Statement
of
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Securities Industry Association
before the
United States Senate
Committee on Banking, Housing, and Urban Affairs
"Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry"
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I. Introduction

Chairman Shelby, Ranking Member Sarbanes, members of the Committee, I am Marc E. Lackritz, President of the Securities Industry Association.[1] I appreciate the opportunity to testify before the Committee today on a number of issues relating to the integrity of the mutual fund industry as well as the broker dealers I represent.

The securities industry is based on two bedrock principles – disclosure and competition. But the public's trust and confidence are the indispensable elements for the capital markets to play their effective roles in channeling capital to its most productive uses. Our industry has raised more than $21 trillion over the past 10 years to finance innovation and growth – new enterprises, new processes, new products, bridges, hospitals, roads, and schools. Without public trust and confidence, our market mechanisms cannot function effectively or efficiently. Our system has thrived because all market participants must adhere to the same rules, vigorously and fairly applied.

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[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 more than 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 nearly 800,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2002, the industry generated $222 billion in domestic revenue and $356 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

Mutual funds are the vehicle by which an overwhelming majority of investors participate in our markets. They offer many small investors an inexpensive way to share in the benefits of owning stocks and bonds. Mutual fund portfolios give investors an avenue for diversifying a relatively minimal investment, thereby managing their risk exposures. For these reasons, mutual funds are extremely popular products for small investors, as well as for retirement plans such as 401(k) plans. As of January 2002, 89 percent of U.S. equity investors owned stock mutual funds, and 51.5 percent of equity investors held only stock mutual funds. Overall, 49.6 percent of all households in the United States owned mutual funds directly or through a retirement account.[2] Twenty-six percent of all household liquid financial assets were in mutual funds as of mid-year 2003.[3]

Broker-dealers and other intermediaries play a critical role in the distribution of mutual funds. Third-party financial professionals such as full service broker-dealers, financial planners, banks and insurance companies distribute approximately 55 percent of mutual fund assets. "Mutual fund supermarkets," generally operated by discount brokers, distribute another five percent of mutual fund assets.[4] Full-service and discount brokers benefit investors and promote competition among funds by offering investors a convenient and accessible way to compare and select from a range of different mutual fund families.

The health of our markets depends to a great extent on the public's continued robust participation in mutual funds. In 2002, equity mutual funds had a market capitalization of $2.7 **trillion** dollars, roughly 22 percent of the total capitalization of our equity markets.[5] Retail investors, the backbone of both the mutual fund industry and our securities markets, put their trust in the integrity of mutual fund managers and advisers,

[2] Investment Company Institute, 2003 Fact Book, at 42-43.

[3] www.sia.com/research/html/key_industry_trends_.html#securities.

[4] Investment Company Institute, www.ici.org/stats/res/per09-03.pdf, at 5. By way of comparison, only 12 percent of purchases of mutual fund assets are made by individual investors directly from the fund.

[5] SIA 2003 Securities Industry Fact Book, at 47, 59.

as well as in the financial advisers who assist their investment decisions and the brokers who implement their trade orders. The interests of retail investors must come first if we want them to continue entrusting their money to mutual funds. Investors must be assured that fraud, self-dealing, or dishonesty will not be tolerated. All investors should be treated fairly, and all aspects of the mutual fund business – including fund fee structures, financial incentives offered to intermediaries to recommend specific funds, fund investment and redemption policies, and fund governance – must be as transparent as possible. In addition, all investors should be assured of reasonably prompt execution and fair pricing of their mutual fund transactions.

In the past several months, state and federal regulators have uncovered a number of instances of distressing behavior by some mutual funds and intermediaries. These include: 1) late trading or market timing in contravention of stated fund policies; 2) lack of full disclosure; and, 3) operational shortcomings relating to breakpoints. All of these instances share a common element: they hurt investors.

In the remainder of this testimony I will discuss each of these disturbing revelations and the measures that we strongly support to resolve these problems and to earn back the public's trust and confidence. Each of these issues must be addressed swiftly and comprehensively by tough enforcement action where wrongdoing has occurred, thoughtful regulatory revisions to make sure that these problems cannot recur, and legislation to fill in existing "gaps" in the law. At the same time, it is equally important that regulatory or legislative solutions do not create new problems or other unintended consequences for investors in the course of remedying existing ones.

