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Statement of

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PRESIDENT

RAYMOND JAMES FINANCIAL, INC

before the

U.S. SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

REVIEW OF CURRENT INVESTIGATIONS AND REGULATORY ACTIONS REGARDING THE MUTUAL

FUND INDUSTRY: FUND COSTS AND DISTRIBUTION PRACTICES

March 31, 2004

538 Dirksen Senate Office Building

I. Introduction

Chairman Shelby, Ranking Member Sarbanes and Members of the Committee.

I am honored to address the Senate Banking Committee concerning a subject that I believe is crucial to the welfare of American investors and our Nation's securities markets, as well as the industry and regulators who support these markets.

I am Chet Helck, the president and chief operating officer of Raymond James Financial. Raymond James provides financial services to individuals, corporations and municipalities through its 5,000 financial advisors throughout the United States and internationally. I am also privileged to represent my firm on the Board of Directors of the

Securities Industry Association (“SIA”) and to testify today on behalf of Raymond James and on behalf of SIA.¹

While I represent a securities firm that serves hundreds of thousands of investors, I am also speaking to you as an experienced financial advisor who has spent more than 20 years providing counsel and services to help individuals take care of their families and realize their financial objectives. Through these experiences, I have witnessed the dramatic impact that knowledgeable advisors who are supported by effective resources can make on their clients’ lives. My experience has taught me full-well that investors’ trust and confidence is a hard-earned, precious and essential asset, on which our business is built. Abuses that undermine investor trust and confidence must be met with tough and firm regulatory action. At the same time, my perspective makes me concerned that proposed mutual fund reforms not have unintended consequences that could ultimately degrade the infrastructure that makes it possible for these relationships to thrive — to the detriment of the investing public, and particularly the small investor.

II. Importance of Professional Advice to the Investing Public

Most Americans realize that they can no longer depend on one lifelong job or an employer's pension to provide them with a secure retirement. They know that they must develop meaningful savings during their working days and then establish an investment

¹ The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Bankers 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 more than 800,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift,

plan to create a revenue stream to sustain them over retirement. Planning for education and health care costs represents similarly daunting financial challenges. For most of us, even if there were no other mitigating factors complicating these planning processes, creating these types of investment plans would be overwhelming.

It is against this backdrop that I suggest that most Americans need financial advice more than ever before. Indeed, many investors have learned to truly value professional financial advice during these difficult times. Even some securities firms that traditionally served only self-directed investors have recently recognized this need and established lines of business to provide advice.

I believe that our current system, which provides investors with the ability to engage professional advisors for financial guidance, works well for millions of Americans and I also believe that mutual funds play a critical role in the financial plans of millions. For that reason, we should all be concerned about instances of illegal conduct occurring in some funds. For the same reason, it is important that proposals for fundamental changes to this system avoid unintended consequences that could harm individual investors and also weaken the financial markets that help make our free enterprise economy so strong.

In my capacity as a member of SIA's Board of Directors, I appreciate that many SIA member firms follow a different business model, encouraging investors to make investment choices on their own. I respect that alternative and certainly believe in competition — that's the American way. But my own career and my firm are dedicated

and pension plans. In 2002, the industry generated \$222 billion in domestic revenue and \$304

to the idea that financial consultants can add great value by helping investors make intelligent choices when confronted with so many investment alternatives.

III. Mutual Funds and the American Investing Public

The focus of your deliberations is the compensation structure for the services associated with selling mutual funds, and the advisory and administration services required to support investors in the purchase of mutual funds. We believe that mutual funds are, and will continue to be, a basic investment vehicle for most Americans. In spite of the barrage of recent bad press concerning these investments, mutual funds are the vehicle by which an overwhelming majority of investors participate in our markets. Mutual funds offer investors an inexpensive way to share in the benefits of owning stocks and bonds and a method for diversifying a relatively small investment, thereby managing their risk exposures. And they allow investors to benefit from professional management of their invested dollars. For these reasons, mutual funds are extremely popular products for small investors, as well as for retirement plans such as 401(k) plans.

