Securities Industry Association
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Via Electronic Mail – rule-comments@sec.gov May 10, 2004

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0506

Re: Proposal to Prohibit the Use of Brokerage Commissions to Finance Distribution (File No. S7-09-04)

Dear Mr. Katz:

The Securities Industry Association ("SIA")[1] appreciates the opportunity to comment on the above referenced proposal[2] to amend rule 12b-1 under the Investment Company Act of 1940 to prohibit funds from compensating a broker-dealer for promoting or selling fund shares by directing brokerage transactions ("directed brokerage") to that broker. The proposing release also requests comment on whether the Commission should propose additional amendments to rule 12b-1, or propose to rescind the rule.

In sum, SIA supports the SEC's proposal to bar funds from using directed brokerage to compensate brokers' selling efforts. While that proposal is a positive development, we do have some concerns that the Commission's proposal could be misunderstood to interfere with best execution obligations, and below we propose a clarification on that point. On the SEC's request for comments on additional amendments to Rule 12b-1, or possible rescission of the rule, we believe that Rule 12b-1 has on the whole been a very successful rule which has helped to dramatically reduce mutual fund sales loads, while helping to make it possible for broker-dealers to provide mutual fund "super markets" and many other services available to millions of small investors. We recommend that, rather than focus on reengineering one aspect of the complex

[1] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs 780,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated an estimated $209 billion in domestic revenue and $278 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

[2] SEC Release No. IC-26356 (February 24, 2004)

relationship between funds and broker-dealers, the Commission should convene a public roundtable to explore the entire mutual fund compensation structure, the services that it funds, possible steps to effectively improve transparency of compensation, and whether payments to broker-dealers are used in a manner consistent with their intended purpose.

Directed Brokerage

While SIA supports the current proposal, we have significant concerns that it may lead to consequences beyond its intended purpose. During the presentation of the rule proposal to the Commission at its February 11, 2004 open meeting, Division of Investment Management Director Paul Roye, in substance, stated that the intent of the rule is to prohibit the direction of brokerage to broker-dealers based on the level of fund shares distributed by the broker-dealer, but it is clearly not intended to prevent the direction of fund portfolio transactions to broker-dealers who can provide best execution, simply because they are a distributor of fund shares.

SIA very much appreciated Mr. Roye's comments at the open meeting, but we are concerned that such comments are not explicitly reflected in the content of the rule proposal or the proposing release. Therefore, we believe that it is absolutely critical that this shortcoming in the proposal be clearly addressed in any final rule (and/or adopting release) which may be issued by the Commission.

We have been told that some fund complexes have already stopped sending orders to broker-dealers that are significant distributors of their shares, even though no directed brokerage arrangement exists between the firm and the broker-dealer. We believe that heightened fund board sensitivity to conflicts of interest, while praiseworthy in many important respects, may cause boards to proscribe fund activities which create a "perception" of potential conflict, even where the reality is quite different, and the underlying activity is in the best interests of shareholders. This would clearly be the result if a fund stopped directing portfolio transactions to a broker-dealer who provided best execution, simply because that broker-dealer happened to also be a distributor of fund shares. We are worried that the practice of funds withholding orders to broker-dealers that happen to sell the fund's shares might become widespread unless the Commission provides more explicit guidance that this rule proposal is not intended in any way to compromise best execution. Investors would be doubly disadvantaged if a fund felt torn between a conflict between its best execution obligation and its (incorrect) understanding that it must abjure from sending orders to a broker-dealer that happens to market the fund. Not only would investors lose some of the benefit of best execution, but their choices would be reduced if broker-dealer distributors of mutual funds felt compelled to limit the funds they distribute to preserve their trade execution business.

The proposing release seeks comment on the impact that eliminating the use of portfolio transaction commissions to pay for distribution might have on commission rates and the other revenue streams that broker-dealers receive in conjunction with the distribution and other services that broker-dealers provide to fund shareholders. We believe that to the extent the unintended consequences discussed above result in fund portfolio transactions flowing to fewer broker-dealers it could lead to less competition and higher, rather than lower commissions. With regard to revenue streams, the rule might not have a significant impact on an aggregate basis, since the overall level of fund portfolio transaction business is governed by factors other than who distributes fund shares. However, smaller broker-dealers who may derive a significant portion of their fund revenue streams through step outs may have to seek ways to increase their other fund revenue streams to remain competitive.

We appreciate that the Commission recognizes that there is an inter-relationship, or synergistic effect, between the various revenue sources that broker-dealers may receive in conjunction with mutual fund transactions. We believe, that as discussed below, such synergetic effect is an important factor to consider in any discussion regarding possible further amendments to rule 12b-1 or other rules impacting broker-dealer revenue streams.

Further Amendments to Rule 12b-1 and Related Matters

Over the past year there has been much discussion regarding the various revenue streams broker-dealers receive in conjunction with mutual fund transactions, (including but not limited to rule 12b-1 payments), the potential conflicts of interest they pose, and the need for better disclosure[3] and possible restrictions with respect to such revenue streams. There has been far less discussion regarding the important and essential investment and other shareholder services which are supported through these revenue streams, and we believe that any regulatory initiatives in this area must take into account the need for it to remain economically viable for broker-dealers to continue to provide important services to fund shareholders.