II. Late Trading/Market Timing

A. Proposals to Address Late Trading

Governing Principles. SIA is greatly distressed by the number of instances of mutual fund late trading. We believe stringent enforcement actions to ferret out and punish such illegal activity will have a strong deterrent effect. We agree with Securities and Exchange Commission Chairman Donaldson, however, that additional regulatory action needs to be taken to eliminate opportunities for such activity in the future. Investors will not accept the *status quo* and mere promises to do better. New rules must be put in place that do right by investors and ensure that these abuses will never happen again.

Appropriate regulatory action should meet several key principles. The rules should:

- Be reliable and "bulletproof" to new forms of evasion;
- Give investors the widest array of opportunities;
- Treat all investors – large and small; institutional and retail – equally;
- Synchronize new mandates with the complexities of existing and well-proven operational systems that investors count on to seamlessly clear and settle many millions of transactions per day.

Proposals for Reform. Several proposals have been advanced to address late trading by establishing a "hard close" for open-end mutual fund purchase or redemption order acceptance no later than the New York Stock Exchange's 4:00 p.m. ET close of business. Each of these proposals is intended to ensure that no transactions accepted after that point in time can receive the fund's pricing for that day. The key difference among the proposals is where they prescribe the "hard close." One approach would require that the mutual fund or its transfer agent must receive orders by 4:00 p.m. to receive same-day pricing. A second proposal has been circulated, but not finalized, under which orders received by the National Securities Clearing Corporation ("NSCC"), the centralized entity through which most mutual fund orders are cleared, would also satisfy the "hard close" requirement. Finally, a third approach would permit the hard close to occur at either the mutual fund, NSCC, or a broker-dealer or other SEC- or bank-regulated intermediary or other entity, so long as the order recipient has a verifiable order capture system.

As discussed below, we think that a hard close that can only occur at the mutual fund has some significant drawbacks for investors, and also may have some major operational difficulties. A hard close at NSCC may best meet concerns about a verifiable order entry deadline, while a hard close at the broker-dealer or other intermediary would be preferable from the vantage point of most retail investors and retirement plan participants. In any event, we must demonstrate to the public not only that late trading will be punished severely, but also that it will be foreclosed from ever happening again.

(i) *Hard Close at the Mutual Fund*. One early proposal to emerge in response to the revelations about late trading is a suggestion that the SEC require that only orders that are received by a mutual fund prior to 4:00 p.m. ET should receive that day's pricing. This proposal may be an effective way of foreclosing late trading. However, measured against the principles that we articulated above it has several significant shortcomings.

Most importantly, it would be likely to create a two-tiered market, in which institutional investors that clear their transactions directly with funds would have the ability to trade until 4:00 p.m. ET, while retail investors who generally hold their mutual funds through a broker-dealer or other intermediary, as well as administrators of many 401(k) and similar retirement plans that generally rely on intermediaries for processing participant orders would have to get in their orders by a much earlier cut-off time in order to complete all processing necessary to transmit orders to the fund by 4:00 p.m..[6]

Because of the multiple steps necessary to clear and settle mutual fund orders, in general investors would face a cut-off time approximately two hours prior to the 4:00 p.m. ET hard close at the fund, although the exact cut-off would vary from firm to firm. Individual fund investors that desire the service of broker-dealers or other intermediaries should not be prejudiced by an early cut-off while other fund investors would be free to trade for approximately two additional hours solely by virtue of their relationship with

[6] Broker-dealers that self-clear, or that act as introducing brokers and clear their transactions through a third party, must process and batch these orders and perform break-point analysis on the orders before they are sent on to NSCC, which processes and clears the orders and transmits them to the fund company through its Fund/Serv facility. Other entities that receive mutual fund transactions from customers, such as banks, must perform similar steps prior to sending the orders to fund companies.

the fund.[7] This could be a substantial hardship. These investors would lose the ability to shape their investment decisions by observing market developments in the last two hours of the trading day.

A 4:00 p.m. hard close could pose an even more serious disadvantage for the 36 million families who invest through employer-sponsored retirement plans. Institutions that provide recordkeeping services to 401(k) plans would likely need to cut off order acceptance much earlier than broker-dealers.[8] In the case of west-coast participants, this could mean that trades would have to be placed in the early morning hours of the business day, and may only be able to receive next-day settlement. This would place retirement plan participants at a marked disadvantage to other institutions.