Overall, 49.6 percent of all households in the United States own mutual funds directly or through a retirement account.² As of January 2002, 89 percent of U.S. equity investors owned stock mutual funds, and 51.5 percent of equity investors held stock only mutual

² billion in global revenues.
http://www.sia.com/research/pdf/equity_owners02.pdf.

funds.³ Twenty-six percent of all household liquid financial assets were in mutual funds as of the end of 2003.⁴

The health of our capital markets depends to a great extent on the public's continued robust participation in mutual funds. As of January 2004, equity mutual funds had a market capitalization of \$3.8 trillion dollars, roughly 25 percent of the total capitalization of our equity markets.⁵

Retail investors put their trust in the integrity of mutual fund managers and advisers, as well as in the financial advisors who assist in their investment decisions and the broker-dealers that implement their trade orders. It is certainly troubling that recent events have severely damaged the reputation of mutual funds and their management companies, as well as those who participate in their distribution. I know that all of us in the industry firmly believe that abuses such as insider trading should be rooted out and punished wherever it occurs – whether at high profile public companies, at broker-dealers or at mutual funds. Abuse of fiduciary responsibilities should be condemned and, where appropriate, punished. And we also recognize that, as I shall discuss in a few moments, better disclosure of mutual fund compensation practices can be helpful to investors and should be required.

In order to restore public trust and confidence in mutual funds and their distributors, the interests of investors must come first. Investors must be assured that fraud, self-

³ *Id.*

⁴ <http://www.federalreserve.gov/releases/Z1/Current>.

⁵ For equity market capitalization (combined New York Stock Exchange and Nasdaq) see <http://www.nyse.com/pdfs/mm1204.pdf>; <http://www.marketdata.nasdaq.com/daily/daily2004.xls>; For mutual fund data see http://www.ici.org/stats/latest/trends_01_04.html#TopOfPage.

dealing, and dishonesty will not be tolerated. Investors should be treated fairly, and should be given clear and useful information about the funds they buy. Fund fee structures, financial support offered to intermediaries, fund investment and redemption policies – all should be as transparent and meaningful as possible. When an investor seeks investment advice, the financial advisor should recommend mutual funds that are suitable in light of an investor's objectives. And all investors should be assured of prompt execution and fair pricing of their mutual fund transactions.

But public trust is a fragile thing. This Committee, and the regulatory community, can either work to restore it – or can diminish that public confidence even further by actions that ultimately detract from that trust. We are confident that this Committee, along with other policymakers, will choose wisely and strengthen the viability of these products and the vital distribution systems that bring them to investors' doorsteps. The recent scandals have presented a serious challenge to all of us who believe that funds serve investors well. We must face these challenges forthrightly and seek thoughtful and workable solutions that will protect investors' interests. This Committee and the regulatory community must help restore public confidence by rooting out instances of wrongdoing, without diminishing the basic value of mutual funds or of the advisory structure that has grown up around it. Because mutual funds are good investment planning solutions for most Americans – particularly those who are of modest means – anything that unfairly undermines their confidence in funds or makes it more difficult to provide meaningful advice concerning them would be a disservice to the investing public.

IV. Compensation for Mutual Fund Sales

As with any product, there are costs associated with distributing and servicing mutual funds. As mutual funds types have proliferated - - a result of vigorous competition and innovation — selling arrangements for funds have expanded as well. Because selling arrangements have raised particular concerns, we address several aspects of these arrangements.

a. Forms of Compensation

Broker-dealers receive payments in connection with sales of mutual funds, unit investment trusts, municipal fund securities, variable annuity contracts and variable life insurance policies (collectively, “funds”) from a variety of sources. Some payments are made by the funds themselves or by investors when they buy or sell fund shares. Other payments may be made by investment advisers, fund distributors or other fund affiliates; and some brokerdealers charge investors directly for their services through the medium of fee-based accounts.

