Report of the Mutual Fund Task Force
Soft Dollars and Portfolio Transaction Costs
November 11, 2004

NASD formed the Mutual Fund Task Force ("Task Force") in May 2004 to consider ways to improve the transparency of mutual fund portfolio transaction costs and distribution arrangements. The Task Force was established after discussions between the Securities and Exchange Commission ("SEC") and NASD staffs, to provide guidance to the SEC as it considers the issues raised in a concept release concerning mutual fund portfolio transaction costs and a rule proposal relating to mutual fund distribution arrangements.[1]

The Task Force is comprised of senior industry executives who represent broker-dealers and mutual fund management companies, as well as representatives from the academic and legal communities. The Task Force has divided its work into two phases. In the first phase, it has considered mutual fund portfolio transaction costs, particularly "soft dollar" services and disclosure.[2] The Task Force met on June 23 and August 2, 2004, to consider these issues.[3] This Report sets forth the Task Force's observations and recommendations concerning soft dollar services and portfolio transaction costs. In its second phase, the Task Force will focus on distribution arrangements, including fees paid pursuant to Rule 12b-1 under the Investment Company Act of 1940 ("1940 Act") and revenue sharing.

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[1] *See* SEC Rel. No. IC-26313 (Dec. 18, 2003), 68 Fed. Reg. 74819 (Dec. 24, 2003) (the "Release"). *See also* SEC Rel. No. IC-26356 (Feb. 24, 2004), 69 Fed. Reg. 9725 (Mar. 1, 2004) and SEC Rel. No. IC-26591 (Sept. 2, 2004), 69 Fed. Reg. 54727 (Sept. 9, 2004).

[2] The term "soft dollars" is not defined under the federal securities laws. Nevertheless, the SEC has defined the term to mean products and services, other than execution of securities transactions, that an investment manager receives from or through a broker-dealer in exchange for the adviser's direction of client brokerage transactions to the broker-dealer. SEC Rel. No. 34-35375 (Feb. 14, 1995), 60 Fed. Reg. 9750 (Feb. 21, 1995). *See also* Office of Compliance, Inspections and Examinations, SEC, Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds (Sept. 22, 1998) ("SEC Sweep Report") at 2.

This definition, which is used in this Report, covers soft dollar products and services of both the executing broker (proprietary) and those of third parties. For purposes of this Report, the term "soft dollars" does not include the use of brokerage commissions to pay for specific fund expenses that the fund otherwise would pay through a deduction from its assets, such as custodial or transfer agency fees.

[3] NASD staff, on behalf of the Task Force, also met or spoke with a number of other industry representatives and industry groups to discuss these issues, including Abel/Noser, Alliance in Support of Independent Research, Bloomberg, Financial Research Corporation, Goldman Sachs & Company, Greenwich Associates, Investment Company Institute, Investment Management Association, Investorside Research Association, Plexus Group, Reuters Group, Rontech Limited, Securities Industry Association, and State Street Corporation.

I. BACKGROUND AND SUMMARY OF TASK FORCE RECOMMENDATIONS

A. The Section 28(e) Safe Harbor

Section 28(e) of the Securities Exchange Act of 1934 ("Exchange Act"), enacted in 1975 shortly after the SEC abolished fixed commission rates, protects an investment adviser from claims that it breached its fiduciary duty by causing clients to pay more than the lowest available commission rates. The safe harbor is available to all discretionary money managers and, in relevant part, allows a manager to pay a higher commission rate if the manager determines that the rate is "reasonable in relation to the value of the brokerage or research services" received from a broker-dealer. If managers were required to seek the lowest available rate, Congress feared that "the future availability and quality of research and other services . . . could be jeopardized, with potentially harmful consequences to all investors."[4]

Section 28(e) thus reflects a Congressional determination that, subject to appropriate controls, the use of client Commission dollars to obtain research and brokerage services serves investor interests and is beneficial to the securities markets.[5] This Congressional finding was consistent with a then-recent SEC conclusion that "providing investment research is a fundamental element of the brokerage function, for which the bona fide expenditure of the beneficiary's funds is completely appropriate."[6]

Section 28(e)(3) provides a broad definition of "brokerage and research services" that has been the subject of SEC staff interpretation. In 1976, the SEC interpreted the Section 28(e) safe harbor to be unavailable for products or services that are "readily and customarily available and offered to the general public on a commercial basis."[7] The industry had difficulty applying the 1976 standard in practice, and thus the SEC staff reviewed soft dollar practices again in the mid-1980s. In 1986, the SEC adopted a revised interpretation under which the term "research services" was deemed to include products or services that provide "lawful and appropriate assistance to the money manager in the carrying out of his responsibilities."[8] Thus, for example,

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[4] H.R. Rep. No. 123, 94th Cong., 1st Sess. 248 (1975). The SEC expressed similar concerns in a 1972 study leading up to the enactment of Section 28(e), which noted that "it is essential that the viability of the process by which research is produced and disseminated is not impaired." SEC Statement on the Future Structure of the Securities Markets, 37 Fed. Reg. 5286, 5290 (Feb. 4, 1972) ("SEC Statement").

[5] For purposes of this Report only, the term "Commission" includes commission equivalents and other portfolio transaction costs that are eligible for the Section 28(e) safe harbor. *See* SEC Rel. No. 34-45194 (Dec. 27, 2001), 67 Fed. Reg. 6 (Jan. 2, 2002) (in which the SEC interpreted the term "commission" in Section 28(e) to include commission equivalents and other forms of remuneration in certain types of "riskless principal" trades). Use of this definition should not be interpreted as an endorsement by the Task Force of an expanded interpretation of the term for other purposes.