The durability of a hard close at the fund to attempts at evasion is also not clear. Unless it is accompanied by a requirement to use auditable technology to ensure that the order entry time at the fund is not subject to abuse, similar to what we propose in connection with the hard close at the broker-dealer alternative, concerns about late trading may linger.[9]

This approach would also pose significant operational challenges. Currently, there is no need for real-time capture, routing and execution of fund orders, since fund

[7] Moving fund holdings from intermediaries to the funds themselves may not be a viable option for many retail investors because they would lose the array of choices of different fund complexes that a broker-dealer can offer, as well as special execution services, such as the ability to liquidate equity or debt securities to purchase fund shares (or vice versa) or to exchange shares of funds of different fund complexes.

[8] This is because the 401(k) system has additional complexities than those faced by broker-dealer recordkeeping systems. For example, 401(k) recordkeepers must place trades collectively, and perform a number of reconciliations at the participant and plan levels in executing transactions. In addition, recordkeepers perform other services that add time to the process such as determining eligibility for loans since federal law regulates the amount of a loan based on a participant's account balance.

[9] In a recent speech at SIA's Annual Meeting in Boca Raton Florida, SEC Chairman Donaldson noted that 10 per cent of funds, as well as 25 per cent of broker-dealers, have been involved in enabling late trading by customers. Therefore, a verifiable order entry time stamp should be an essential element of any response to late trading that relies on when orders are received by a fund or an intermediary. Remarks of Chairman William H. Donaldson to the Securities Industry Association, November 7, 2003, http://www.sec.gov/news/speech/spch110703whd.htm, at 2-3 ("Donaldson Boca speech").

pricing is only established once a day. Consequently, many firms extract such orders to batch and route to the fund or NSCC. To require that firms present mutual fund trades to the fund by 4:00 p.m. ET would result in many broker-dealers extracting a day's worth of orders and transmitting all of them to the fund near the 4:00 p.m. close. This could create a huge technology jam that funds may not be prepared to manage.

Funds may also not be prepared to manage other aspects of the clearing process that this approach may effectively shift onto them. For example, in today's world a broker-dealer might receive an order prior to 4:00 p.m., and after the 4:00 p.m. close send a fund, via NSCC, an order to sell a certain number of shares (or a certain dollar amount) of a fund, including a post-4:00 p.m. "enrichment" of the data by factoring the closing price into performing its breakpoint analysis and crediting the customer's account for the cash (or debit it for the shares). With a 4:00 p.m. hard close, the fund itself would have to perform this enrichment function with the closing price data. Funds are not currently set up to do this, and might seek to subcontract this work back to NSCC. Thus, operationally the "hard close at the fund" approach could start to closely resemble the "hard close at NSCC" proposal.

(ii) *Hard Close at NSCC*. We understand that NSCC (which operates the NSCC/Fund/Serv mutual fund processing system) is considering proposing the development of a centralized time stamp facility as an answer to concerns about late trading. That facility would enable intermediaries to transmit fund orders throughout the day to NSCC or batch them prior to 4:00 p.m., but still provide the opportunity to submit essential enrichment data which is necessary to complete the transaction after the close. Among other things, this data would include information related to breakpoint entitlement, calculation of contingent deferred sales loads, and exchanges between funds.

This approach, while still under discussion, is a very promising way to address the late trading issue as measured against our key principles. It should be possible to design this proposal so that it is reliable and resistant to evasion. This is particularly the case since NSCC, as a third-party processor with no relationship to the customer and only a very limited relationship with the intermediaries and funds, would have no motive to circumvent the order entry timing requirement. This proposal also builds directly on a well-tested and experienced clearing system. While it would certainly require expanding some technology and systems, it appears to pose a much less daunting operational challenge than a hard close at the fund.

The impact on investors would also not be as severe as under a hard close at the fund. However, the NSCC approach would still face some drawbacks on this score. Investors who transact mutual fund purchases and redemptions through broker-dealers and other intermediaries, and retirement plan administrators, would still have to get their trades in at some point before the 4:00 p.m. close in order to get the benefit of same-day pricing. We have not been able to determine how significant this gap would be, but it would certainly be a much smaller disparity than would be created by a requirement that would only permit same-day pricing for orders received by the fund by 4:00 p.m. ET.