In addition to these various sources, broker-dealers may receive payments in several different ways. Some payments may represent hard dollar payments from funds and investors (encompassing sales loads and 12b-1 fees). Other payments may represent hard dollar payments from fund affiliates (commonly known as “revenue sharing”). Still other payments may be made in the form of commission payments on fund portfolio brokerage transactions (often referred to as “directed brokerage”).

Some observers believe that fund payments, directed brokerage and revenue sharing are simply “taxes” that broker-dealers impose upon funds and their affiliates, and that all such payments go straight to the broker-dealers’ bottom lines. However, these arrangements are necessary to enable broker-dealers to support the administrative costs associated with fund sales and investor reporting, and provide more comprehensive investor services such as financial planning, total portfolio review and performance reporting that investors have come to expect.

In recent years, broker-dealers have been handling functions that mutual fund organizations previously might have performed exclusively. This shift in function has provided many operating efficiencies and benefits to investors, including consolidation of investments within a single financial services organization, and easier access to investment services. Revenue-sharing payments often help reimburse broker-dealers for some of the following expenses associated with processing fund transactions and maintaining customer accounts:

- Customer sub-accounting
- Mailing trade confirmations, prospectuses and other disclosure documents.
- Comprehensive Tax Reporting.
- Maintaining information Web sites.
- Implementing changes initiated by funds, including revising systems and procedures and communicating changes to financial advisors and customers.
- Overseeing and coordinating fund wholesaler activities at the firm.

To the extent that the services are performed by the broker-dealer, instead of the fund, investors are not paying more. For example, there is a cost to maintaining an accurate shareholder record — whether the fund's transfer agent performs that function or the fund delegates that responsibility to the broker-dealer.

In addition, broker-dealers use revenue-sharing payments to fund other activities, such as educational seminars for their financial advisors and their clients about the different funds they consider. These activities make the financial advisors more knowledgeable about the funds and can help them tailor their recommendations more effectively. SIA members offer a broad spectrum of fund choices — ranging from offering perhaps a few families of funds to thousands of different share classes. But regardless of how many mutual funds a broker-dealer sells, it is in investors' best interest if the broker-dealer's financial advisors are well acquainted with those funds and can help their customers choose wisely. Revenue sharing contributes significantly to that goal.

b. 12b-1 Fees

The SEC adopted Rule 12b-1, which permitted mutual funds to use their assets to pay for distribution, as long as the fees were disclosed and regulated.⁶ Since Rule 12b-1 was adopted, more than half of all mutual funds have enacted Rule 12b-1 plans, using these charges, alone or with sales loads, as the primary means of financing distribution.⁷ Other mutual funds have added a relatively modest Rule 12b-1 fee to pay for some sales commissions, printing prospectuses and sales literature, advertising, and

⁶ SEC DIVISION OF INVESTMENT MANAGEMENT, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION, at 322 (1992) ("Protecting Investors Study"), *citing* SEC DIVISION OF INVESTMENT MANAGEMENT REGULATION, MUTUAL FUND DISTRIBUTION AND SECTION 22(D) OF THE INVESTMENT COMPANY ACT OF 1940, at 19, 20-22 (1974) ("1974 Distribution Report")

similar expenses.⁸ It is important to note that while Rule 12b-1 was intended to assist no-load mutual funds to finance their distribution expenses, the vast majority of load mutual funds have adopted Rule 12b-1 plans as a complement to, or a substitute for, a front-end sales load.