[6] SEC Statement *supra* n. 4. The SEC Sweep Report reaffirmed that "[r]esearch is the foundation of the money management industry. Providing research is one important, long-standing service of the brokerage business. Soft dollar arrangements have developed as a link between the brokerage industry's supply of research and the money management industry's demand for research." *See* SEC Sweep Report, at 2.

[7] SEC Rel. No. 34-12251 (Mar. 24, 1976) at 1.

[8] SEC Rel. No. 34-23170 (Apr. 23, 1986) at 10, 51 Fed. Reg. 16004 (Apr. 30, 1986).

a money manager may rely on the Section 28(e) safe harbor to pay for third-party research and for hardware that provides investment information, even though these products and services are available to the general public.

B. Conflicts of Interest

Because a manager can use client Commission dollars to obtain research and other services that the manager otherwise would have to pay for from its own assets, there could be incentives for a manager to enter into brokerage arrangements that may not serve a client's best interests. Thus, it is possible that a manager could be induced to trade a client account more actively than is in the client's best interest in order to generate soft dollar credits, or to be less vigilant in obtaining best execution for all client trades. An adviser also may pay more in soft dollars for research than the adviser would be willing to pay from its own assets. In addition, advisers may face conflicts of interest due to the potential for using one fund's Commissions to pay for soft dollar research that benefits another fund. For example, under Section 28(e), a large-cap equity fund's Commissions may pay for research that benefits a bond fund's investors, despite the fact that the bond fund does not pay Commissions on its portfolio transactions. Due to these potential conflicts, the SEC requires managers to disclose soft dollar practices to their clients and, as noted above, has provided guidance to the industry as to the scope of the safe harbor afforded by Section 28(e).

C. Disclosure Issues

Some have questioned the adequacy of current disclosure requirements regarding soft dollar expenditures and other portfolio transaction costs. Portfolio transaction costs represent a significant component of overall fund expenses and are reflected in a fund's total return and performance figures. Transaction costs are not, however, included in a fund's expense ratio because accounting principles dictate that they are either included as part of the cost basis of securities purchased or subtracted from the net proceeds of securities sold.

The accounting treatment of portfolio transaction costs can be especially pertinent to soft dollar practices. An adviser to Fund A could pay for research with hard dollars, using its management fee, which is reflected in Fund A's prospectus fee table. Fund B's investment adviser could pay for the same research with soft dollars, using Fund B's Commissions, and that expense would not appear in the fee table. Unlike some other types of expenses paid through Commissions (including custody and transfer agent fees), soft dollar services are not required to be "grossed-up" in the fund's fee table.[9] Fund B thus could appear to have a lower investment advisory fee – and a lower expense ratio – than Fund A, even if the ultimate cost to each fund were the same.

[9] Since 1995, the SEC has required a fund's fee table to "gross-up" the amounts of various expenses (such as custody fees, transfer agency fees, printing and legal fees, and other miscellaneous fees) that the fund pays with its brokerage commissions. SEC Rel. No. 33-7197 (July 21, 1995), 60 Fed. Reg. 38917 (July 28, 1995). The SEC has not, however, required the management fee set forth in the fee table to be grossed-up to reflect research and brokerage services obtained through the use of soft dollars.

Moreover, public disclosure concerning portfolio transaction costs is limited to a gross annual expenditure for commissions, which appears in a fund's statement of additional information ("SAI"), a document not widely used by the investing public. Further disclosure would assist investors in understanding the magnitude of portfolio transaction costs and, in particular, the magnitude of soft dollar expenditures.

D. Task Force Conclusions and Recommendations

The Task Force unanimously agreed that the safe harbor set forth in Section 28(e) of the Exchange Act should be preserved. The Task Force believes that investors will be best served if research of all types, including both proprietary and third-party research, continues to be widely available to all investment managers.[10] The Task Force notes that soft dollar practices may be especially beneficial to the clients of smaller investment advisers. These smaller advisers can afford neither a large internal research staff nor extensive hard dollar payments for research. They can, however, supplement their internal research efforts through the use of soft dollar arrangements.[11]

In the Task Force's view, the safe harbor for soft dollar practices set forth in Section 28(e) is an important element in the current system for providing research and remains valid. The Task Force recognizes, however, that the advantages of these practices must be balanced against the need to address the potential conflicts of interest and disclosure issues that they raise.[12]

The Task Force's consideration of these issues led to a number of specific recommendations on ways to improve the existing regulation of these costs. The Task Force recommends that the SEC:

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[10] A reinterpretation of the scope of the Section 28(e) safe harbor in a manner that precludes the use of soft dollars to obtain third-party research would, in the view of the Task Force, harm investors by inhibiting the availability of the valuable research that is available through many independent research providers. It also may encourage small independent research providers to open trading desks so that their research may be deemed "proprietary" research subject to the protection of the safe harbor. Creating incentives for firms to open trading desks for the sole purpose of qualifying research under Section 28(e) appears to be counter to the interests of the investing public and may compromise an adviser's duty to obtain best execution.