SIA recently has endeavored to close the information gap through a variety of means including written submissions to the Commission[4], and testimony before Congress.[5] Additionally, we are attaching hereto a White Paper entitled "Mutual Fund Distribution and Shareholder Servicing Practices" which provides an historical perspective on how and why the current broker-dealer compensation structure evolved, and a detailed description of the distribution, administrative, recordkeeping, and other shareholder services it supports. The White Paper describes the evolution of new revenue sources over a quarter-century, to match a simultaneous burgeoning of fund shareholder servicing by broker-dealers. This evolution gives rise to a need for better transparency with regard to all revenue streams between funds and broker-dealers. We trust the Commission will find the White Paper useful in its further consideration of what modifications if any, might be appropriate regarding rule 12b-1 or any other regulations affecting broker-dealer revenue streams.

Many broker-dealers enter into a variety of types of agreements relating to 12b-1 plans, revenue sharing and other targeted services, and they tend to view these arrangements on an aggregate basis in terms of their ability to adequately fund the costs associated with all of the services they provide to fund shareholders, or costs they incur in conjunction with distribution activities. We would respectfully suggest that in reviewing the current regulatory structure impacting revenue streams, the Commission take a similar "macro" approach, rather than considering 12b-1 payments or other revenue streams separately. We believe such an approach is important, because to the extent further regulations restrict or eliminates any revenue stream, it will have to be replaced from other available sources if broker-dealers are to continue to provide the same level of shareholder servicing.

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[4] See SIA Comment Letter to Jonathan G. Katz, SEC Secretary from George R. Kramer, SIA Acting General Counsel, "Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, File No.S7-06-04 (April 12, 2004).

[5] See testimony of SIA President Marc E. Lackritz before the Senate Committee on Banking, Housing and Urban Affairs on November 18, 2003 and before the Senate Subcommittee on Financial Management, The Budget and International Security on January 27, 2004. Also see testimony of Chet Helck, President of Raymond James Financial on behalf of Raymond James and SIA before the Senate Banking Committee on March 31, 2004.

Consistent with this view, we recommend that the Commission convene a roundtable, similar to what was successfully done in the hedge fund context or some other forum, in which all interested parties can participate, to explore the overall mutual fund compensation structure, the services that are funded through this structure and the adequacy of the present disclosure regime. Specific topics might include, but not be limited to:

- Description of the various revenue sources and the regulations applicable to them.

- Description of shareholder services funded through these revenues and the role which funds, broker-dealers, intermediaries and others, play in providing these services.

- The adequacy of the current disclosure regime with respect to compensation structures, particularly from a conflict of interest standpoint, and what should be done to enhance transparency in the most effective way.

- The extent to which payments received by broker-dealers are used in a manner consistent with their intended purpose (e.g.-12b-1 payments). What measures should be taken to achieve consistency? Do rules need to be modernized to reflect current realities? Are new rules needed? Should any rules be rescinded, and what would be the consequences?

SIA would be most interested in contributing to such a roundtable or similar program.

Specific Request For Comment Regarding Refashioning of Rule 12b-1

As noted above, we would envision that the appropriateness of the current regulatory structure, including rule 12b-1, be one of the principal topics that should be considered in a roundtable or similar program. However, the Commission has specifically requested comment in the proposing release on the feasibility of an approach whereby 12b-1 payments would be deducted directly from shareholder accounts rather than from fund assets. This approach appears to be based on the premise that 12b-1 payments have largely become a substitute for a sales load. While there is some truth to that premise in a no-load context, or with respect to B shares which typically carry higher 12b-1 fees in lieu of a front-end load, as a general matter most 12b-1 fees are a reflection of the on-going servicing and investment guidance which inures to the benefit of the vast majority of fund shareholders. The premise that 12b-1 fees are solely transaction-based and represent installment payments of a sales load is simply not accurate.

The attached White Paper clearly supports the premise that 12b-1 payments and other fees enable broker-dealers to provide a panoply of shareholder services that is provided on an ongoing basis. The fact that a substantial portion of mutual fund shares are held through 401(k) plans, other retirement plans, asset allocation programs or 529 college tuition plans, also adds another significant servicing component to mutual fund holdings. Eliminating 12b-1 fees would discourage broker-dealers from marketing retirement plans to small and medium-sized businesses, affecting overall pension coverage. In addition, those plans would be less likely to be offered support services that make it possible to maintain plan coverage for their employees. Therefore, while some modifications to rule 12b-1 may be appropriate, we do not believe such modifications should entail applying the fee on an individual shareholder basis.

We appreciate all of the steps the Commission has undertaken to address the problems that have surfaced with respect to mutual funds over the last year and half, and we look forward to working further with the Commission to bring about any further modifications to the regulatory structure that may be necessary to assure that the public's trust and confidence in this most important investment vehicle is justified. Any questions regarding this letter or attachment should be directed to the undersigned.

Sincerely,

Michael D. Udoff
Vice President
Associate General Counsel and Secretary

cc: The Honorable William H. Donaldson, Chairman
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Paul S. Atkins, Commissioner
The Honorable Harvey J. Goldschmid, Commissioner
The Honorable Roel Campos, Commissioner
Director Paul F. Roye, Division of Investment Management
Deputy Director Cynthia M. Fornelli, Division of Investment Management
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