Statement of

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before the

U.S. SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS
SUBCOMMITTEE ON FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY

OVERSIGHT HEARING ON MUTUAL FUNDS: HIDDEN FEES, MISGOVERNANCE AND OTHER PRACTICES THAT HARM INVESTORS

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I. Introduction

Chairman Fitzgerald, Ranking Member Akaka, and members of the Subcommittee, I am Marc E. Lackritz, President of the Securities Industry Association.[1] We commend you for holding this important hearing in furtherance of your Committee's long and proud tradition of effective oversight to protect the public. SIA's Board of Directors has made restoring the public's trust and confidence in the nation's securities markets and our industry our top priority this year. Today's hearing provides an excellent opportunity for all of us to work toward improving how we serve our customers.

A. What SIA Member Firms Do

SIA member-firms underwrite securities – stocks and bonds – to raise funds – capital – for private companies and public entities. These companies and public bodies use the funds we raise to expand and grow – hiring new workers, investing in new equipment, and building public works. Our industry has raised more than $21 trillion over the past 10 years to finance innovation and growth – new enterprises, new processes, new products, and new bridges, hospitals, roads, and schools. We also help

[1] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Bankers Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs more than 800,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2002, the industry generated $222 billion in domestic revenue and $304 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

individual investors achieve their financial goals, such as planning for a child's education or for a comfortable retirement. Thus, as intermediaries between those who have capital and those who need it, we have created capital markets to channel capital to its most productive uses.

Without public trust and confidence, our market mechanisms cannot function effectively or efficiently. The securities industry is based on two bedrock principles –disclosure and competition. The public's trust and confidence are the indispensable elements for the capital markets to work effectively. Our system has thrived because all market participants must adhere to the same rules, vigorously and fairly applied.

B. Role of Mutual Funds

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 small 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 third-quarter 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, mutual fund supermarkets (discount brokers), financial planners, banks, retirement plans, and insurance companies distribute the vast majority of mutual fund assets.[4] Indeed, individual investors make only 12 percent of purchases of mutual fund assets directly from funds. 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. As of November 2003, equity mutual funds had a market capitalization of $3.5 **trillion** dollars, roughly 23 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, as well as in the financial advisers who assist their investment decisions and the brokers who implement their trade orders.

Yet all is far from well with mutual funds. Recent revelations of wrongdoing – including late trading and market timing contrary to fund prospectuses, as well as other practices – have shaken investors' confidence in many mutual fund organizations and in the intermediaries distributing mutual funds.

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[2] http://www.sia.com/research/pdf/equity_owners02.pdf

[3] http://www.federalreserve.gov/releases/Z1/Current/

[4] Investment Company Institute, www.ici.org/stats/res/per09-03.pdf, at 5.

[5] For equity market capitalization (combined New York Stock Exchange and Nasdaq) see http://www.nyse.com/pdfs/mmv1203.pdf; http://www.marketdata.nasdaq.com/daily/daily2003.xls; For mutual fund data see http://www.ici.org/stats/latest/trends_11_03.html#TopOfPage

In order to restore public trust and confidence in mutual funds and their distributors, the interests of investors must come first. Investors must be assured that fraud, self-dealing, and dishonesty will not be tolerated. Investors should be treated fairly, and should be given complete, clear, and useful information about the funds they buy. All aspects of the mutual fund business – including fund fee structures, financial incentives offered to intermediaries, fund investment and redemption policies, and fund governance – must be as transparent as possible. And all investors should be assured of prompt execution and fair pricing of their mutual fund transactions.

A two-pronged approach is necessary to restore the public's trust in mutual funds. Swift, sure, and tough enforcement actions are the proper remedy to address clear violations of the law. Federal, self-regulatory organization ("SRO"), and state law enforcement authorities should stop the wrongdoers in their tracks. Vigorous enforcement protects investors' assets immediately and has an *in terrorem* effect against other would-be wrongdoers. SIA strongly supports tough, swift, and vigorous enforcement of the law.

In addition, the time has come to implement necessary reforms as well. We support efforts to improve disclosures and sales and trading practices to ensure that investors' interests come first. We offer our expertise and our full engagement in this effort so that the reforms will achieve our mutual goals of strengthening investor protection and avoiding future problems.