[11] *See* SEC Sweep Report, *supra* n. 2, at 34. The SEC Sweep Report notes that, at the time of the Report, for most large institutional managers examined, soft dollar expenditures were "minimal"; an institutional manager with $60 billion under management used 20 percent of its commissions to generate soft dollar credits. In contrast, a small adviser with $2.5 million under management used 86 percent of its commissions to generate soft dollar credits.

[12] Contrary to the Task Force's view, the Mutual Fund Directors Forum recently recommended that, as a matter of best practice, mutual fund directors should not permit fund advisers to use fund brokerage commissions to obtain soft dollar research. Report of the Mutual Fund Directors Forum, "Best Practices and Practical Guidance for Mutual Fund Directors" at 17-22 (July 2004). The Forum reasoned that its "guiding principles – that brokerage commissions are an asset of a fund, that best execution is the most important factor and that transparency is important – weigh strongly in favor of abandoning soft dollar arrangements involving fund assets." *Id.* at 20-21. The Task Force, however, believes that further disclosure and close review by fund boards is the preferable alternative.

- Narrow its interpretation of the scope of research services for purposes of the safe harbor set forth in Section 28(e), to better tailor the safe harbor to the types of services that principally benefit clients rather than the adviser;

- Ensure that a fund board obtains appropriate information regarding a fund adviser's brokerage allocation practices, including soft dollar products and services received;

- Mandate enhanced disclosure in fund prospectuses to foster better investor awareness of soft dollar practices;

- Consider soft dollar issues raised by other managed advisory accounts;

- Apply disclosure requirements to all types of Commissions;

- Explicitly require that advisers provide certain information concerning portfolio transaction costs to fund boards; and

- Require enhanced disclosure to fund shareholders about portfolio transaction costs.

II. TASK FORCE RECOMMENDATIONS CONCERNING SOFT DOLLARS

A. Current Disclosure Requirements

An adviser is obligated under both the 1940 Act and state law always to act in the best interests of its clients. This duty precludes an adviser from using client assets (including brokerage commissions) for the adviser's benefit or the benefit of other clients, absent full disclosure and either express or implied client consent.[13] These requirements apply whether or not an adviser is relying on the Section 28(e) safe harbor with regard to its soft dollar practices. Accordingly, the SEC has directed that advisers must fully disclose to their clients the products and services obtained through the use of soft dollars.[14]

In carrying out their responsibilities to fund shareholders, directors have a duty to oversee brokerage allocation practices, including soft dollar practices. Moreover, in evaluating a fund's contract with an investment manager, the fund's board has a duty to request and evaluate, and the adviser has a duty to provide, all information necessary to consider the terms of the contract.[15]

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[13] SEC Sweep Report, *supra* n. 2, at 9. *See also SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-192 (1963).

[14] SEC Rel. No. 34-23170 (Apr. 23, 1986) at 20, 51 Fed. Reg. 16004 (Apr. 30, 1986). SEC Form ADV requires advisers to disclose their soft dollar practices, including whether clients may pay commissions higher than those obtainable from other brokers in return for the research and/or other products and services; whether research is used to service all accounts or just those accounts paying for it; and any procedures that the adviser used during the last fiscal year to direct client transactions to a particular broker in return for products, research and services received.

[15] *See* SEC Sweep Report, *supra* n. 2, at 12.

In fulfilling this responsibility, a well-informed board typically receives reports that provide all relevant information about an adviser's soft dollar practices.[16]

In addition, SEC Form N-1A requires a mutual fund to disclose in its SAI how the fund selects brokers to effect securities transactions and how the fund evaluates the reasonableness of commissions paid.[17] In particular, if a fund considers the receipt of research services in selecting brokers, the fund must identify the nature of the services. If applicable, the fund must explain that its investment adviser may use these research services in servicing all of the adviser's accounts, and that the adviser may not use all of the services in connection with the fund. If a fund adviser directed fund brokerage transactions to a broker because of research services provided, the fund is required to state in its SAI the amount of the transactions and related commissions.[18]

B. The SEC Should Narrow Its Interpretation of the Scope of the Safe Harbor Under Section 28(e)

The Task Force recommends that the SEC narrow its interpretation of the scope of the Section 28(e) safe harbor to better tailor it to the types of soft dollar services that principally benefit the adviser's clients rather than the adviser. The Task Force considered whether the SEC should return to its 1976 standard. The Task Force concluded, however, that the difficulties in administering the standard argue against such a position. Moreover, a return to the 1976 standard could greatly inhibit the availability of third-party research, a discriminatory result that would not serve investor interests.

The current issues surrounding soft dollars services have centered on research, not brokerage, and the Task Force is not aware of actual or perceived abuses of soft dollar expenditures to cover brokerage services.[19] Thus, the Task Force focused its discussions on the questions surrounding the definition of research services. The SEC should clarify that, both with regard to research and brokerage services, soft dollar usage encompasses products and services obtained with or without a formal or informal agreement or even without being directly requested by the adviser.

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[16] An adviser is not required to provide a fund board of directors with a copy of its Form ADV disclosure concerning its soft dollar practices. *See* SEC Rule 204-3(b)(2) under the Investment Advisers Act of 1940. In practice, however, it is common for a fund board to receive information about a manager's soft dollar practices that is more detailed than the disclosure required by Form ADV.

[17] Item 15(c) of Form N-1A under the 1940 Act.

[18] Item 15(d) of Form N-1A under the 1940 Act.

