SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release No. IC–26591; File No. S7–09–04]

RIN 3235–AJ07

Prohibition on the Use of Brokerage Commissions To Finance Distribution

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission is adopting amendments to the rule under the Investment Company Act of 1940 that governs the use of assets of open-end management investment companies (''funds'') to distribute their shares. The amended rule prohibits funds from paying for the distribution of their shares with brokerage commissions. The amendments are designed to end a practice that poses significant conflicts of interest and may be harmful to funds and fund shareholders.

DATES: *Effective Date:* October 14, 2004.

Compliance Date: December 13, 2004. Section III of this release contains more information on the compliance date.

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SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission (''SEC'' or ''Commission'') is adopting amendments to rule 12b–1 [17 CFR 270.12b–1] under the Investment Company Act of 1940 [15 U.S.C. 80a] (''Investment Company Act'' or ''Act'').[1]

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I. Background

Funds buy and sell large amounts of securities each year for their portfolios.[2] Fund advisers choose which broker or dealer will effect transactions (''executing broker''), and can use commissions to reward brokers or dealers for promoting the sale of fund shares (''selling brokers''). Brokers are prohibited from conditioning the promotion of fund shares on the receipt of brokerage commissions from a fund.[3] Since 1981, however, fund advisers have been permitted to follow a disclosed policy ''of considering sales of shares that the fund issues as a factor in the selection of broker-dealers to execute portfolio transactions, subject to best execution.''[4]

Last year we conducted a review of current brokerage practices. Our staff found that the use of brokerage commissions to facilitate the sale of fund shares is widespread among funds that rely on broker-dealers to sell fund shares.[5] In some cases transactions are directed to selling brokers. In other cases where the selling broker lacks capacity to execute fund securities transactions, fund advisers will cause the fund to enter into ''step out'' and other types of arrangements under which a portion of the commission is directed to the selling brokers.[6] Fund advisers and selling brokers keep track of the value of directed brokerage, and if an insufficient amount of brokerage is directed to a selling broker, the broker may require compensation from the adviser. If the compensation that a selling broker receives for distributing shares of a fund (or a fund complex) falls below agreed-upon levels, the selling broker may reduce its selling efforts for the funds.

Pressures to distribute fund shares (or to avoid making payments for distribution out of their own assets) have caused advisers to direct more fund brokerage (or brokerage dollars) to selling brokers. The directed brokerage has been assigned explicit values, recorded, and traded as part of increasingly intricate arrangements by which fund advisers barter fund brokerage for sales efforts. These arrangements are today far from the benign practice that we approved in 1981 when we allowed funds to merely consider sales in allocating brokerage.[7]

Fund brokerage is an asset of the fund, and its use to pay for distribution expenses implicates rule 12b–1, which regulates the use of fund assets to pay selling brokers or otherwise finance the sale of fund shares.[8] Rule 12b–1 permits funds to use their assets to pay distribution-related costs, subject to certain conditions designed to address concerns about the conflicts of interest arising from allowing funds to finance distribution.[9] In 1981, shortly after we

[1] Unless otherwise noted, all references to statutory sections are to the Investment Company Act of 1940, and all references to ''rule 12b–1'' or any paragraph of the rule will be to 17 CFR 270.12b–1, as amended.

[2] In 2003 alone, mutual fund securities transactions totaled approximately $8.3 trillion. Investment Company Institute, Mutual Fund Fact Book 131 (2004) (reporting approximately $4.3 trillion in total purchases and approximately $4 trillion in total sales of portfolio securities by equity, hybrid, and bond funds). This figure does not include purchases and sales by money market funds.

[3] NASD Conduct Rule 2830(k) (the ''Anti-Reciprocal Rule''). *See also* In the Matter of Morgan Stanley DW Inc., Securities Act Release No. 8339 (Nov. 17, 2003) (''Morgan Stanley'') (finding that broker-dealer's program for giving marketing preferences to funds in exchange for cash and brokerage commissions violated NASD Conduct Rule 2830(k)); *NASD Charges Morgan Stanley with Giving Preferential Treatment to Certain Mutual Funds in Exchange for Brokerage Commission Payments,* NASD News Release (Nov. 17, 2003) (''NASD News Release'') (announcing companion NASD action for violation of NASD Conduct Rule 2830(k) by, among other things, favoring the distribution of shares of particular funds on the basis of brokerage commissions to be paid by the funds).

[4] *See* Order Approving Proposed Rule Change and Related Interpretation under Section 36 of the Investment Company Act, Investment Company Act Release No. 11662 (Mar. 4, 1981) [46 FR 16012 (Mar. 10, 1981)] (''1981 Release'') (emphasis added). We made this statement in our order approving the NASD's amendment to the Anti-Reciprocal Rule in 1981 to permit NASD members, subject to the prohibition, to sell shares of funds that follow a disclosed policy ''of considering sales of their shares as a factor in the selection of broker/dealers to execute portfolio transactions, subject to best execution.'' *See also* discussion *infra* note 10 and accompanying text.