II. Need for Reform[6]

A. Background on Changes in Industry Practice

Mutual funds allow investors to enjoy the benefits of diversified portfolios and professional management. But there are expenses associated with operating any mutual fund. Funds pay an investment adviser for the professional management associated with the fund. There are also compliance and recordkeeping costs, trading commissions, and marketing expenses. Of course, different fund organizations take different approaches and costs vary. Inevitably, all of these services – which give investors important choices and benefits – have a cost.

Investors also have many choices as to how they buy funds. Depending on the choices they make, investors may encounter several different arrangements for paying distribution and shareholder service expenses, (*e.g.* A shares (front-end load); B shares (12b-1 fee plus back-end load), C shares (level load), and no-load – see glossary for definitions).

As noted, many investors buy mutual funds, perhaps after consultation with a broker-dealer's registered representative ("RRs"). Broker-dealers literally can offer thousands of mutual funds to their customers. Firms and their RRs cannot hope to be informed about all of those funds, so often they will narrow the universe to several fund families. Fund organizations may provide broker-dealers with payments (so called "revenue sharing") with respect to those funds. Fund organizations may pay broker-dealers for "shelf space," *i.e.*, a preferred relationship with some funds as opposed to

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[6] Our testimony is not intended to cover every aspect of mutual fund trading practices, but focuses instead on the questions contained in the Subcommittee's invitation to testify.

others. These practices, while not new, have become more complex in recent years.[7] As a result, we support improved disclosure of such revenue-sharing arrangements.

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

- Customer Sub-accounting
- Mailing confirms, prospectuses and other disclosure documents.
- Maintaining information websites.
- Implementing changes initiated by funds, including revising systems and procedures and communicating changes to registered representatives and customers.
- Overseeing and coordinating fund wholesaler activities at the firm.

In the absence of such third-party payments, many of these administrative and other expenses incurred in processing mutual fund transactions and servicing mutual fund accounts would be borne by fund shareholders through higher fund operating expenses. In addition, broker-dealers use revenue-sharing payments to fund other activities, such as education seminars for their RRs about the different funds they sell. These activities make the RRs more knowledgeable about the funds and can help them tailor their recommendations more effectively.

As a general matter, we do not believe that payments for these administrative services present the same type of potential conflict as payments for "shelf space" or inclusion on a preferred list. Revenue-sharing payments have aided the development of mutual fund supermarkets and benefited fund investors who appreciate the convenience and broad access to different mutual fund offerings that these supermarkets provide. Moreover, across the industry (both within and outside fund supermarkets) it is common for revenue-sharing payments to be based upon the full range of services provided, rather than individual costs associated with specific services. As a practical matter, it is not always possible to attribute a specific percentage of a revenue-sharing payment to the offering of shelf space or inclusion on a preferred list, as opposed to other services. Accordingly, it is important to recognize that the term "revenue sharing" encompasses many different practices.

B. <u>Improving Disclosure of Relationships between Broker-Dealers and Funds</u>

Improved disclosure should:

- Provide investors with timely, clear information in a useful format so that they can make informed investment decisions;

[7] If an RR recommends a specific fund to a customer, NYSE and NASD rules provide that the fund must be "suitable" for that investor.

Foster fierce competition, which affords investors broader investment choices at the lowest cost.

It is important to make disclosure investor-accessible and investor-friendly rather than a “Where's Waldo?” search through fragments of disclosures for relevant information. Achieving this goal requires a coordinated effort among Congress, regulators and SROs, as well as the mutual fund and securities industries. Mutual fund investors need relevant information on many levels when evaluating a proposed mutual fund investment.

First, they need useful information about the fund they are considering. They need to know what type of fund they are buying – debt or equity, blue chip, or small cap – and they need to know the risks and range of returns of such funds. They also need information on expenses, soft dollars, directed brokerage (refer to glossary for definitions) – anything material that will help them understand the pros and cons of the fund they are considering.

They also need to know about commercial arrangements that a mutual fund organization may have with a broker-dealer or its RRs that might provide incentives to the intermediary.

Most importantly, investors need information in a clear format that is comparable across funds and fund families and that promotes consumer choice and competition.