(iii) *Hard Close at the Intermediary*. The third proposal, which SIA advanced in an October 31 letter to the SEC, would permit same-day pricing for orders received by the broker-dealer or other intermediary by 4:00 p.m., as well as orders received by the mutual fund or its processing agent by 4:00 p.m.. This would be subject to the qualification that the recipient of the order must have an electronic order capture system, with verifiable order entry time aligned with an atomic clock to document receipt. This requirement would eliminate a salesperson's ability to either withdraw a fund order after 4:00 p.m. or receive current day pricing for an order entering the system after 4:00 p.m..

This proposal is the most attractive of the three from the standpoint of investor fairness. Investors would receive same-day pricing under the same terms that they do today, regardless of whether they are institutional or retail, trading through a broker-dealer or other intermediary, or directly with a fund.

For broker-dealers this approach is also workable as an operational matter. Broker-dealers are already required to use a verifiable order entry time stamp aligned with an atomic clock for processing equity transactions. Mutual funds and their processing agents as well as banks and other intermediaries would need to build similar systems, but the technology and processes already exist.

Bank regulators such as the Office of the Comptroller of the Currency would need to impose a companion rule to require a hard close on order acceptance by 4:00 p.m. together with a required electronic capture system. For entities which are unregulated, or unable to comply with the hard close time stamping requirement or other comparable verification systems, orders would need to be placed with the fund directly, or some other designated regulated entity that has electronic time stamping capability to ensure receipt by the hard close cutoff time.

We are confident that this approach would not be subject to abuse. It would rely on the same electronic order audit system that the SEC and self-regulatory organizations required firms to adopt so that the regulators could monitor order-handling processes for equity securities. Components of the system should also include written policies and procedures to insure compliance, with senior management sign-off on the adequacy of those procedures, and an annual external audit to measure compliance with, and the effectiveness of, these procedures.

B. Proposals to Address Market Timing.

"Market timing" refers to a trading strategy in which an investor engages in frequent transactions in mutual funds in anticipation of changes in market prices. Usually this is done to try to profit from discrepancies between the time when an underlying asset is priced and the time when a fund's net asset value is set. A common example is a mutual fund investing exclusively in foreign securities traded in markets that close prior to U.S. markets, and which may be sensitive to changes in the U.S. market. A market timer may choose to buy or redeem fund securities, depending on whether the U.S. market is going up or down substantially on the day, in the hope that the opening price of the underlying asset will change as a result of the U.S. market move. The investor would receive an arbitrage profit on the lag between the pricing of the fund and of its underlying assets.

Market timing is not inherently illegal, but it can pose problems for many mutual funds. For example, market timing activity can drive up a fund's administrative costs as the fund manager must either sell assets or hold extra cash to meet redemption demands of market timers. It also has the potential to dilute the interests of other fund shareholders who do not engage in market timing. Because of these drawbacks, many funds have policies and procedures to discourage market timing.

Recent enforcement actions and press reports of ongoing investigations by federal and state regulators appear to involve just such instances in which funds and intermediaries facilitated market- timing transactions despite statements in the fund prospectus that the fund would not assist such activities. As a result of these developments, a number of regulatory proposals have been advanced to address market-timing transactions. Here are two potentially useful steps:

- SEC Chairman Donaldson has proposed that rules regarding disclosure of fund policies and procedures on market timing should be tightened, and that funds should be required to have procedures to fully comply with any representations that they make concerning their market timing policies and procedures;[10]

- SIA has also proposed, subject to customer privacy rights, a requirement that sufficient trade-level customer detail be provided to funds to assist them in identifying market-timing activity on transactions that are submitted by the intermediary on an aggregated basis.

Both of these steps would do a great deal to deter market timing in contravention of fund policies. A further step would be to permit funds to impose a fee (of two percent or some other level) on any fund shares redeemed within five days of purchasing them.

[10] Additionally, in 2001, the SEC issued guidance suggesting that funds might have an obligation to apply methodologies to apply a fair value to fund assets in situations where changes in the U.S. market create a potential discrepancy between an international mutual fund's day-end net asset value and the overseas closing price of foreign securities that it holds. Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission, April 30, 2001.