[5] *See* Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26356 (Feb. 24, 2004) [69 FR 9726 (Mar. 1, 2004)] (''Proposing Release'').

[6] For further description of these practices, *see* Proposing Release, *supra* note, at nn.12–14 and accompanying text.

[7] *See supra* note 4 and accompanying text.

[8] 17 CFR 270.12b–1. Because it is an asset of the fund, fund brokerage must be used for the fund's benefit. *See* Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV, Investment Advisers Act Release No. 1862 (Apr. 5, 2000) [65 FR 20524 (Apr. 17, 2000)], at text following n.166 (''Client brokerage, however, is an asset of the client—not of the adviser.''). *See also* American Bar Association, *Fund Director's Guidebook,* 59 Bus. Law. 201, 243 (2003) (''Brokerage commissions are assets of the fund, and the fund's directors are ultimately responsible for determining policies governing brokerage practices.'').

[9] *See* Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11414 (Oct. 28, 1980) [45 FR 73898 (Nov. 7, 1980)]. In order to rely on rule 12b–1, among other requirements, a fund must adopt ''a written plan describing all material aspects of the proposed financing of distribution'' that is approved by fund shareholders and fund directors. 17 CFR 270.12b–1(b). We adopted rule 12b–1 pursuant to section 12(b) of the Act, which makes it unlawful for a fund ''to act as a distributor of securities of which it is the issuer, except through an underwriter, in contravention of such rules and regulations' as we prescribe. 15 U.S.C. 80a-12(b). Section 12(b) was intended to protect funds from bearing excessive sales and promotion expenses. Investment Trusts

adopted rule 12b–1 and in light of its adoption, we concluded that ''it is not inappropriate for investment companies to seek to promote the sale of their shares through the placement of brokerage without the incurring of any additional expense.'' [10]

After reviewing the current directed brokerage practices described above, in February 2004, we proposed to amend rule 12b–1 to prohibit the use of fund brokerage to compensate broker-dealers for selling fund shares.[11] Our proposal was intended to end practices that we concluded were inconsistent with the rationale of our 1981 decision and involved unmanageable conflicts of interest. The NASD also has proposed a corresponding change to its rules.[12]

II. Discussion

We received thirty-three comment letters in response to our proposal to ban funds' use of directed brokerage to compensate brokers for the sale of fund shares. Twenty-three of these commenters supported the proposal, agreeing with our conclusion that the practice of using brokerage to reward sales of fund shares involves substantial conflicts of interest. Seven commenters opposed the proposed ban.[13]

We are adopting the amendments to rule 12b–1 substantially as proposed. We are taking this action because we have concluded that the practice of trading brokerage for sales of fund shares may harm investors in mutual funds in at least four ways:

• *Adverse Impact on Best Execution of Fund Transactions.* The decision to use brokerage commissions to pay for distribution poses significant conflicts. Fund advisers, whose compensation is based on the amount of assets held by the fund, have an incentive to promote the sale of fund shares to increase their advisory fees, and to avoid having to pay brokers out of their own pockets for selling fund shares (''revenue sharing'').[14] Competition among fund advisers to secure a prominent place in selling brokers' distribution networks (''shelf space'') has created powerful incentives to direct brokerage based on distribution considerations.[15] This can adversely affect decisions on how and where to effect portfolio securities transactions, or how frequently to trade portfolio securities.[16] Because of the practical limitations on the ability of fund directors to actively monitor and evaluate the motivations behind the selection of brokers to effect portfolio securities transactions, we believe that reliance on fund directors to police the use of fund brokerage to promote the sale of fund shares is not sufficient.[17]

• *Circumvention of Limits on Distribution Expenses.* Pursuant to section 22(b) of the Investment Company Act,[18] the NASD prohibits its members (*i.e.*, broker-dealers) from selling shares of funds that impose excessive sales loads and other distribution costs directly or indirectly on shareholders.[19] By using these directed brokerage arrangements, fund advisers and brokers are able to circumvent the NASD rules on excessive sales charges, thus undermining the protections afforded fund shareholders by those rules and by section 22(b) of the Act.

• *Transparency of Distribution Expenses.* Under our rules, fund investors receive information about fund expenses, including distribution expenses, in a fee table contained in every fund prospectus, which identifies the amount of sales load, as well as ''12b–1 fees'' that are deducted from fund assets.[20] The practice of trading brokerage for sales efforts involves costs that are built into brokerage commissions, which are treated as capital items rather than expenses. Thus, the practice of directing brokerage for distribution of fund shares diminishes the transparency of fund distribution costs and the ability of an investor or prospective investor to understand the amount of those costs.[21]

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and Investment Companies, *Hearings on H.R. 10065 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce,* 76th Cong., 3d Sess. 112 (1940) (statement of David Schenker).

[10] 1981 Release, *supra* note 4. (emphasis added). This conclusion was stated in our order approving the NASD's amendment to its Anti-Reciprocal Rule. *See supra* notes—and accompanying text.