The impact of these fees has been positive. They have allowed funds to reduce front-end sales charges. They have contributed to development of longer holding periods and a more stable investment profile for clients. And, because they are paid over an extended period of time, they promote a continuing relationship, encouraging the financial advisors to offer continued service over a period of time.

c. Mutual Fund Share Classes

Sometimes lost in the discussion of mutual fund fees is the fact that the fund industry also created a number of share classes. The wide variety of share classes available today affords investors a variety of options for compensating advisors for their services. Advisors and clients can select fund classes to establish a compensation arrangement that is consistent with clients' objectives, time horizons and personal preferences. Each class of a multiple class fund must have a different arrangement for shareholder services or distribution or both, and must pay all of the expenses of that arrangement. Some multiple class funds enter into arrangements whereby particular classes of fund shares are sold to specific institutional investors, such as banks acting in a fiduciary,

⁷ Protecting Investors Study, at 320.

⁸ *Id.*

advisory, agency, custodial, or similar capacity on behalf of customer accounts, insurance companies, investment counselors, brokers, or other financial institutions.⁹

Multiple class funds also permit investors to select the method of financing distribution best suited to their investment horizon and the size of their investment.¹⁰ Some investors may wish to pay a front-end sales load, whereas others may wish to avoid paying a front-end sales load, and are willing to pay a Rule 12b-1 fee and contingent deferred sales charge ("CDSC") instead.¹¹

As the type and level of mutual fund charges began to change, the NASD revised its rules governing the level of mutual fund sales loads and distribution fees to provide consistency of approach and fairness to investors (NASD Conduct Rule 2830(d)).

d. Brokerage and "Soft Dollar Payments"

When Congress enacted Section 28(e) of the Securities Exchange Act of 1934, it recognized the need for money managers to obtain research from a wide range of sources. Section 28(e) permits money managers to pay for research and related services through commission ("soft") dollars rather than paying for them in cash. Such

⁹ See *id.*, at 330.

¹⁰ *Id.*, at 331.

¹¹ A CDSC is a sales load paid by investors upon redemption that declines over the period of a shareholder's investment. So-called B shares typically feature a combination of Rule 12b-1 fees ranging from 0.50% to 1.00% of the average daily net assets of a mutual fund attributable to the B shares (annualized), and CDSCs in lieu of front-end sales loads, while so-called A shares typically feature front-end sales loads and Rule 12b-1 fees of no more than 0.25% of the average daily net assets of the mutual fund attributable to the A shares (annualized). However, the NASD has taken enforcement actions against broker-dealers who have sold B shares to individuals in instances in which A shares would have been an economically superior investment. See, e.g., McLaughlin, Piven, Vogel Securities, Inc. (MPV) (press release available at http://www.nasdr.com/news/pr2003/release_03_027.html).

research helps money managers, including fund managers, do a better job of serving their customers.

Eliminating this source of research dollars would be contrary to investors' interests.

Research improves the quality of markets by helping money managers channel capital to the most promising companies. Research analysts challenge companies to explain their business models and their record of results. Reducing research dollars would mean the elimination of research on certain types of companies. Reducing research dollars could therefore adversely affect the ability of smaller, newer companies to obtain financing for their activities. We all know that new businesses create the most jobs in America; raising their cost of capital hurts everyone.

Some have urged that research is not a legitimate expense for investors to bear through "soft dollar" payments made in the form of trades placed by broker-dealers on behalf of the fund company. Over the years, the S.E.C. has monitored the use of soft dollars by the industry. We believe that few abuses have been found and, in general, soft dollars have proved to be pro-investor and pro-competitive, because they increase competition among money managers, encourage independent research, and give investors more choices.

We believe that research, whether from the broker-dealer, or a third party, contributes to the effort to identify better investments. Third party research is a valuable resource to money managers because it provides managers with ideas and insights that otherwise might be overlooked; and any ban on soft dollars is likely to diminish independent

research.¹² Consequently, we believe that any movement to abolish soft dollars or to prohibit the use of soft dollars to obtain independent research would adversely affect the quality of the research available to money managers, which would ultimately harm investors.¹³

d. Raymond James and its Mutual Fund Expenses

Let me give you some examples of what costs are supported at Raymond James. At Raymond James, we sell over 11,000 mutual fund share classes, offered by over 200 fund companies. During fiscal 2003, the total cost to our firm for providing the administrative support for mutual fund sales was approximately \$30 million. These payments also help fund our Mutual Fund Research Department, which analyzes the universe of mutual fund offerings to generate a recommended list of mutual funds that we consider to have superior prospects. And that list has nothing to do with our receipt of "revenue sharing" payments; there are mutual funds on that list from whom we receive no payments, and there are funds from which we receive payments that are not on that list.