The proceeds of this fee would go to the fund for the benefit of the fund's long-term shareholders. As originally proposed, the only exceptions would be for money market funds, and for a fund that prominently discloses that it is designed for short-term trading and that secures a specific SEC exemption from the requirement.

While we generally disfavor regulatory approaches that involve pricing regulation, the problems that have arisen are such that we support such a proposal. We think it will be a very effective step toward ending abusive market timing transactions. The only modification that we suggest is that the SEC provide a narrow exemption for hardship cases, so that an investor can make a single transaction without incurring the two percent fee if the investor can demonstrate in writing that the transaction is necessary to meet an unanticipated personal financial hardship.

In addition to these steps, the recent amendment to H.R. 2420 would require the SEC to adopt regulations to eliminate stale pricing, the underlying source of both late trading and abusive market timing. While the steps outlined above may be sufficient to address this issue, we believe that swift action on many fronts needs to be considered. Therefore, we not only support the 2 percent redemption fee, but also SEC action to address the overall issue of stale pricing.

We strongly support tough enforcement action against abusive market timing as well as prompt implementation of regulatory reform. This will go a long way towards repairing the damage to public trust and confidence that revelations of abusive market timing have caused.

III. Disclosure Proposals

We favor clear, direct, timely disclosure of all material information to investors in a central place. It is important to make it investor-accessible and investor-friendly rather than a "Where's Waldo?" search through fragments of disclosures for relevant information.

A. Revenue Sharing and Differential Compensation

We strongly support efforts to enhance transparency of revenue sharing and differential compensation to mutual fund investors. At a minimum such enhanced disclosure should embody the following elements:

- A balanced presentation of the nature of services received (including the inclusion of funds on preferred or select lists, or provision of shelf space) and expenses reimbursed pursuant to revenue sharing arrangements;

- A listing of funds or fund families with whom revenue sharing arrangements exist;

- The aggregate amount of revenue sharing payments received during a specified period;

- The funds or fund families with respect to which higher percentage rates of compensation are paid to associated persons;

- The extent, if any, to which associated persons may only recommend the purchase of funds with respect to which the broker-dealer participates in revenue sharing arrangements.

As you know, a number of regulatory and legislative initiatives directed at improving transparency have emerged in recent months. These include H.R. 2420 introduced by Congressman Richard Baker (R-LA),[8] proposals made by Representatives Oxley and Baker in a letter to SEC Chairman Donaldson,[9] an NASD rule proposal regarding compensation for the sale of investment company securities[10] and testimony by SEC Chairman Donaldson on September 30, 2003 before the Senate Committee on Banking, Housing and Urban Affairs, in which Chairman Donaldson stated that:

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[8] See H.R. 2420 mark-up dated July 24, 2003. H.R. 2420 focuses on additional customer statement disclosure or other non-prospectus disclosure. Proposals regarding revenue sharing and differential compensation appear in Section 12 of the bill.

[9] Letter to SEC Chairman Donaldson from Representative Michael Oxley (R-OH), Chairman, House Financial Services Committee and Representative Richard Baker (R-LA), Chairman Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (July 30, 2003).

[10] NASD *Notice to Members* #03-54 (September 2003). The NASD proposal appears to require additional disclosure to be delivered in some manner other than by means of the confirmation, the customer statement, or prospectus.

> I envision that a revised confirmation would include information about revenue sharing arrangements, incentives for selling in-house funds and other inducements for brokers to sell fund shares that may not be immediately transparent to fund investors…

Meanwhile, as a by-product of the recommendation of the NASD Mutual Fund Breakpoint Task Force – in which SIA has been an active participant and which I will discuss in a moment – task force working groups are currently developing confirmation modifications and a new disclosure document prototype to enhance disclosure of breakpoint information to customers. Each of these different initiatives has the potential to enhance the transmission of relevant information to mutual fund investors. However, when considered together, there appears to be a substantial risk of disclosure fragmentation and associated investor confusion, particularly if these initiatives proceed without coordination and consistency of treatment.

Therefore, in submissions we have made to the NASD[11] and SEC[12] we have urged that any rulemaking in this area be designed to:

- Achieve a uniform approach across regulatory entities regarding disclosure mechanisms for information on revenue sharing and differential compensation arrangements;
- Focus disclosure on circumstances where such arrangements are likely to influence recommendations made to investors, or limit the scope of recommendations that may be offered;
- Utilize disclosure vehicles that will facilitate, rather than inhibit or deflect, investors' attention away from all material information that should be considered when making a mutual fund investment.

