12b-1 fee. That fund has since grown to more than \$1 billion in assets.

6. *How would rescission of rule 12b-1 affect distribution arrangements, e.g., fund supermarkets and other arrangements that anticipate the receipt of 12b-1 fees?*

Fund companies would have to pay supermarket costs out-of-pocket, as many no-load funds already do. Alternatively, the supermarkets would charge transaction fees to shareholders, as already occurs in some cases.

7. *If we rescind the rule, should we propose a new rule that would prohibit the use of fund assets to pay for sales and distribution expenses?*

If the Commission believes that rescinding rule 12b-1 would not prevent funds from using fund assets to pay for sales and distribution expenses, it should indeed propose a new rule that prohibits the use of fund assets to pay for sales and distribution expenses.

We appreciate the Commission's work on directed brokerage and more generally on 12b-1 fees. We believe the Commission will serve investors well by eliminating directed brokerage. Morningstar further thinks that changes to or the rescission of rule 12b-1 will make for a more-transparent, more-efficient mutual-fund marketplace. We thank the Commission for this opportunity to comment.

Sincerely,

Bridget B. Hughes, CFA  
Senior Fund Analyst  
Morningstar, Inc.  
225 West Wacker Drive  
Chicago, Illinois 60606