[19] The safe harbor for brokerage services paid for with Commission dollars extends to the execution of transactions and incidental functions (such as clearance, settlement and custody). Section 28(e)(3) of the Exchange Act.

The Task Force recommends that the SEC interpret the safe harbor to protect only brokerage services as described in Section 28(e)(3) and the "intellectual content" of research.[20] The Task Force proposes that the SEC define "intellectual content" as "any investment formula, idea, analysis or strategy that is communicated in writing, orally or electronically and that has been developed, authored, provided or applied by the broker-dealer or third-party research provider (other than magazines, periodicals or other publications in general circulation)." Under this definition of "research services," the safe harbor would not protect the means by which such content is provided.[21]

This definition should protect substantive research that advances the management of client accounts and would not discriminate against third-party research. It would protect services specifically cited by the statutory language of Section 28(e), such as advisory services concerning "the value of securities, the advisability of investing in, purchasing, or selling securities and the availability of securities or purchasers or sellers of securities."[22] It also would protect research and database services that allow a subscriber to conduct customized research using various analytical tools.

The proposed definition of research services would not protect such benefits as:

- Computer hardware and software, unrelated to any research content or analytical tool;
- Phone lines and data transmission lines;
- Terminals and similar facilities (as distinct from any research content or analytical tool);
- Magazines/newspapers/journals/on-line news services;
- Portfolio accounting services;
- Proxy voting services unrelated to issuer research; and
- Travel expenses incurred in company visits.[23]

The Task Force recommends that, in adopting a new interpretation of research services, the SEC include an illustrative list of what items would be included in or excluded from the definition. The SEC should note that the list is only meant to be illustrative, particularly in an age of rapid technological change. The Task Force recommends that the SEC, from time to time, publish a new list or other interpretive assistance about the application of the definition.

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[20] To the extent that the SEC narrows the definition of soft dollar-eligible research, it is possible that some advisers may try inappropriately to reclassify some services as brokerage services products. The Task Force suggests that the SEC monitor the use of the safe harbor for brokerage services for such inappropriate attempts to maintain the *status quo* by expanding the brokerage services aspect of the safe harbor.

[21] Extending the safe harbor to the means by which the intellectual content of research is provided appears unwarranted because, given technological developments, the means and the content itself are no longer inextricably linked.

[22] Section 28(e)(3) of the Exchange Act.

[23] Some benefits that do not qualify as research for purposes of Section 28(e) may, however, qualify as brokerage services under the safe harbor.

The Task Force considered whether soft dollars should be available for products with mixed uses – in other words, products that have uses that fall inside and outside of the 28(e) safe harbor. Absent a requirement that a product meet some minimum threshold of safe harbor eligibility, there is a risk that soft dollars will be used to pay for non-research services, since it may be difficult to allocate the precise cost of the research at low thresholds. Further, advisers arguably should not be using soft dollars on products and services that are not significantly research-oriented. The Task Force recommends that the SEC consider limiting the protection of the safe harbor to products with a significant use within the safe harbor.

C. The SEC Should Mandate Expanded Disclosure to Fund Boards About Soft Dollar Practices

Section 15(c) of the 1940 Act requires a mutual fund's board of directors to request and review such information as reasonably may be necessary to evaluate the terms of an advisory contract between the fund and its investment adviser. Mutual fund boards typically review information regarding the transaction costs incurred by the fund and any soft dollar benefits obtained by the fund's adviser, but the types of information reviewed may vary significantly among fund complexes. Until recent years, review of soft dollar practices by some fund boards often appears to have been cursory and perfunctory.[24]

While board review of portfolio brokerage allocation, including soft dollar practices, has evolved in recent years, the Task Force believes that the SEC should take steps to ensure that every fund board understands the types of information that should be reviewed in exercising effective oversight over an adviser's soft dollar practices. The Task Force recommends that the SEC mandate that a fund's adviser provide the board of directors with, at a minimum, the following information for each fund:

- Portfolio turnover rate;
- List of brokers used and total Commissions paid to each broker, expressed in dollars and in basis points;
- The aggregate average Commission rate per share and the average Commission rate per share by broker;
- The average Commission rate paid to brokers that provide soft dollar services to the fund's adviser *versus* the average rate paid to brokers that do not provide such benefits;
- List of brokers from which the fund adviser obtains soft dollar products and services (proprietary and/or third-party research) that includes a description of the products or services received, total commissions directed to the broker by the fund and all of the adviser's clients;
- The conversion ratio or price of research offered by each broker through which the adviser obtains third-party research benefits; and

[24] The SEC Sweep Report notes that "[s]ome boards receive periodic disclosure that is extensive and detailed and includes summaries designed to permit the directors to evaluate the benefits that the adviser received from its use of fund brokerage. We found that most fund boards, however, are simply given a copy of the fund adviser's Form ADV." *See* SEC Sweep Report, *supra* n. 2, at 36.

- The amount of third-party research benefits obtained with fund commissions, expressed in dollars and in basis points.[25]

Requiring fund advisers to provide the information delineated above to fund boards will establish minimum standards that will protect all investors, regardless of the funds in which they invest. This requirement will support a more rigorous discipline on the purchase of research and brokerage services with soft dollars, particularly in the context of the board's consideration of the fund adviser's management fee.