In addition to administrative support and research, we are required to provide educational programs for our financial advisors to help them deal with the complexities and regulatory requirements involved in making effective use of mutual funds in client financial planning. During the past twelve months, on major regional and national educational conferences we spent well over \$7 million. Many of the sessions in these

¹² We note that one objective of last year's Global research settlement was to require investment banks to fund independent research.

¹³ Market forces also may affect how investment advisers buy execution and research services from broker-dealers and third party providers.

conferences qualified for continuing education credit by regulators, CFP and CPA societies and others. These are serious substantive courses that improve the effectiveness of our financial advisors and better equip them to help clients face the issues that they must face.

All of these costs and programs are supported by the payments that we receive from mutual fund companies and their managers in all the forms that we have discussed: sales loads, revenue sharing and directed brokerage. In our view, it is entirely reasonable that the fund complexes sponsoring these mutual fund families should help defray the expense of educating our financial advisors about their particular products. The net result of this effort is that our financial advisors have a much deeper understanding about the products that they sell and can be of much greater help to their clients in making investment choices. Why would anyone want to dismantle a system that provides such advantages to investors?

V. Full Disclosure - But Meaningful and Cost-Effective Disclosure

The Securities and Exchange Commission has proposed new confirmation rules that would require brokers, dealers and municipal securities dealers to provide customers with information about distribution-related costs that investors incur when they purchase those types of securities, as well as disclosure of other distribution-related arrangements. Furthermore, it has proposed new point of sale disclosure rules that would require brokers, dealers and municipal securities dealers to provide point of sale

disclosure to customers about costs and conflicts of interest.¹⁴ (The SEC has also proposed rule amendments that would prohibit funds from using portfolio brokerage commissions to pay for the cost of distributing their shares.¹⁵)

Raymond James has been an industry leader with respect to client disclosure of mutual fund sales and compensation.¹⁶ Our long-form confirmation discloses a comprehensive range of relevant information, including many items currently being proposed by the SEC. These include:

- How the sales charge was computed
- Information regarding possible discounts to which the customer may be entitled.
- Information regarding other available sales classes.
- The fact that Raymond James may be receiving compensation in the form of revenue sharing from the fund or its management company.

In addition, ever since 1994, Raymond James has produced a pioneering document entitled "Your Rights and Responsibilities as a Raymond James Client". Each client receives one, and it is available on our website. There, we provide additional comprehensive information regarding how mutual funds are distributed, the different options for purchase, and the existence of revenue sharing arrangements that result in payments to Raymond James.

¹⁴ *Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds*, Release Nos. 33-8358; 34-49148; IC-26341; <http://www.sec.gov/rules/proposed/33-8358.htm>.

¹⁵ *Prohibition on the Use of Brokerage Commissions to Finance Distribution*, Release No. IC-26356; <http://www.sec.gov/rules/proposed/ic-26356.htm>.

¹⁶ SIA notes that many firms take different approaches to disclosure and we don't mean to suggest that other approaches are inadequate.

It is from this perspective that we are comfortable in supporting clear, concise and meaningful disclosure of compensation practices, including those we have discussed in this paper. The SEC has proposed such disclosure and we, along with others in the industry, will be submitting our thoughts as to how these disclosures can be made meaningful and useful, without at the same time imposing excessive costs on the industry, costs which are ultimately borne by the investing public.