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[11] Letter to Barbara Sweeney, NASD from Stuart R. Strachan, Chair, SIA Investment Company Committee "Rule Proposal Regarding Compensation for the Sale of Investment Company Securities, (October 17, 2003).

[12] Letter to Paul F. Roye, Director, SEC Division of Investment Management from Stuart R. Strachan, Chair, SIA Investment Company Committee, "Revenue Sharing and Differential Compensation (October 31, 2003).

B. Disclosure of Operating Expenses

SIA fully believes that investors should have full, complete, and useful information on mutual fund fees since they can have a significant effect on an investor's return. We believe that the most efficient means for providing this information to investors is for funds to calculate expenses based on a hypothetical $1,000 investment. House Report 108-351 accompanying H.R. 2420 (Nov. 4, 2003) notes at 11 that:

> The SEC recently proposed a new rule requiring disclosure in a fund's semi-annual and annual report to include (1) a dollar example of the fees an investor would have paid on a hypothetical $10,000 investment, using the actual exposes incurred by the fund and the actual return achieved by the fund; and (2) the same dollar example using the actual expenses incurred but assuming a 5 percent return over the period so funds could be compared against each other. *** H.R. 2420 generally codifies the pending SEC proposal, but includes two important changes: first the dollar example in the annual report must be based on a hypothetical $1,000 investment. The Committee believes that using $1,000 as the example will make it easier for investors to calculate the amount of fees paid. Second, the legislation includes a requirement that account statements include a legend prominently stating that (1) the investor has paid fees on the mutual fund investment, (2) those fees have been deducted from the amount shown on the statement, and (3) the investor can find more information by referring to documents disclosing the amounts of those fees.

SIA generally concurs with these provisions. Providing information on a $1,000 investment both with respect to that fund's return and with respect to a hypothetical five percent return will facilitate exactly the type of comparison-shopping that H.R. 2420 and the SEC contemplate. At the same time, the costs of these changes (which ultimately investors bear) will be in proportion to the benefit that investors derive.[13]

[13] *See* Memorandum from Paul F. Roye, Director, Division of Investment Management, SEC, to the Honorable William H. Donaldson, Chairman, SEC, June 9, 2003 at 13-18. *See also*, GAO, Mutual Funds, Greater Transparency Needed in Disclosure to Investors, June 2003 (GAO-03-763) at 11 *et seq*.

In addition, SIA appreciates the Report language noting that such disclosures should indicate that the customer's portfolio already reflects those charges and that they are not additional charges that the broker-dealer or fund will deduct. Absent such clarification, investors might be confused. SIA believes that any new disclosure should afford funds appropriate flexibility and ensure that fee disclosures do not receive disproportionate emphasis.

SIA also believes that this aspect of H.R. 2420 attempts to place an appropriate emphasis on mutual fund fees as part of the larger investment decision. As noted, fees can have an important effect on an investor's return. But fees are only one aspect of an investment decision. Investors (and their brokers, in the case of broker-sold funds) need to consider not just expenses, but whether the investment is appropriate for the investor's situation.

C. Soft Dollars, Directed Brokerage, and Related Issues

SIA supports efforts to improve disclosure of brokerage arrangements between funds, their advisers, and broker-dealers. 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) enables money managers to pay for research and related services through commission ("soft") dollars rather than paying for them in cash. Such research helps money managers, including fund managers, do a better job of serving their customers. Over the years, the Commission has issued interpretations on the scope of research services that may be provided and examined industry practices.[14] The 1998 Report notes, "the vast majority of products and services received by adviser are within the safe harbor established by Section 28(e) of the Exchange Act."[15] In general, SIA has viewed soft dollars as both pro-investor and pro-competitive.

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[14] *E.g.*, Interpretive Release Concerning Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Rel. 34-23170 (Apr. 23, 1986) ("1986 Release") and Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers, and Mutual Funds, Sept. 22, 1998 ("1998 Report").

[15] *Id* at 4.