Among the items of information noted above is the dollar amount of third-party research benefits obtained with fund commissions. This number is readily available to advisers and brokers, due to the fact that advisers generally obtain third-party research by placing portfolio trades with a particular broker and acquiring third-party research credits based on a ratio tied to actual brokerage commissions paid. The Task Force's recommendation for disclosure to fund boards of the dollar amount of third-party research is not meant in any way to disparage the value of third-party research. To the contrary, as noted earlier, the Task Force unanimously concluded that many types of independent research are valuable and that it is appropriate to use fund commissions to acquire third-party research under the safe harbor in Section 28(e).

The Task Force also considered whether it is possible for an adviser to provide the board with an analogous good faith estimate of the total dollar amount of proprietary research obtained with fund brokerage commissions. Ultimately, the Task Force was unable to reach a consensus on this point. The views of the Task Force members reflect a sharp disagreement on the value to fund boards, and ultimately to investors, of estimates of the amount of propriety research obtained with fund brokerage commissions.

A substantial number of Task Force members believe that the SEC should require an adviser to provide a fund board with a good faith estimate[26] of the amount of proprietary research obtained with fund brokerage commissions.[27] These members observed that a board might have an incomplete understanding of the amount of research obtained by the adviser through fund brokerage, unless third-party research figures are augmented by proprietary research amounts, even if the adviser derives the proprietary research figures, of necessity, from subjective

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[25] Many of these items of information are cited in the Sweep Report as examples of what some fund boards review in overseeing portfolio brokerage allocation practices. *See* Sweep Report, *id.*, at Appendix G.

[26] At least one Task Force member feels strongly that advisers, with input from broker-dealers, could provide fund boards with the actual dollar amount of proprietary research obtained with fund Commissions

[27] Two members of the Task Force would go further, and would support a requirement that such estimates be provided to fund investors, such as by disclosing the estimates in the fund prospectus. The overwhelming majority of the Task Force, however, concluded that it would be misleading to investors to provide such information, given the inherently subjective nature of estimating the value of proprietary soft dollar benefits. Given that under identical circumstances, one adviser's estimate could vary significantly from another's, an investor's ability to make meaningful comparisons across funds would be hampered by the inclusion of such estimates.

estimates. These Task Force members are of the view that such estimates could be based upon, but not controlled by, any data supplied by broker-dealers with whom the adviser has a soft dollar relationship.[28] They also noted that some advisers already provide fund boards with estimates concerning proprietary research, and that the SEC should endeavor to make this practice standard in the industry.[29]

The views of these Task Force members were influenced, in part, by recent action of the UK Financial Services Authority ("FSA"). The FSA recommended that the boards of directors/trustees of fund management clients be given clear information about the respective costs of execution and research paid for on their behalf by their manager, and the overall expenditure on these services, and that fund managers be encouraged to seek, and brokers to provide, clear payment and pricing mechanisms that enable individual services to be purchased separately. The FSA intends to allow the securities industry time to implement these goals before considering regulatory intervention.[30]

A majority of the Task Force, in contrast, strongly objected to a recommendation that the SEC require an adviser to provide a fund board with an estimate of the dollar amount of Section 28(e)-eligible proprietary research and brokerage services obtained. These Task Force members believe that it is illusory to conclude that such estimates will add value to a board's oversight. They believe that most advisers would be forced to develop an arbitrary formula that could be applied to the total commissions. While a more accurate

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[28] To facilitate fund boards' review, a minority of Task Force members believes that broker-dealers providing research or brokerage services on a soft dollar basis should provide investment managers with a reasonable, good faith estimate of the percentage of total Commissions that the broker-dealer received from the adviser for research services. These Task Force members believe that even where the adviser's view of the value of research services differs markedly from the estimates provided by the broker-dealer, the broker-dealer's estimated price or value may serve as a useful benchmark and an important additional item of information in the periodic discussions between an adviser and fund board. While these members believe that broker-dealers should be able to use any appropriate method to establish this breakdown, the majority of the Task Force believes that that there is no meaningful way for many brokers to provide good faith estimates of the breakdown of total Commissions.

[29] Task Force members favoring adviser disclosure of proprietary research estimates believe that the simplest, most effective disclosure would be a reasonable, good faith estimate of the percentage of the fund's average net asset value (NAV) that was used to obtain soft dollar research benefits. In the Task Force's view, the SEC should avoid requiring estimates that are unduly detailed or complicated, which inherently would be less susceptible to good faith estimation.

[30] Financial Services Authority, "Bundled Brokerage and Soft Commission Arrangements: Feedback on CP176," Policy Statement 04/13 (May 2004) at 28-29, 36. The FSA originally proposed to limit the range of goods and services that could be purchased with soft dollars and bundled commissions, to require fund managers to value the goods and services that could still be softed or bundled, and to rebate an equivalent amount to their customers. *See* FSA Consultation Paper 176, "Bundled Brokerage and Soft Commission Arrangements" (April 2003). The FSA has determined not to proceed with this proposal for now, pending the industry's response to Policy Statement 04/13.

The FSA made a number of other recommendations regarding soft dollar practices, including a requirement that the range of goods and services that fund managers can buy with their clients' transaction commissions be limited to execution and research.

estimate could be attempted by examining each individual trade and estimating the value of each component of each commission paid, such an undertaking would be extremely costly and time-consuming, with no assurance that that the resulting estimate is any more accurate. These Task Force members also fear that the estimates, although inherently subjective and arbitrary, inevitably will be perceived as "hard numbers" by some. Moreover, absent a uniform methodology for valuing proprietary soft dollar services, the estimates will vary significantly among advisers. In light of these considerations, these members would object to an SEC requirement that an adviser provide proprietary research estimates to a fund board.