Briefly, we believe that additional disclosure to investors about revenue sharing is useful; but we believe that there are better ways to provide relevant information without imposing excessive costs that investors ultimately have to bear – and without distracting them from other important information. Raymond James, along with other firms and SIA, are busy working on our suggestions for improvement, so I can't give you all our comments right now – the proposal runs to over 120 pages with over 200 footnotes. But from Raymond James's perspective, we would like to make two suggestions regarding this proposal:

1. It is time for the SEC to move away from paper disclosure – the proposal itself indicates the annual printing costs will add more than a billion dollars a year to the cost of mutual fund sales, ultimately to be borne by the investors. Let us enter the 21st century and put as much as possible of the important disclosures on our web sites, where investors can access them readily – and have our confirmations refer the investors to our web sites. For those clients who don't have computer access, our confirmation forms can give them the phone number to request a copy of the information on the website.

2. Don't require transaction-by-transaction breakdown of revenue sharing payments – it would require extraordinary programming costs that again would be borne by investors. Instead, let us use hypothetical examples of the costs that would be borne by investors at different purchase levels: say \$10,000, \$50,000 and \$100,000. That should be enough to give every purchaser a sense of the impact on his investment of these costs.

I am sure that we will have other comments, but I think that should give you a sense of the direction we are trying to move: provide relevant information, but do it in a cost-effective and concise way.

We believe that the SEC has all the power and authority necessary to provide for this kind of disclosure and we would urge that they exercise that authority responsibly. Their active rulemaking agenda and enforcement docket indicates that they are not shy about using the authority that Congress granted to them.

However, we believe that full and clear disclosure, rather than complex over-regulation of payment structures or levels, is the best way to approach fund payments to broker-dealers. We further believe that, with better disclosure, many of these issues can be resolved through the working of the competitive marketplace. So long as fund investors and their financial advisors receive clear information regarding compensation practices, they will be able to choose from the universe of products those that are consistent with their objectives and suitable for their investment goals at a reasonable cost. We hope

to work with the Commission to develop disclosure that is meaningful, relevant, and cost effective.

VI. Conclusion

America has changed from a Nation of savers to a Nation of investors. At Raymond James, we believe very strongly that a large number of Americans need access to professional investment advice. A majority of our citizens can now be counted among the investing population, and we know that many of these investors place a significant value on consulting with a financial advisor in planning for their futures. If compensation and payments to broker-dealers are fully disclosed in a manner that is meaningful to the investor, investors can determine whether or not that compensation is fair and acceptable. This decision-making process is greatly facilitated by the fact that we operate in a competitive industry that currently presents investors with a range of choice concerning not only products, but also varying models of service that allow investors to choose the level of advice they prefer.

Because we believe that investor protection is paramount to the future of the financial markets and our country's economic well-being, we recommend that disclosure and structural reform efforts should aim to ensure that:

- Fund shareholders are able to readily access meaningful information about the costs they incur, the various types of payments received by the distributors of funds, including broker-dealers and the nature of the services being provided;

- Competitive forces, not government fiat, set appropriate levels of compensation, whether through fund payments, directed brokerage, revenue sharing or other structures; and
- Investors are presented with the broadest possible array of fund choices.

Above all, we believe that it is critically important for Congress, regulators, self-regulators, State officials, the mutual fund industry, and the securities industry to work together to restore the trust and confidence of investors in mutual funds as a product, and in those who are committed to providing advice and service to those investors in how to make the best use of that product.

Thank you for your attention.

Attachment: **Glossary of Mutual Fund Terms (Exhibit A)**

Glossary

Many mutual fund terms do not have hard and fast definitions, but below are commonly understood definitions of important terms.

Classes of Funds -- There are many different types of mutual funds designed to meet the needs of different investors. As disclosed in the investment policy of the fund, the fund manager may purchase only certain types of portfolio securities. For example:

Equity or Stock Funds -- common stocks. Some examples include:

Growth funds -- focus on stocks that may not pay a regular dividend but have the potential for large capital gains.

Index funds -- aim to achieve the same return as a particular market index, such as the S&P 500 Composite Stock Price Index, by investing in all — or perhaps a representative sample — of the companies included in an index.