At the same time, we recognize that there are opportunities for abuse with respect to soft dollars. The 1998 Report documented problems and abuses of significant concern. SIA strongly supports SEC and SRO enforcement efforts to curb soft dollar abuses and to deter others from engaging in such abuses. We also believe that mutual funds should ensure effective disclosure of soft dollar practices both to investors and to fund trustees. Section 3 of H.R. 2420 is intended to address these concerns and we generally support those goals.

Directed brokerage also has been a subject of concern. The 1998 Report – in citing the 1986 Release – states that unlike soft dollars, directed brokerage does not present the same conflict of interest issues, since "**the fund's commission dollars [are used] to obtain services that directly and exclusively benefit the fund.**"[16] In these situations the fund directs the money manager to execute a portion of the fund's trades through a particular broker-dealer. In return for the brokerage commissions the broker-dealer typically provides services directly to the fund or pays certain fund expenses.

We believe that with respect to both soft dollars and directed brokerage, a key investor protection issue is best execution. If fund investors received mediocre executions because of soft dollar or directed brokerage arrangements, the relationships are indefensible. Poor executions in the absence of soft dollar or directed brokerage arrangements would be just as indefensible. In short, advisers, fund trustees, and broker-dealers must serve the needs of fund investors with respect to research and execution services.

SIA supports disclosure to investors and fund trustees to ensure that arrangements with broker-dealers are disclosed fairly and in context. Again, disproportionate emphasis on costs may confuse and distract investors or trustees from examining the investment and all relationships among service providers. Nonetheless, balanced disclosure of

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[16] 1998 Report at 13 (emphasis added in 1998 Report, not in 1986 Release).

material information is essential if investors and the trustees acting on their behalf are going to make intelligent, informed decisions.

IV. Breakpoints

A. Overview

Late in 2002, the SEC and NASD became concerned that investors in mutual funds were not receiving "breakpoint" discounts, which are essentially volume discounts for purchases. The NASD indicates, "during routine examinations of broker-dealers by [the NASD's] Philadelphia District Office, NASD discovered that broker-dealers selling front-end loaded mutual funds were not properly delivering breakpoint discounts to investors.[17] The regulators' concerns were first articulated in an NASD *Notice to Members* dated December 23, 2003 and a letter from the SEC to senior brokerage firm executives. SIA, along with the Investment Company Institute ("ICI"), cooperated fully with the SEC and the NASD in an effort to publicize regulators' concerns and to help ensure that broker-dealers and funds addressed the situation. For example, SIA subsequently urged its membership to review their breakpoint procedures and promptly take any necessary corrective action.

In March 2003, the SEC, NASD and NYSE issued a report on breakpoint practices.[18] After examining 43 firms, the Report noted:

> Most of the firms examined, in some instances, did not provide customers with breakpoint discounts for which they appear to have been eligible. Overall, examiners identified a significant number of transactions that appeared to be eligible for a discount, though did not receive a discount or incurred other unnecessary sales charges. Three firms did not provide a discount in all sampled transactions that appear to have been eligible for a discount, and two firms provided customers with all available discounts.

[17] Testimony of Mary Schapiro, NASD Vice Chairman and President Regulatory Policy and Oversight, Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on House Financial Services, November 3, 2003, at 4.

[18] Staff Report: Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds, http://www.nasdr.com/pdf/-text/bp_joint_exam.pdf.

However, the Report also noted “many of the problems do not appear to be intentional failures to charge correct loads.”

B. Recommendations

In response to a request from the SEC Chairman,[19] the NASD organized a Task Force to address breakpoint concerns. The SEC asked the SIA and ICI to co-chair the effort. The Task Force was composed of a broad cross-section of the financial industry, including representatives from the NASD, NYSE, NSCC, broker-dealers, mutual funds, and transfer agents. SEC staff attended the meetings as well. On July 22, 2003, the Task Force issued its report with the following recommendations:

> (A) Common Definitional Standards: The mutual fund industry should adopt common definitions of terms frequently used in defining breakpoint opportunities.
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> (B) Central Breakpoint Schedule and Linkage Database: The mutual fund industry should create a central, comprehensive database of pricing methods …, breakpoint schedules, and the linkage rules used to determine when a breakpoint has been reached and should make that database easily accessible to broker/dealers' registered representatives…
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> (C) Mutual Fund Prospectus and Web Site Disclosure: Mutual funds should provide the critical data regarding pricing methods, breakpoint schedules and linkage rules in their prospectuses and on their Web Sites, in a prominent and clear format.
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> (D) Confirmation Disclosure: Confirmations should reflect the entire percentage sales load charged to each front-end load mutual fund purchase transaction.
>
> (E) Standardized Checklists or Order Verifications: As an initial matter, broker/dealers should require registered representatives to complete electronic or paper checklists or place notations on firm paper or electronic records
>
> (F) Record of Linkage Information: At the time an investor first purchases front-end load shares of a particular fund family, his broker/dealer should

[19] Letter from then-SEC Chairman Harvey Pitt to NASD Chairman Robert Glauber dated January 15, 2003.

record the investor's linking information, preferably using a standardized worksheet.