D. The SEC Should Mandate Expanded Disclosure to Fund Investors About Soft Dollar Practices

The Task Force also considered recommending that the SEC require that a fund disclose to investors whether its manager relies on the Section 28(e) safe harbor and, if so, to provide a reasonable, good faith estimate of the percentage of Commissions and/or the fund's NAV that was used to obtain soft dollar benefits.[31] Absent a uniform methodology to measure the percentage of Commissions used to obtain soft dollar benefits, Task Force members were concerned that this disclosure would lack comparability across fund groups. Generally speaking, as noted above, the use of soft dollars to obtain third-party research readily may be quantified, due to the manner in which broker-dealers use soft dollar ratios to award credits that may be used to obtain third-party research. As described above, however, proprietary research presents more difficult challenges, and most Task Force members were uncomfortable recommending disclosure of data that represents only an estimate of the breakdown of Commissions into brokerage and non-brokerage components. Similarly, these Task Force members were uncomfortable with disclosure to investors of third-party data only, which might imply that third-party research expenditures were the only soft dollar research expenditures incurred.

In addition, most Task Force members believed that, even if accompanied by lengthy explanatory narrative disclosure, the probability that numerical breakdowns would mislead or confuse investors would outweigh the potential benefits of disclosure. Most of the Task Force members felt that it was preferable for the board to review information about soft dollar practices on investors' behalf, since the board is vested with authority under the 1940 Act to ensure that the adviser has properly resolved potential conflicts and to review the adviser's best execution responsibilities.[32]

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[31] The Task Force also explored disclosure of percentage ranges used for soft dollar services and disclosure of very general levels of soft dollar use, as well as disclosure on a fund family or manager basis.

[32] As discussed above, Item 15(d) of Form N-1A already requires a fund to disclose in its SAI the amount of the transactions and related commissions paid in connection with an arrangement or understanding that is used to obtain research services from a broker. The Task Force recommends that the SEC remind mutual funds of their obligation to comply with these existing disclosure requirements. The SEC also should interpret the requirement to apply to understandings that are informal, as well as formal, contractual relationships – in other words, to any receipt of goods and services through soft dollars.

A few Task Force members did support disclosure of a reasonable, good faith estimate of these soft dollar research amounts to shareholders. They expressed the view that disclosure to shareholders of this information would respond to the criticism that soft dollar usage is an expense hidden from fund shareholders and would help to educate the shareholder body about the magnitude of these expenses. They also expressed the view that, even if an average retail investor may not appreciate fully this kind of disclosure, more sophisticated financial intermediaries would be able to use this information to make more informed recommendations to their clients.

Rather than requiring funds to provide quantitative estimates of soft dollar use, the Task Force recommends that the SEC require funds to provide shareholders with additional information concerning the fund's soft dollar practices. As discussed above, Item 15(c) of SEC Form N-1A already requires a mutual fund to disclose in its SAI how the fund selects brokers and, if a fund considers the receipt of research services in selecting brokers, the nature of the services. The Task Force recommends that the SEC expand these disclosure standards to require, in addition, that a fund state:

- Whether it obtains third-party research through soft dollars; and

- Whether it obtains proprietary research through soft dollars.

Task Force members generally agreed that this additional disclosure should be included in the fund prospectus and not be relegated to the SAI. Prospectus disclosure will make the information prominent and readily accessible to investors and the financial press, encouraging a heightened scrutiny that is unlikely if the information is set forth in the SAI. To ensure that the information is useful to investors, the Commission should require funds to present the information clearly and simply, in a manner that avoids boilerplate language or needlessly lengthy or complex explanations.

E. The SEC and Other Regulators Should Consider Soft Dollar Issues Raised by Other Managed Advisory Accounts

The Section 28(e) safe harbor is available to all discretionary money managers. However, as a matter of practice, mutual fund and pension fund managers are the only managers that *must* meet the safe harbor, due to the self-dealing limitations under Section 17 of the 1940 Act and the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). Other managers, such as hedge fund managers, may engage in soft dollar practices that do not fall within the scope of Section 28(e). The Task Force recommends that the SEC consider whether it makes sense to continue to have different soft dollar rules apply depending on the type of managed advisory account executing the transaction.

The Task Force believes that the same types of conflicts that may arise in the use of soft dollar arrangements by investment companies also may occur when other fund managers obtain soft dollar benefits. Also, research obtained by a money manager can serve multiple advisory clients, such as mutual funds and hedge funds. Applying one set of rules with regard to mutual fund-

related soft dollar transactions and another set of rules with regard to non-fund or mixed transactions may be difficult for that money manager, and may cause compliance challenges. For these reasons, the Task Force recommends that the SEC consider making compliance with Section 28(e) mandatory for all discretionary investment advisers, whether or not registered with the SEC, and that the SEC recommend to the Department of Labor and the federal banking regulators that they require all other discretionary investment managers not subject to SEC jurisdiction to comply with the standards of the safe harbor.