[11] Proposing Release, *supra* note 5.

[12] Under the proposed rule change, the NASD would eliminate the provision of the Anti-Reciprocal Rule that allows NASD members to sell shares of funds that follow a disclosed policy of considering the sale of fund shares in the selection of executing brokers. *See* Proposed Amendment to Rule Relating to Execution of Investment Company Portfolio Transactions, NASD Rule Filing 2004–027 (Feb. 10, 2004) (*http://www.nasdr.com/pdf-text/rf04_27.pdf*). The proposed amendment currently is under review by the Commission.

[13] Some commenters recommended enhanced disclosure of directed brokerage practices as an alternative approach. Other commenters questioned whether it would be possible to provide effective disclosures. After reviewing these comments, we believe that there would not be an effective way of providing comprehensive information that would allow many fund investors to evaluate a fund adviser's use of brokerage and the conflicts involved.

[14] *See* Proposing Release, *supra* note 5, at nn. 36–37 and accompanying text.

[15] *See* Rich Blake, *How High Can Costs Go?,* Institutional Investor, May 2001, at 62–63 (''Just as fund companies need to cut through the clutter of all the funds available for sale, they must also attract the attention of the average sales person, who might familiarize himself with just a handful of funds among hundreds in any given asset category.'').

[16] *See* Letter from Matthew P. Fink, President, Investment Company Institute, to William H. Donaldson, Chairman, SEC (Dec. 16, 2003) (*http://www.ici.org/statements/cmltr/03_sec_soft_com.html#TopOfPage*) (noting that the use of brokerage commissions to finance distribution ''can give rise to the appearance of a conflict of interest, as well as the potential for actual conflicts, given the fact-specific nature of the best execution determination.''). As with all other portfolio securities transactions, however, the fund adviser has a duty to seek best execution. The adviser must see that these portfolio securities transactions are executed ''in such a manner that the client's total cost or proceeds in each transaction is most favorable under the circumstances.'' In the Matter of Kidder, Peabody & Co., Inc., Investment Advisers Act Release No. 232 (Oct. 16, 1968). *See also* Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Securities Exchange Act Release No. 23170 (Apr. 23, 1986) [51 FR 16004 (Apr. 30, 1986)]; Applicability of the Commission's Policy Statement on the Future Structure of the Securities Markets to Selection of Brokers and Payment of Commissions by Institutional Managers, Investment Company Act Release No. 7170, [1971–72 Transfer Binder] Fed. Sec. L. Rep. (CCH) 78,776 (May 17,1972) (advisers ''must assign executions and pay for brokerage services in accordance with the reliability and quality of those services and their value and expected contribution to the performance of the account they are managing'').

[17] For these reasons, the rule provides for a ban, rather than the alternative approach, suggested by some commenters, that fund boards receive periodic reports about brokerage allocations.

[18] 15 U.S.C. 80a–22(b).

[19] NASD Conduct Rule 2830(d). The rule deems a sales charge to be excessive if it exceeds the rule's caps. A fund's sales load (whether charged at the time of purchase or redemption) may not exceed 8.5 percent of the offering price if the fund does not charge a rule 12b–1 fee. NASD Conduct Rule 2830(d)(1)(A). If the fund also charges a service fee, the maximum aggregate sales charge may not exceed 7.25 percent of the offering price. NASD Conduct Rule 2830(d)(1)(D). The aggregate sales charges of a fund with a rule 12b–1 fee may not exceed 7.25 percent of the amount invested, and the amount of the asset-based sales charge (the rule 12b–1 fee) may not exceed 0.75 percent per year of the fund's average annual net assets. NASD Conduct Rule 2830(d)(2)(B), (E)(i). Under the cap, therefore, an increase in the fund's sales load could reduce the permissible level of payments a selling broker may receive in the form of 12b–1 fees. The NASD designed the rule so that cumulative charges for sales-related expenses, no matter how they are imposed, are subject to equivalent limitations. *See* Order Approving Proposed Rule Change Relating to the Limitation of Asset-Based Sales Charges as Imposed by Investment Companies, Securities Exchange Act Release No. 30897 (July 7, 1992) [57 FR 30985 (July 13, 1992)], at text accompanying n.9.

[20] Item 3 of Form N–1A requires all funds to provide a fee table that discloses, among other things, ''Distribution [and/or Service] (12b–1) Fees.'' This phrase is defined in instruction 3.b. to Item 3 as including ''all distribution or other expenses incurred during the most recent fiscal year under a plan adopted pursuant to rule 12b–1.''

[21] In February, we proposed two rules under the Securities Exchange Act of 1934 [15 U.S.C. 78a] (''Exchange Act'') that would require broker-dealers to provide their customers with specific information, at the point of sale and in transaction confirmations, regarding the costs and conflicts of interest that arise from the distribution of fund shares. *See* Confirmation Requirements and Point of

Continued

• *Consequence of Broker Conflicts.* Finally, these practices may corrupt the relationship between broker-dealers and their customers.[22] Receipt of brokerage commissions by a broker-dealer for selling fund shares creates an incentive for the broker to recommend funds that best compensate the broker rather than funds that meet the customer's investment needs.[23] Because of the lack of transparency of brokerage commissions and their value to a broker-dealer, customers are unlikely to appreciate the extent of this conflict.