SIA strongly supports 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 clear, simple 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 which 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, such as proprietary funds or on sales of class B shares;

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

A number of legislative and regulatory initiatives directed at improving transparency – such as enhanced disclosure of the arrangements between fund organizations and broker-dealers – have emerged in recent months. We generally support efforts to give investors additional information about the arrangements between fund organizations and broker-dealers. We have previously indicated to the NASD[8] and SEC[9] that any rulemaking in this area should 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;
- Use disclosure vehicles that will focus investors' attention toward the material information that should be considered when making a mutual fund investment.

We urge policymakers to write new "rules of the road" to ensure that investors receive clear disclosure of the material aspects of the relationship between their broker-dealer (including its RRs) and the fund. SIA stands ready to assist policymakers with this effort.

C. Disclosure of Operating Expenses

Investors should have full, clear, and useful information on mutual fund fees since they will have a significant effect on an investor's return. 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 expenses 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

[8] 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).

[9] 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).

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 will be in proportion to the benefit that investors derive.

D. Soft Dollars, Directed Brokerage, and Related Issues

SIA supports efforts to improve disclosure of brokerage arrangements among 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) permits 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. An SEC staff report notes, "the vast majority of products and services received by advisers are within the safe harbor established by Section 28(e) of the Exchange Act."[10] In general, soft dollars are both pro-investor and pro-competitive, because they increase competition among money managers, encourage independent research[11], and give investors more choices.

At the same time, we recognize that there are risks of abuse with respect to soft dollars. 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. We would welcome a study of soft-dollar arrangements to ensure that they continue to benefit investors.

"Directed brokerage" practices also have been a subject of concern. The term "directed brokerage" means different things to different people. In general, directed brokerage refers to an arrangement in which a fund directs the execution of a portion of the fund's trades through a particular broker-dealer. In exchange for those brokerage commissions, the broker-dealer agrees to pay certain fund expenses, provide services to the fund, or provide a cash rebate to the fund through a commission recapture program. Directed brokerage programs involve the use of brokerage commissions to pay expenses of an investment adviser's client (*i.e.*, the fund). Directed brokerage has become increasingly common in the mutual fund industry, in particular because the use of directed brokerage to reduce fund expenses provides a direct benefit to fund shareholders. 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

[10] SEC, Office of Compliance, Inspections and Examinations Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers, and Mutual Funds, September 22, 1998 ("1998 Report").

[11] We note that one objective of last year's settlement regarding research analysts was to require investment banks to fund independent research.

"the fund's commission dollars [are used] to obtain services that directly and exclusively benefit the fund."[12]

However, certain practices also referred to as "directed brokerage" can create a different potential conflict. A fund's adviser may "direct" brokerage transactions to reward securities firms that also sell the adviser's funds. Fund managers are permitted in some circumstances to consider sale of fund shares as one factor in the selection of broker-dealers as long as the selection is consistent with their duties of best execution[13]. Directing brokerage to a broker-dealer purely as a *quid pro quo* for selling the fund's shares raises serious concerns. Moreover, SEC officials have raised the question of whether these practices represent the use of fund assets to pay for distribution and thus should be permitted only under a Rule 12b-1 plan approved by the fund's board of trustees.[14] With respect to both soft dollars and directed brokerage, the key investor protection issue to maintain is "best execution." The SEC has characterized best execution as the ability "to execute securities transactions for clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances."[15] The SEC has also stated that the "determinative factor is not the lowest possible commission cost but whether the transaction represents the best qualitative execution for the [fund]."[16] This entails considering the full range and quality of a broker's services, including execution capability, commission rate, financial responsibility, and responsiveness to the adviser. 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

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[12] 1998 Report, citing Interpretive Release Concerning Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Exchange Act Release No. 23170 (Apr. 23, 1986) (the "1986 Release")(emphasis added).

[13] NASD Rule 2830(k).

[14] That, in turn, might raise questions about exceeding limits on 12b-1 fees. Rule 12b-1 itself does not restrict the amount of expenses that may be paid pursuant to a 12b-1 plan. The NASD, however, has determined that a fund's 12b-1 plan fees should not exceed 100 basis points annually, 75 basis points of which could be for distribution expenses and 25 basis points for service fees. Rule 2830(d)(2)(E)(i) and (d)(5). After funds with asset based and contingent deferred sales load became popular, NASD, with the SEC's approval, determined that 12b-1 plan fees should be governed by the rules that apply to sales loads. NASD took this action so that shareholders paying for distribution indirectly through 12b-1 plan fees would pay no more than shareholders paying for distribution directly through front-end loads. *See* U.S. Securities and Exchange Commission, *Division of Investment Management: Report on Mutual Fund Fees and Expenses* (Dec. 2000) at n. 28.