Sector funds -- may specialize in a particular industry segment, such as technology or consumer products stocks.

Debt Funds -- bonds and other debt instruments. Quality of the bonds may vary from U.S. Treasury securities or highly rated corporate bonds, to more risky "junk" bonds. Some funds invest in only tax-exempt securities.

Specific examples might include:

Blue Chip -- securities of well-established companies with seasoned management or large market share. A fund might be a blue chip growth fund, which focuses on companies with long-term growth prospects, but does not pay dividends.

Small Cap -- securities of smaller, typically newer companies. A fund might be a small cap (for "capitalization") value fund, in which the fund will buy stocks of companies whose current stock prices do not appear adequately to reflect their underlying value as measured by assets, earnings, cash flow, or business franchises.

Differential Compensation -- Broker-dealers and/or their registered representatives receive higher incentive payments for promoting certain funds (e.g., in-house funds or funds with which the broker-dealer has a revenue sharing arrangement).

Directed Brokerage -- many people use this term to describe different things.

Under one definition, directed brokerage is an arrangement under which an account manager directs trades to a specific broker-dealer. In return, the broker-dealer agrees to pay certain fund expenses. Fund prospectuses disclose these arrangements, often as a fee table footnote. These arrangements do not ordinarily raise conflict of interest issues because the fund directly benefits from the arrangement. For example, Fund A directs trades to Broker-Dealer X and that broker-dealer pays custody expenses for Fund A. A conflict of interest may arise if the fund's investment adviser has previously agreed to cap the fund's expenses at a particular level, and the arrangement allows the adviser to assume less of the fund's expenses.

Under another definition, sometimes called "brokerage for sales," a fund manager or distributor directs fund brokerage to broker-dealers that sell shares of the fund. There are limitations on a broker-dealer's ability to seek brokerage commissions in exchange for selling shares of a mutual fund. For example, NASD Rule 2830(k) provides, in part:

(1) No member [*i.e.*, broker-dealer] shall, directly or indirectly, favor or disfavor the sale or distribution of shares of any particular investment company or group of investment companies on the basis of brokerage commissions received or expected by such member from any source, including such investment company, or any covered account.

However, there are exceptions to these and other prohibitions. NASD Rule 2830(k) further states:

(7) Provided that the member does not violate any of the specific provisions of this paragraph (k), nothing herein shall be deemed to prohibit:

(B) a member from selling shares of, or acting as underwriter for, an investment company which follows a policy, disclosed in its prospectus, of considering sales of shares of the investment company as a factor in the selection of broker-dealers to execute portfolio transactions, subject to the requirements of best execution;

Fee Arrangements for Mutual Funds -- There are many different types of fee arrangement for funds.

Front-End Sales Charge (or Front-End Load) - a sales charge deducted at the time of purchase from the purchase price for fund shares. It is expressed as a percentage of the total purchase or offering price of the fund's shares. The individual investor pays this charge directly.

Breakpoints -- Fund front-end sales charges may contain breakpoints that provide reduced sales charges for larger purchases. Funds disclose

breakpoints in their prospectuses. They also disclose conditions for waivers of sales charges and for aggregating purchases or signing letters of intent that would result in lower sales charges.

Contingent Deferred Sales Charge ("CDSC") -- a sales charge deducted upon redemption of fund shares. This charge is assessed against the individual investor. The CDSC generally declines over a period of five or six years, so that a redemption within one year of purchase is subject to the maximum CDSC while the CDSC is reduced for redemptions in later years and disappears for redemptions more than five or six years from the date of purchase.

No-Load Funds -- The fund does not charge any type of sales load. But, not every type of shareholder fee is a "sales load." A no-load fund may charge fees that are not sales loads, such as purchase fees, redemption fees, exchange fees, and account fees. No-load funds also have operating expenses.