A. Ban on Directed Brokerage

Rule 12b–1(h)(1) prohibits funds from compensating a broker-dealer for promoting or selling fund shares by directing brokerage transactions to that broker.[24] The prohibition applies both to directing transactions to selling brokers, and to indirectly compensating selling brokers by participation in step-out and similar arrangements in which the selling broker receives a portion of the commission.[25] The ban extends to any payment, including any commission, mark-up, mark-down, or other fee (or portion of another fee) received or to be received from the fund's portfolio transactions effected through any broker or dealer.[26]

B. Policies and Procedures

The amendments we are adopting today recognize that many funds are likely to find that, for some portfolio transactions, the broker-dealer who can provide best execution also distributes the fund's shares. The prohibition we adopt today is not intended to compromise best execution. Nevertheless, the fact that a selling broker provides best execution would not cure a violation of the prohibition on funds or their advisers directly or indirectly compensating the broker for promoting fund shares with payments from portfolio transactions. Rule 12b–1(h)(2) permits a fund to use its selling broker to execute transactions in portfolio securities[27] only if the fund or its adviser has implemented policies and procedures designed to ensure that its selection of selling brokers for portfolio securities transactions is not influenced by considerations about the sale of fund shares.[28] These procedures must be approved by the fund's board of directors, including a majority of the independent directors, and must be reasonably designed to prevent: (i) The persons responsible for selecting broker-dealers to effect transactions in fund portfolio securities transactions (*e.g.*, trading desk personnel) from taking into account, in making those decisions, broker-dealers' promotional or sales efforts,[29] and (ii) the fund, its adviser and principal underwriter from entering into any agreement or other understanding under which the fund directs brokerage transactions or revenue generated by those transactions to a broker-dealer to pay for distribution of the fund shares.[30] These procedures must be designed to prevent funds from entering into informal arrangements to direct portfolio securities transactions to a particular broker.[31]

The procedures should be incorporated into each fund's compliance policies and procedures, which each fund is required to adopt by our rule 38a–1.[32] Fund chief compliance officers should assure themselves that the required procedures are in place as well as any others that they believe are reasonably necessary to prevent violation of the prohibition against directing brokerage for sales of fund shares. Compliance officers of broker-distributed funds should monitor the operation of the policies and procedures, and should consider periodic testing of brokerage allocations to determine whether there is a significant correlation between sales and the direction of brokerage that may suggest the existence of informal arrangements in violation of the rule.

Several commenters urged that we modify the rule to incorporate a safe harbor for funds that use selling brokers to execute portfolio securities transactions. Many of these commenters asserted that without a safe harbor included in the amended rule, funds would be discouraged from selecting selling brokers to execute portfolio transactions. We believe that a safe harbor is unnecessary. As described above, we are requiring instead that funds that select their selling brokers to execute trades implement policies and procedures designed to ensure that those selections are based on the quality of the execution rather than the promotion of fund shares.[33] The inclusion of this requirement acknowledges that, consistent with the ban we are adopting today, there will be some instances, in which funds will execute portfolio securities transactions through their selling brokers.

C. Further Amendments to Rule 12b–1

We also requested comment on the need for further amendments to rule 12b–1, including the rescission of the rule. We received approximately 1,650 comments in response to this request for comment. Comment letters provided a number of alternatives and suggestions that we have asked the staff to explore.

Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendment to the Registration Form for Mutual Funds, Securities Exchange Act Release No. 49148 (Jan. 29, 2004) [69 FR 6438 (Feb. 10, 2004)]. Because we are prohibiting the payment of brokerage commissions to finance fund share distribution, funds will no longer be able to pay for share distribution with brokerage commissions. Thus, we will consider the effect of this prohibition when evaluating any further action with regard to disclosures of brokerage commissions associated with portfolio securities transactions.

[22] *See, e.g.*, Morgan Stanley, *supra* note 3 (finding broker-dealer had willfully violated section 17(a)(2) of the Securities Act of 1933 [15 U.S.C. 77q(a)(2)] and rule 10b–10 [17 CFR 240.10b–10] under the Exchange Act by failing to disclose to its customers who purchased fund shares that it was being paid by certain fund companies, with a combination of cash and brokerage commissions, to make special efforts to market those funds; also finding broker-dealer had violated NASD Rule 2830(k), which essentially prohibits NASD members from favoring the sale of mutual fund shares based on the receipt of brokerage commissions); NASD News Release, *supra* note 3. *See also* Laura Johannes and John Hechinger, *Conflicting Interests: Why a Brokerage Giant Pushes Some Mediocre Mutual Funds,* Wall St. J., Jan. 9, 2004, at A1.