[15] *See* SEC Release No. 34-9598 (May 9, 1972); Kidder, Peabody & Co., IA-Release No. 232 (Oct. 16, 1968). The SEC staff has noted:

> Although a mutual fund's investment adviser has an obligation to seek the best execution of securities transactions arranged for or on behalf of the fund, the adviser is not necessarily obligated to obtain the lowest possible commission cost. The adviser's obligation is to seek to obtain the most favorable terms for a transaction reasonably available under the circumstances.

Memorandum from Paul F. Roye, Director, Division of Investment Management, SEC, to the Honorable William H. Donaldson, SEC Chairman, Regarding Correspondence from Chairman Richard H. Baker, House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (June 19, 2003) at 26 ("Roye Memorandum"). *See also* Rules 11Ac1-5 and 11Ac1-6 under the Exchange Act.

[16] *Id*.

arrangements are also indefensible. With respect to research and execution services, advisers, fund trustees, and broker-dealers must put investors first.

Arrangements between funds and broker-dealers should be disclosed fairly and in context to investors and fund trustees. Clear, simple disclosure of material information is essential if investors and their intermediates are going to make intelligent and informed decisions. We support efforts to improve disclosure of information with respect to soft dollars and directed brokerage.

E. Late Trading

SIA is appalled by reports of late trading of mutual fund shares. As Attorney General Spitzer has noted, such activity is the equivalent of betting on a horse race after it is over. Reforms should make late trading virtually impossible to achieve. At the same time, SIA believes that these reforms should not penalize innocent investors, particularly those in 401(k) or 529 plans, and we have concerns that the recent SEC proposal to require a hard close solely at the fund or registered clearing agency level might have such an effect.

In an October 31, 2003 letter to the SEC[17] SIA suggested an alternative approach that 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 requirement 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. The proposal 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.

We welcome further debate on eliminating late trading and hope that policymakers will adopt a solution that protects all investors and does not create competitive disadvantages for some. Late trading has had a terribly corrosive effect on investor confidence; we must find and implement an effective remedy *now*.

F. Regulation of Hedge Funds and Mutual Funds

Mutual funds and the broker-dealers that sell them intend those products as investment vehicles for the average investor, not the financial sophisticate. SIA also appreciates that investment advisers and portfolio managers should not discriminate against mutual funds and inappropriately favor hedge funds that they manage. However, provisions in legislation that would make it difficult for an investment adviser and its portfolio manager to manage both mutual funds and hedge funds under any circumstances may go too far.

Side-by-side management of mutual funds and hedge funds raises potential conflicts of interest that have been highlighted throughout the investigation leading up to the SEC staff's recent Hedge Fund Report.[18] These conflicts are not unique to situations

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[17] Letter from Marc E. Lackritz, President, Securities Industry Association, to Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission (Oct. 31, 2003).

[18] SECURITIES AND EXCHANGE COMMISSION, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS (September 2003) ("Hedge Fund Report"). *See also SEC Chairman Donaldson Releases Staff Report on Hedge Funds*, (pub. avail. Sept. 29, 2003) at http://www.sec.gov/news/press/2003-125.htm.

involving hedge funds. Rather, they are endemic to the management of multiple accounts regardless of the nature of the client.[19] Recent legislative proposals purport to address these conflicts of interest by banning the joint management of registered and unregistered funds.

Specifically, the proposals would prohibit an individual from serving as portfolio manager to a registered fund while simultaneously serving as portfolio manager to an unregistered fund (or such other categories of funds as the SEC may prescribe by rule). The proposals would permit the SEC, by rule, regulation or order, to allow joint management by a portfolio manger in "exceptional circumstances when necessary to protect the interest of investors." However, any such rule, regulation or order would require: (i) enhanced disclosure by the fund of any conflicts of interest raised by the joint management; (ii) fair and equitable policies and procedures for the allocation of securities among the jointly managed accounts; and (iii) certification by the fund's independent directors in the periodic reports to shareholders or in some other appropriate document that those policies and procedures are fair and equitable.