Rule 12b-1 Fees -- The SEC adopted Investment Company Act Rule 12b-1 in 1980, which permits fund assets to be used for distribution and shareholder services. NASD Rule 2830 establishes a general limit of 0.75% for distribution, 0.25% for service fees. The fund distributor pays fees from fund assets to broker-dealers and others who sell fund shares and/or provide ongoing services to fund shareholders.

Class A Shares -- are typically subject to a front-end sales charge. The front-end sales charge often has "breakpoints" for larger size investments. Funds often establish waiver categories, disclosed in their prospectuses, so that particular categories of investors are permitted to purchase shares with a reduced or waived front-end sales charge. Class A shares also may have a Rule 12b-1 fee that generally does not exceed 0.25% of average annual net Class A assets.

Class B Shares -- typically have no front-end sales charge, a relatively high Rule 12b-1 fee of up to 1.00%, and a contingent deferred sales charge. Because the fund underwriter pays brokers a commission up-front for sales of Class B shares, the Rule 12b-1 fee is designed to pay the underwriter back for these advances. Class B shares typically convert to Class A shares within a year or two after the CDSC disappears.

Class C Shares -- Class C shares generally have no, or very low, front-end sales charges or CDSC. They may have a Rule 12b-1 fee of up to 1.00%. Class C shares typically do not convert to Class A shares.

4:00 P.M. Pricing -- Investment Company Act Rule 22c-1 requires that fund share orders must be received by the time specified in the fund's prospectus to receive that

day's net asset value (NAV) per share price. In other words, if you buy mutual fund shares on Monday, the order must reach the fund by 4:00 p.m. to get Monday's NAV. If you send in your order at 5:00 p.m. on Monday, you should get Tuesday's NAV. Past SEC staff interpretations have permitted orders to be received by intermediaries, such as a broker-dealer, by 4:00 p.m. for same day NAV. The fund prospectus typically discloses the 4:00 p.m. deadline and who must receive the order by that time. "Late trading" refers to the illegal practice of helping an investor get today's price after 4:00 p.m. For example an investor enters an order to buy a fund's shares on Monday at 5:00 p.m. and gets Monday's NAV.

Revenue Sharing -- A fund adviser or distributor pays additional compensation to a broker-dealer or other financial intermediary. The payments may be for several different purposes. One purpose is to encourage the broker-dealer to provide "shelf space." Shelf space arrangements range from simply making the fund available to investors or more prominently featuring the fund. Payments may also be for administrative or recordkeeping functions, such as keeping track of the fund's shareholder records at the broker-dealer. Disclosure is generally required in the fund prospectus and Statement of Additional Information ("SAI"). Delivery of the prospectus containing this disclosure satisfies requirements of Exchange Act Rule 10b-10 (*i.e.*, the confirmation rule).

"Soft dollars" or "paying up" for research -- Section 28(e) of the Securities Exchange Act of 1934 makes it lawful for an investment manager (who has discretion to trade an account) to pay higher than the minimum commission when the manager also receives brokerage and research services from that broker-dealer. Congress enacted this provision at the time that it unfixed brokerage commissions. Congress wanted to ensure that, in appropriate circumstances, investment managers would be able to pay more than the absolute lowest available commission without breaching their fiduciary duty.

Under Section 28(e), the commissions must be reasonable in light of services received by the investment manager. The broker-dealer that provides brokerage may provide the research services or the broker-dealer may arrange that a third-party provide the research to the investment manager. If the product/service is also used for non-research purpose ("mixed use"), the investment manager must develop and document a reasonable cost allocation. Mutual funds must disclose soft dollar arrangements in a general way in their Statements of Additional Information ("SAI"). Investment advisers must disclose soft dollar practices in their Form ADV Part II. SEC interpretations establish requirements for reliance on 28(e) (e.g., any research obtained must provide "lawful and appropriate assistance" to the account manager in carrying out his responsibilities).

For more information, see http://www.siainvestor.com/index_flash.htm or <http://www.sec.gov/investor/pubs/inwsmf.htm>.

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