[23] *See* Ruth Simon, *Why Good Brokers Sell Bad Funds,* Money, July 1991, at 94.

[24] Rule 12b–1(h)(1). The rule prohibits funds from financing distribution of fund shares through the direction of any service related to effecting a fund brokerage transaction, including performing or arranging for the performance of any function related to processing a brokerage transaction. The prohibition reaches transactions executed by government securities dealers and municipal securities dealers.

[25] Rule 12b–1(h)(1)(ii). The prohibition also extends to circumstances in which two funds cooperate to direct brokerage commissions to the selling broker of the other fund. See section 48 under the Act [15 U.S.C. 80a–47(a)] (making it unlawful for a person to do indirectly what the person could not do directly).

[26] Rule 12b–1(h)(1)(ii).

[27] Some commenters expressed concern that the rule would inhibit funds from using selling brokers to execute fund brokerage transactions, and requested that the Commission clarify that the rule does not prohibit a fund from using a selling broker to execute brokerage transactions.

[28] Rule 12b–1(h)(2). *See supra* note 16.

[29] Rule 12b–1(h)(2)(ii)(A).

[30] Rule 12b–1(h)(2)(ii)(B). This provision should be interpreted broadly to reach any arrangement or other understanding, whether binding or not, between a fund and a broker-dealer, including an understanding to direct brokerage to a government securities dealer or a municipal securities dealer, or an understanding in which each of two funds directs brokerage to the other fund's selling broker.

[31] Under our compliance rule, a fund's compliance officer is required to report annually to the board regarding the operation of the fund's policies and procedures, including policies and procedures to ensure that brokerage allocation is not influenced by considerations of fund distribution. 17 CFR 270.38a–1(a)(4)(iii)(A). Therefore, we did not include a provision in the rule, as suggested by some commenters, that would require periodic reporting of brokerage allocation to the board.

[32] 17 CFR 270.38a–1.

[33] Rule 12b–1(h)(2).

These included an approach set forth in the Proposing Release that would refashion rule 12b–1 to provide that funds deduct distribution-related costs directly from shareholder accounts rather than from fund assets.[34] Commenters also addressed concerns regarding revenue sharing. We will take these and other comments we received into consideration as we evaluate whether and how to amend the rule further. We are not adopting any further changes to rule 12b–1 today.

III. Effective and Compliance Dates

The amendments to rule 12b–1 will be effective on October 14, 2004. The compliance date of these rule amendments is December 13, 2004. No later than the compliance date, funds must be in compliance with the ban in paragraph (h)(1) of the rule and funds that use their selling brokers to execute portfolio securities transactions must have in place the policies and procedures prescribed by paragraph (h)(2)(ii) of rule 12b–1. Funds may make corresponding changes to their registration statements at the time of the next regularly scheduled amendment.

IV. Cost-Benefit Analysis

We are sensitive to the costs and benefits that result from our rules. The amendments prohibit the use of brokerage commissions to compensate broker-dealers for the distribution of fund shares. In the Proposing Release, we requested comment and specific data regarding the costs and benefits of the proposed amendments.[35] We received no comments on the costs and benefits of the proposed amendments.

A. Benefits

The amendments will benefit funds and their shareholders. The practice of directing brokerage for sales involves substantial conflicts of interest that can harm shareholders. Fund advisers control fund brokerage and, as a result of their compensation structures, have incentives to maximize the size of funds they advise, while fund shareholders are interested in maximizing their fund returns by minimizing overall costs, including transaction costs. Fund advisers that overtrade fund portfolio securities in order to generate additional sales of fund shares, or that fail to optimize transactions costs, impose real costs on fund investors, which these rule amendments seek to eliminate. The opaqueness of fund transaction costs makes it impossible for investors to control the conflict or to understand the amount of actual costs incurred for distribution of fund shares.

The elimination of the practice of directing fund brokerage for distribution also may yield secondary benefits to funds if it leads to lower institutional brokerage rates, lower portfolio turnover rates, and better transparency of distribution costs. The Commission has no way of quantifying these benefits.

B. Costs

The amendments may decrease the commissions received by broker-dealers who may seek to make up for any shortfall from other sources. In response, fund advisers may seek to increase sales loads paid by investors, or to increase the amount of payments to broker-dealers deducted from fund assets under a rule 12b–1 plan. The ability of advisers to obtain these funds is, however, subject to NASD limits, and by the requirement that fund shareholders approve increases to fees deducted pursuant to a rule 12b–1 plan. Alternatively, advisers may be required to increase the payments that they make to broker-dealers out of their own assets, which are likely to cause advisers' costs to rise.[36] Advisers may resist making these payments because of uncertainty that they may be recouped.