(G) Prospectus Disclosure Regarding Customer's Role in Assisting in Securing Breakpoint Discounts: The SEC should mandate that a fund's prospectus disclose that investors may need to provide their broker/dealer with the information necessary to take full advantage of the breakpoint discounts.

(H) Confirmation Breakpoint Legend: Confirmations for purchases of front-end load mutual fund shares should include a disclosure legend that alerts customers that they may be eligible for breakpoint discounts and refers customers to the appropriate materials (e.g., mutual fund prospectus or Web Site) to determine breakpoint discount eligibility.

(I) Written Disclosure Statement: Broker/dealers should provide to each investor a disclosure statement at the time of or prior to the confirmation of his initial purchase of front-end load fund shares.

(J) Registered Representative Training: NYSE and NASD rules require broker/dealer registered personnel to undergo periodic training.

(K) Investor Education: The investing public should fully understand the availability of breakpoint discounts because there are particular instances, as cited above, in which investors must be active participants in assuring their receipt of an eligible breakpoint.

The Task Force has appointed working groups led by the NASD, ICI, and SIA to implement these goals. The Task Force met again on October 28, 2003 so that each working group could report on its activities. Briefly, the groups have made substantial progress in completing the effort, which will result in a better and more extensive flow of information to investors regarding breakpoint opportunities, an enhanced investor ability to determine whether they received the sales charge reductions to which they are entitled, improved systems for capturing and storing information regarding accounts entitled to be aggregated for breakpoint purposes, and improved communication of information between funds and broker-dealers regarding breakpoint policies.

While the development of standardized definitions of breakpoint terminology is helpful, the wide variation in breakpoint policies across hundreds of fund families and thousands of funds still poses a daunting challenge. While we do not advocate a standardization of breakpoint policies, we do believe it appropriate for the regulators, SIA and ICI to continue to work together to explore ways in which breakpoint policies can be made easier to apply, so that the risk of any further operational problems regarding customers receiving the correct breakpoint is further reduced.

It is important to note that the SEC charged the Task Force with addressing breakpoint problems prospectively. The SEC and the self-regulators have been working with firms to ensure that mutual fund customers are made whole.[20]

V. Conclusion

Like many investors, regulators, and policymakers, we have been surprised and dismayed by the reports of abuses relating to the sale of mutual funds to investors. Although any report of malfeasance in the financial industry is one too many, these reports have been particularly upsetting because mutual funds are the investment vehicle of choice for many Americans. Reports of abuses in this aspect of the financial world have a particularly corrosive effect on public trust in the investing and capital raising process. At SIA's recent Annual Meeting, SEC Chairman William Donaldson said:

> I have spent many years in and around the securities industry, during which time I have seen that we have the world's most creative, and most industrious workforce. I have also seen that this industry is populated by fundamentally decent and honest people. Indeed, these traits provide the foundation of our economic vibrancy. The securities industry has found itself stuck in a legal and ethical quagmire, but I am confident that the industry will work together to pull the industry out of the muck and live up to a higher ethical standard. You can be sure that if you don't, those of us in government will.[21]

We are fully committed to addressing these concerns thoroughly – by supporting vigorous enforcement of current rules and by supporting appropriate legislative and

[20] SIA understands that these efforts range from letters of caution from self-regulators to SEC notices of possible Enforcement action (so-called "Wells" notices.) As a policy matter, generally SIA does not involve itself with enforcement matters.
[21] Donaldson/Boca Speech.

regulatory reforms. We and our member-firms will work with policymakers to ensure that mutual fund investors once again can have justifiable faith in these products and our markets. We look forward, Mr. Chairman, to working with you and the Committee to earn back the public's trust and confidence.