III. TASK FORCE RECOMMENDATIONS CONCERNING PORTFOLIO TRANSACTION COSTS

A. Current Disclosure Requirements

Under generally accepted accounting principles (GAAP), portfolio transaction costs are added to the purchase price or deducted from the sales price of a security and are not reflected in the fund's expense ratio. Today, the only data mandated for prospectus disclosure that can be used by investors to evaluate the trading activity of a mutual fund, and thereby shed light on the fund's portfolio trading costs, is the requirement that the prospectus disclose the portfolio turnover rate in its financial highlights table.[33] The financial highlights table typically contains additional financial information and is presented toward the back section of the prospectus. Additional information on portfolio transaction costs must be disclosed in the SAI, a document not typically used by investors. The SAI must describe:

- The manner in which portfolio transactions are effected, including a general statement about commissions and markups/markdowns on principal trades;
- The manner in which the fund will select brokers to effect securities transactions;
- The manner in which the fund will evaluate the overall reasonableness of the brokerage commissions paid, including the factors that the fund will consider in making these determinations;
- The aggregate dollar amount of commissions paid during each of its three most recent fiscal years. If the amount paid during either of the two years preceding the fund's most recent fiscal year differed materially from the amount paid during its most recent fiscal year, the fund must state the reasons for the difference;
- The total dollar amount of commissions paid to any affiliated broker-dealer;
- The percentage of the fund's total commissions paid to any affiliated broker-dealer during the most recent fiscal year; and

[33] Funds also must disclose in the prospectus whether they may engage in active and frequent trading of portfolio securities to achieve their investment strategies. Item 4(b) of Form N-1A.

- The percentage of the fund's dollar amount of portfolio transactions that involve the payment of commissions that was executed through any affiliated broker-dealer during the most recent fiscal year.

As discussed in Part II.C., fund boards should review a variety of information concerning portfolio transaction costs. This information should include the fund's portfolio turnover rate, a list of brokers used, the total commissions paid to each broker, and the aggregate average commission rate per share and per broker.

B. The SEC Should Apply Disclosure Principles to All Forms of Commissions

As discussed above, the SEC has interpreted the term "commission" under the Section 28(e) safe harbor to include commission equivalents and other forms of remuneration in certain types of "riskless principal" trades.[34] Specifically, in 2001, the SEC modified its interpretation of the term "commission" in Section 28(e) to include "a markup, markdown, commission equivalent or other fee paid by a managed account to a dealer for executing a transaction where the fee and transaction price are fully and separately disclosed on the confirmation and the transaction is reported under conditions that provide independent and objective verification of the transaction price subject to self-regulatory organization oversight. Fees paid for Eligible Riskless Principal Transactions that are reported under NASD Rule 4632, 4642 or 6420 would fall within this interpretation."[35] The Task Force understands that, with the decimalization of stock prices, dealers are trading on a riskless principal basis more frequently than when stock prices were fractionalized and that commission equivalents are an increasingly large component of the funds that support the provision of soft dollar services.

The Task Force supports this interpretation and agrees with the SEC's analysis in reaching its conclusion on this issue. Nevertheless, to the extent current rules do not provide for disclosure of commission equivalents and other remuneration that is eligible for the safe harbor, those rules either need to be modified or reinterpreted to cover these costs. Accordingly, all of the Task Force's recommendations regarding disclosure of commissions should be understood to cover commission equivalents and other remuneration eligible for the Section 28(e) safe harbor. As noted above, in the Report, the term Commission refers to traditional commissions, commission equivalents, and any other remuneration eligible for the Section 28(e) safe harbor.

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[34] A "riskless principal" transaction is a "transaction in which a member [broker-dealer], after having received an order to buy a security, purchases the security as principal at the same price to satisfy the order to buy or, after having received an order to sell, sells the security as principal at the same price to satisfy the order to sell." NASD Rule 4632(d)(3)(B).

[35] SEC Rel. No. 34-45194 (Dec. 27, 2001), 67 Fed. Reg. 6 (Jan. 2, 2002). The SEC release distinguishes "eligible" riskless principal transactions that meet the definition of "riskless principal transaction" under NASD Rule 4632(d)(3)(B) from "traditional" riskless principal transactions. "Traditional" riskless principal transactions can include an undisclosed fee (reflecting a dealer's profit on the difference in price between the first and second legs of the transaction) and are not subject to the disclosure requirements of NASD Rule 4632, 4642 or 6420. Fees paid in connection with "traditional" riskless principal transactions do not fall within the definition of "commission" under Section 28(e).

C. The SEC Should Explicitly Require Disclosure About Trading Costs to Fund Boards

Under the 1940 Act, a mutual fund's board has a responsibility to oversee the fund's portfolio trading practices, and fund boards receive information that is intended to assist their review of the adviser's performance of these responsibilities. The Task Force recommends that the SEC explicitly require that, at a minimum, the adviser supply the following information to fund boards:

- The adviser's policies and procedures for monitoring transaction costs and brokerage allocation; and

- Information concerning the reasonableness of all transaction costs, including commissions, commission equivalents, mark-ups and markdowns, market impact costs, opportunity costs, and other intangible trading costs.

The board would be expected to use this information to determine whether the adviser is sufficiently ensuring that the fund does not pay excessive transaction costs and is adequately monitoring the execution quality of the fund's transactions.

D. The SEC Should Require Enhanced Disclosure About Trading Costs to Shareholders

In recent years, the SEC and NASD have adopted and proposed a series of measures to enhance investor understanding of the fees and expenses associated with the purchase of and investment in mutual funds.[36] The Task Force nevertheless is concerned that many investors may not appreciate the impact of portfolio transaction costs on fund performance. In many cases, this impact may be significant. More prominent and clear disclosure concerning these costs may better inform investors.