We oppose language that limits such management to "exceptional circumstances." Permitting side-by-side management of mutual and hedge funds only where enhanced disclosure of conflicts has been made and policies are in place to assure fair allocation of investment opportunities between funds provides sufficient safeguards to investors. Limiting side-by-side management to "exceptional circumstances" would effectively operate as a ban. Such a ban would deprive small mutual fund investors of the same benefits and expertise available to wealthy investors. It seems unfair to deny to small mutual fund investors the most talented fund managers, while ensuring that they would be available only to the most privileged, wealthy few who qualify for hedge fund investing.

III. Conclusion

SIA abhors abusive activities involving mutual funds. We urge the SEC, the NASD, and state authorities to bring wrongdoers to justice swiftly and surely. We are proud of our work on mutual fund breakpoints to ensure that all investors get the discounts to which they are entitled, and we remain committed to working with policymakers to develop effective new disclosures and to prevent abuses going forward.

We are also proud of the capital our industry has raised, the jobs we helped create, the innovation and growth we helped foster, the new products and services we've made available, and the dreams we have helped our customers achieve. We are eager to work with you, and other Congressional committees and regulators, to improve mutual funds so they can continue to be an effective investment vehicle for all Americans.

Thank you very much.

[19] Of course, the presence of incentive compensation in the typical hedge fund does tend to heighten the potential for conflicts, although incentive compensation is not unique to hedge fund accounts.

Glossary

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

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

Equity or Stock Funds -- common stocks. Some examples include[20]:

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

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

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

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

Specific examples might include:

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

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

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

[20] Some of this information is from the SEC's website, noted below.

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

Under one definition, directed brokerage is an arrangement under which an account manager directs trades to a specific broker-dealer. In return, the broker-dealer agrees to pay certain fund expenses. Fund prospectuses disclose these arrangements, often as a fee table footnote. These arrangements do not raise conflict of interest issues because the fund directly benefits from the arrangement. For example, Fund A directs trades to Broker-Dealer X and that broker-dealer pays custody expenses for Fund A.

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

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

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

> (7) Provided that the member does not violate any of the specific provisions of this paragraph (k), nothing herein shall be deemed to prohibit:
>
> (B) a member from selling shares of, or acting as underwriter for, an investment company which follows a policy, disclosed in its prospectus, of considering sales of shares of the investment company as a factor in the selection of broker/dealers to execute portfolio transactions, subject to the requirements of best execution;

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

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

Breakpoints -- Fund front-end sales charges may contain breakpoints that provide reduced sales charges for larger purchases. Funds disclose breakpoints in their prospectuses. They also disclose conditions for waivers of sales charges and for aggregating purchases or signing letters of intent that would result in lower sales charges.

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

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

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

Class A Shares -- are typically subject to a front-end sales charge. The front-end sales charge often has "breakpoints" for larger size investments. Funds often establish waiver categories, disclosed in their prospectuses, so that particular categories of investors are permitted to purchase shares with a reduced or waived front-end sales charge. Class A shares also may have a Rule 12b-1 fee of 0.25-0.50% of average annual net Class A assets.

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

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

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

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

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

"Soft dollars" or "paying up" for research -- Section 28(e) of the Securities Exchange Act of 1934 makes it lawful for an investment manager (who has discretion to trade an account) to pay higher than the minimum commission when the manager also receives research services from that broker-dealer.[21] Congress enacted this provision at the time that it unfixed brokerage commissions. Congress wanted to ensure that, in appropriate circumstances, investment managers would be able to pay more than the absolute lowest available commission without breaching their fiduciary duty.

Under Section 28(e), the commissions must be reasonable in light of services received by the investment manager. The broker-dealer that provides brokerage may provide the research services or the broker-dealer may arrange that a third-party provide the research to the investment manager. If the product/service is also used for non-research purpose ("mixed use"), the investment manager must develop and document a reasonable cost

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[21] Section 28(e) of the Securities Exchange Act of 1934 provides

> no person … in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law unless expressly provided to the contrary by a law enacted by the Congress or any State subsequent to the date of enactment of the Securities Acts Amendments of 1975 solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion.

allocation. Mutual funds must disclose soft dollar arrangements in a general way in their Statements of Additional Information ("SAI"). Investment advisers must disclose soft dollar practices in their Form ADV Part II. SEC interpretations establish requirements for reliance on 28(e) (*e.g.*, any research obtained must provide "lawful and appropriate assistance" to the account manager in carrying out his responsibilities).

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