We assume that a great many, if not all, funds are likely to find that, for some portfolio transactions, the broker-dealer who can provide best execution also distributes the fund's shares. These funds will incur costs in order to comply with the requirement for policies and procedures contained in the amendments.[37] Specifically, these funds or their advisers would be required to institute policies and procedures reasonably designed to prevent: (i) The persons responsible for selecting broker-dealers to effect transactions in fund portfolio securities from taking broker-dealers' promotional or sales efforts into account in making those decisions; and (ii) the fund, its adviser or principal underwriter, from entering into any agreement under which the fund directs brokerage transactions or revenue generated by those transactions to a broker-dealer to pay for distribution of the fund's shares. We do not anticipate that drafting or implementing these policies and procedures will be costly.

By narrowing the options for financing distribution of fund shares, the proposed amendments could impose costs on funds and their advisers. If the remaining methods of financing distribution are not adequate, funds may not grow as quickly as they otherwise would have. Advisers, whose compensation is generally tied to net assets, may experience slower growth in their advisory fees, and fund shareholders may not benefit from the economies of scale that accompany asset growth.[38]

V. Consideration of Promotion of Efficiency, Competition, and Capital Formation

Section 2(c) of the Investment Company Act mandates the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[39]

As discussed above, the amendments prohibit funds from compensating selling brokers with commissions generated from fund portfolio securities transactions. This new prohibition could promote efficiency by eliminating brokers' selling efforts, which are not indicative of their execution capabilities, as a factor that fund advisers use in selecting an executing broker. Efficiency also will be enhanced because, if commissions are not used to finance the distribution of a fund's shares, lower commission rates may be available or the fund may be able to obtain other services more directly beneficial to it and its shareholders.

We do not anticipate that these amendments will harm competition; they are, in fact, intended to enhance competition. All funds are precluded from using this form of compensation. In addition, the amendments should reduce incentives that broker-dealers currently have to base their fund recommendations to customers on payment for distribution. The amendments also could foster greater competition in brokerage commission rates by unbundling distribution from execution.

[34] *See* Proposing Release, *supra* note 5, at nn. 63–67 and accompanying text.

[35] *See* Proposing Release, *supra* note 5, at section V.C.

[36] Advisers may seek to increase their management fees to offset increased payments to broker-dealers. Any increase in management fees would have to be approved by the fund's shareholders. *See* 15 U.S.C. 80a–15(a).

[37] We assume that a great majority of, if not all, funds are likely to find that, for some portfolio transactions, the broker-dealer who can provide best execution also distributes the fund's shares.

[38] Historically, however, fund shareholders have not always enjoyed lower expenses as a result of increased assets (the absence of lower expenses can result from a number of causes, including that advisers are failing to pass on scale economies to shareholders or that advisers are not themselves earning scale economies).

[39] 15 U.S.C. 80a–2(c).

Although we do not anticipate that these amendments will adversely impact competition, we do not know whether these amendments will affect all funds in the same manner. Certain types of portfolio managers, for instance, might rely more heavily on directed brokerage to ensure adequate shelf space for the funds they advise than other advisers, which could result in an increase in some funds' costs. The ban on directed brokerage to pay for distribution also could lead to an increase in costs for some funds if the amendments compel the fund to modify the way it distributes its shares. This potential differential impact on funds could affect competition.

The amendments prohibit a fund from relying on its selling brokers to effect fund portfolio securities transactions unless the fund has policies and procedures in place designed to ensure the active monitoring of brokerage allocation decisions when executing brokers also distribute the fund's shares. Thus, funds will not be unnecessarily limited in their choice of executing brokers, and the amendments will not have adverse effects on competition in the provision of brokerage services. We do not anticipate that the amendments will affect capital formation.

VI. Paperwork Reduction Act

As explained in the Proposing Release, the amendments contain a ''collection of information'' requirement within the meaning of the Paperwork Reduction Act of 1995 (''PRA'').[40] We published notice soliciting comments on the collection of information requirements in the Proposing Release and submitted these requirements to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for the collection of information requirements associated with the proposed amendments is ''Rule 12b–1 under the Investment Company Act, 'Distribution of Shares by Registered Open-End Management Investment Company.' '' An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. The OMB control number for rule 12b–1 is 3235–0212.

Rule 12b–1 permits funds to use their assets to pay distribution-related costs. In order to rely on rule 12b–1, a fund must adopt ''a written plan describing all material aspects of the proposed financing of distribution'' that is approved by fund shareholders and fund directors. Any material amendments to the rule 12b–1 plan similarly must be approved by fund directors, and any material increase in the amount to be spent under the plan must be approved by fund shareholders. In considering a rule 12b–1 plan, the fund board must request and evaluate information reasonably necessary to make an informed decision. Rule 12b–1 also requires the fund to preserve for six years copies of the plan, any related agreements and reports, as well as minutes of board meetings that describe the factors considered and the basis for implementing or continuing a rule 12b–1 plan.