The Task Force therefore recommends that the SEC amend Form N-1A to provide additional disclosure concerning portfolio transaction costs. These items should be disclosed together, so that their combined effect will be to advance investor understanding of portfolio transaction costs. The SEC thus should require a brief narrative description in the prospectus of the various types of trading costs incurred by the fund, including Commissions, markups and markdowns, market impact costs, and opportunity costs. The prospectus also should disclose:

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[36] For example, in September 2003, NASD proposed rules that would require disclosure of information at the time a customer opens a securities account regarding a mutual fund's cash compensation, revenue sharing, and differential payout arrangements. NASD *Notice to Members* 03-54 (September 2003). In December 2003, NASD proposed rules that would require disclosure of a mutual fund's sales load and expense ratio in fund performance sales material. NASD *Notice to Members* 03-77 (December 2003). In February 2004, the SEC proposed to require disclosure at the point of sale and in confirmations regarding the fees, expenses, revenue sharing, and compensation practices in connection with offers and sales of mutual funds, variable annuities, and Section 529 plans. SEC Rel. No. 33-8358 (Jan. 29, 2004), 69 Fed. Reg. 6437 (Feb. 10, 2004). Members of the Task Force express no view on these proposals, which are beyond the scope of the Task Force.

- That the fund's performance numbers, but not the fee table, reflect these trading costs;

- The fund's portfolio turnover rate, in close proximity to other information about the costs of portfolio transactions;

- The percentage of the total dollar value of all transactions that were executed on a Commission basis;

- The average Commission paid per share; and

- The total Commissions paid as a percentage of total net asset value. This figure would enable investors to evaluate the amount of Commissions paid based on the size of the fund and compare that cost across funds.

Finally, the Task Force recommends that the SEC move the existing disclosure concerning total Commissions from the SAI to the prospectus and accompany the additional information recommended above.

The Task Force recommends that this data be presented in a chart form and cover a five-year period, which is consistent with the format of the financial highlights table. An example of such a chart is shown:

	2004	2003	2002	2001	2000
Total Commissions Paid	$900,000	$800,000	$700,000	$700,000	$650,000
Total Commissions Paid to Affiliated Broker-Dealers	$250,000	$170,000	$195,000	$180,000	$160,000
Commissions as Percentage of Net Asset Value	.19%	.18%	.17%	.16%	.16%
Percentage of Transaction Volume (in $) Executed on a Commission Basis[37]	60%	40%	35%	35%	30%
Average Commission Per Share[38]	4.5 cents	5.0 cents	5.5 cents	6.0 cents	6.0 cents
Portfolio Turnover Rate	87%	103%	78%	125%	83%

[37] As noted earlier, as used in this Report, the term "Commissions" includes the remuneration received in riskless principal transactions. At times, a fund adviser may be unaware of whether a transaction was executed on a principal or a riskless principal basis. In disclosing riskless principal transactions, a fund adviser should be permitted to rely in good faith on information provided by broker-dealers that execute the fund's portfolio transactions.

[38] The Task Force notes that a fund generally incurs higher transaction costs when buying or selling foreign securities, as compared to U.S. stocks, and urges the SEC to ensure that disclosure is not mandated in such a way as to disadvantage funds that invest significantly in foreign securities.

In considering enhanced quantitative disclosure of various portfolio transaction costs, the Task Force decided against recommending quantitative disclosure of intangible transaction costs, such as market impact and opportunity costs. In doing so, the Task Force has attempted to balance the benefits of additional disclosure against the possibility that certain items of disclosure might mislead or confuse investors. Total Commission dollars are relatively easy to quantify, but other implicit portfolio transaction costs, such as the execution costs associated with principal trades executed on a net basis, market impact costs, and opportunity costs, are far more difficult to measure. In fact, industry participants who are responsible for analyzing these costs for their firms disagree about which measure is most accurate for the various costs.[39] On the other hand, those costs are substantial, and it is important that investors understand that there are significant costs beyond Commissions.

On balance, the Task Force believes that narrative disclosure about these intangible costs, in close proximity to the chart described above, is preferable to potentially inaccurate and misleading attempts to quantify costs that are intangible in nature. The Task Force recommends that the SEC continue to monitor both technological developments and the evolution in accepted methodologies for calculating intangible portfolio transaction costs. The SEC may wish to consider additional rulemaking in this area when there is greater consensus as to valuation techniques.

IV. CONCLUSION

Soft dollars and portfolio transaction costs raise very important policy issues that the SEC must continue to address. The Task Force believes that these issues can best be addressed through a combination of greater transparency for both fund boards and investors, and tightened standards regarding the use of soft dollars for research. The Task Force greatly appreciates the opportunity to presents its views on possible ways to address some of these issues. The Task Force and its members stand ready to help in any way that they can as the SEC and its staff proceed in addressing these important matters.

[39] The SEC has acknowledged the difficulty and disagreement over measuring these implicit transaction costs. "Spread, impact and opportunity costs are implicit costs. Because the implicit costs, which are difficult to identify and quantify, can greatly exceed the explicit [commission] costs, there is no generally agreed-upon method to calculate securities transaction costs." SEC Rel. No. IC-26313 (Dec. 18, 2003), 68 Fed. Reg. 74819 (Dec. 24, 2003).

MUTUAL FUND TASK FORCE

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