As discussed above, today we are adopting amendments to rule 12b–1 substantially as proposed. To eliminate a practice that poses significant conflicts of interest and may be harmful to funds and fund shareholders, we are amending rule 12b–1 to prohibit funds from paying for the distribution of their shares with brokerage commissions. Funds that use their selling brokers to execute securities transactions will be required to implement, and their boards of directors (including a majority of independent directors) to approve, policies and procedures. The policies and procedures must be reasonably designed to prevent: (i) The persons responsible for selecting broker-dealers to effect transactions in fund portfolio securities from taking broker-dealers' promotional or sales efforts into account in making those decisions; and (ii) the fund, its adviser or principal underwriter, from entering into any agreement under which the fund directs brokerage transactions or revenue generated by those transactions to a broker-dealer to pay for distribution of the fund's shares. This requirement includes the following new information collections: (i) A fund's documentation of its policies and procedures, and (ii) the approval by the board of directors of those policies and procedures.

The new information collection requirements are mandatory. Responses provided to the Commission in the context of its examination and oversight program are generally kept confidential.[41] None of the commenters addressed the PRA burden associated with these amendments. OMB approved the information collection requirements.[42]

VII. Final Regulatory Flexibility Analysis

This Final Regulatory Flexibility Analysis has been prepared in accordance with 5 U.S.C. 604. It relates to the amendments to rule 12b–1, which governs the use of fund assets to finance the distribution of fund shares. The Initial Regulatory Flexibility Analysis (''IRFA''), which was prepared in accordance with 5 U.S.C. 603, was published in the Proposing Release.[43]

A. Reasons for the Proposed Action

As described more fully in Section I of this Release, the amendments are necessary to address the practice of directing brokerage commissions to particular broker-dealers in order to compensate them for selling fund shares, a practice we believe poses significant conflicts of interests and may be harmful to funds and fund shareholders.

B. Significant Issues Raised by Public Comment

When the Commission proposed the rule amendments that it is now adopting, it requested comment with respect to the proposal and the accompanying IRFA. We received no comments on the IRFA. Twenty-three commenters supported the Commission's proposal to ban the use of directed brokerage to finance distribution. Commenters noted that the practice gives rise to conflicts of interest, causes shareholders to be treated inequitably, may lead to portfolio churning in order to generate brokerage commissions, facilitates circumvention of the NASD's limits on sales charges, may result in inappropriate recommendations by brokers to their customers, and increases execution costs for funds.

Seven commenters opposed the ban on the use of brokerage commissions to pay for distribution. They argued that the proposed ban is unnecessary to protect investors and would inhibit the ability of funds to obtain best execution, increase commission rates by concentrating the brokerage business among fewer brokers, and eliminate a method of compensating broker-dealers for processing fund transactions and maintaining customer accounts. Opposing commenters offered the following alternatives to the proposed ban: (i) Enhanced disclosure of directed brokerage arrangements; (ii) Commission guidance about improper

[40] 44 U.S.C. 3501 to 3520.

[41] *See* section 31(c) of the Investment Company Act [15 U.S.C. 80a–30(c)].

[42] In the Proposing Release, we estimated that the aggregate burden for all funds in the first year after adoption would be 649,500 hours. We further estimated that the average weighted annual burden for all funds over the three-year period for which we requested approval of the information collection burden would be approximately 628,833 hours. *See* Proposing Release, *supra* note 5, at section VII.

[43] *See* Proposing Release, *supra* note 5, at section VIII.

arrangements; (iii) requiring funds to adopt policies and procedures governing brokerage allocation practices; (iv) as with other fund assets, prohibiting the use of brokerage commissions for distribution unless they are used in accordance with a rule 12b–1 plan; and (v) enhanced review and enforcement efforts with respect to existing restrictions on the use of directed brokerage.

C. Small Entities Subject to the Rule

A small business or small organization (collectively, ''small entity''), for purposes of the Regulatory Flexibility Act, is a fund that, together with other funds in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.[44] Of approximately 5,124 registered investment companies, approximately 204 are small entities.[45] As discussed above, the amendments prohibit all funds, regardless of size, from using portfolio brokerage commissions to finance distribution. All funds that use selling brokers to execute portfolio transactions must implement policies and procedures. While we have no reason to expect that small entities will be disproportionately affected by the amendments, it is possible that a larger portion of smaller funds secure shelf space through the use of directed brokerage than is the case with larger funds. If true, smaller funds could incur some unanticipated costs as they adapt to these amendments.

D. Reporting, Recordkeeping, and Other Compliance Requirements

The amendments do not include any new reporting or recordkeeping requirements. The amendments introduce a new prohibition, applicable to all funds, including small entities, on the use of fund brokerage commissions to compensate selling brokers. In addition, all funds, including small entities, are prohibited from using selling brokers to execute portfolio transactions unless they have implemented policies and procedures reasonably designed to prevent: (i) The persons responsible for selecting broker-dealers to effect transactions in fund portfolio securities from taking broker-dealers' promotional or sales efforts into account in making those decisions; and (ii) the fund, its adviser or principal underwriter, from entering into any agreement under which the fund directs brokerage transactions or revenue generated by those transactions to a broker-dealer to pay for distribution of the fund's shares. The board of directors must approve these policies and procedures.

E. Commission Action To Minimize Effect on Small Entities

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. Alternatives in this category would include: (i) Establishing different compliance or reporting standards that take into account the resources available to small entities; (ii) clarifying, consolidating, or simplifying the compliance requirements under the rule for small entities; (iii) using performance rather than design standards; and (iv) exempting small entities from coverage of the rule, or any part of the rule.

Establishing different standards for small entities is not feasible because we believe that a complete ban on the use of brokerage commissions to finance distribution is necessary in light of the intensity of the conflicts of interest that surround the practice. It would be inappropriate to apply a different standard for small entities, whose advisers may face even greater pressure than advisers to larger funds to take all measures to enhance distribution. Shareholders of small funds should receive the same protection as shareholders in large funds.

We do not believe that clarification, consolidation, or simplification of the compliance requirements is feasible. The amendments contain a straightforward ban on the use of brokerage commissions to finance distribution. The special requirements applicable to a fund that uses a selling broker to execute its portfolio securities transactions are likewise clear.

We do not believe that the use of performance rather than design standards is feasible. The amendments prohibit the use of brokerage commissions to finance distribution because the experience of our staff, including a recent staff review of brokerage commission practices, has led us to believe that the conflicts surrounding this practice are largely unmanageable. The requirement that funds that rely on selling brokers to execute transactions must have in place policies and procedures to prevent the persons making brokerage allocation decisions from taking fund sales into account and to prohibit directed brokerage agreements is a performance standard, because it permits funds or their advisers to implement policies and procedures tailored to their organizations.

We believe that it would be impracticable to exempt small entities from the ban. Doing so would deny to small funds and their shareholders the protection that we believe they are due. We also believe that it would be impracticable to exempt small entities that effect fund portfolio transactions through a selling broker from the requirement that they implement policies and procedures.

Statutory Authority

The Commission is proposing amendments to rule 12b–1 under the Investment Company Act pursuant to the authority set forth in sections 12(b) [15 U.S.C. 80a–12(b)] and 38(a) [15 U.S.C. 80a–37(a)] of the Investment Company Act.

List of Subjects in 17 CFR Part 270

Investment companies, Securities.

Text of Rule

■ For reasons set forth in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended to read as follows:

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

■ 1. The authority citation for part 270 continues to read in part as follows:

Authority: 15 U.S.C. 80a–1 *et seq.*, 80a–34(d), 80a–37, and 80a–39, unless otherwise noted.

* * * * *

■ 2. Section 270.12b–1 is amended by:

■ a. Removing the periods at the end of paragraphs (a)(1) and (a)(2) and adding semi-colons in their places;

■ b. Removing the word ''and'' at the end of paragraphs (b)(2) and (b)(3)(iii);

■ c. Removing the comma at the end of the introductory text of paragraph (b)(3)(iv) and adding a colon in its place;

■ d. Removing the word ''and'' at the end of paragraph (b)(3)(iv)(B);

■ e. Adding the word ''and'' at the end of paragraph (b)(4);

■ f. Removing the word ''and'' at the end of paragraph (e);

■ g. Removing the period at the end of paragraph (f) and adding a semi-colon in its place;

■ h. Removing the period at the end of paragraph (g) and adding ''; and'' in its place; and

■ i. Adding paragraph (h).

The addition reads as follows.

[44] 17 CFR 270.0–10.

[45] Some or all of these entities may contain multiple series or portfolios. If a registered investment company is a small entity, the portfolios or series it contains are also small entities.

§ 270.12b–1 Distribution of shares by registered open-end management investment company.

* * * * *

(h) Notwithstanding any other provision of this section, a company may not:

(1) Compensate a broker or dealer for any promotion or sale of shares issued by that company by directing to the broker or dealer:

(i) The company's portfolio securities transactions; or

(ii) Any remuneration, including but not limited to any commission, mark-up, mark-down, or other fee (or portion thereof) received or to be received from the company's portfolio transactions effected through any other broker (including a government securities broker) or dealer (including a municipal securities dealer or a government securities dealer); and

(2) Direct its portfolio securities transactions to a broker or dealer that promotes or sells shares issued by the company, unless the company (or its investment adviser):

(i) Is in compliance with the provisions of paragraph (h)(1) of this section with respect to that broker or dealer; and

(ii) Has implemented, and the company's board of directors (including a majority of directors who are not interested persons of the company) has approved, policies and procedures reasonably designed to prevent:

(A) The persons responsible for selecting brokers and dealers to effect the company's portfolio securities transactions from taking into account the brokers' and dealers' promotion or sale of shares issued by the company or any other registered investment company; and

(B) The company, and any investment adviser and principal underwriter of the company, from entering into any agreement (whether oral or written) or other understanding under which the company directs, or is expected to direct, portfolio securities transactions, or any remuneration described in paragraph (h)(1)(ii) of this section, to a broker (including a government securities broker) or dealer (including a municipal securities dealer or a government securities dealer) in consideration for the promotion or sale of shares issued by the company or any other registered investment company.

By the Commission.

Dated: September 2, 2004.

Margaret H. McFarland,

Deputy Secretary.

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