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Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

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For Information Contact:

George J. Benston
(404) 727-7831
Marshall Blume
(215) 898-7616
Kenneth E. Scott
(650) 723-3070

Statement of the Shadow Financial Regulatory Committee

on

Prohibition of Directed Brokerage and Other Abuses by Investment Management Companies

May 24, 2004

The Securities and Exchange Commission (SEC) has proposed prohibiting investment management companies from directing brokerage to particular brokerage houses in exchange for selling and supporting their mutual funds. The Shadow Financial Regulatory Committee supports this proposal.

The Committee recognizes that mutual funds are sold and distribution costs must be covered. When they are paid for directly by purchasers, in the form of up-front load charges, or indirectly, in the form of management and 12b-1 fees, the amounts are disclosed and can be taken into account by mutual fund investors. However, when distribution and other expenses are paid for with brokerage fees in excess of competitive commission rates, they are not disclosed to investors as expenses. Under generally accepted accounting principles, commissions are added to the amounts paid for stock purchased or deducted from the amounts received from stock sold, and, therefore, are not reported as an expense. Although the total amount of commissions is disclosed, investors cannot determine the component allocated to distribution expense. Consequently, investors who find the expense ratios a valuable indicator of future fund performance may be misled. Moreover, investment management companies may have an incentive to churn their portfolios to generate revenue to pay for sales.

The Committee believes that the SEC's proposal does not go far enough. As the Committee urged in Statement 200 "Mutual Fund Expenses and Soft Dollars," (December 8, 2003), Congress should repeal Section 28(e) of the Securities Exchange Act of 1934, which provides a safe harbor for soft dollars. Soft dollars arise from investment companies paying commissions in excess of competitive amounts. The brokerage firms return much of the difference to investment companies in the form of "research," broadly defined. Because the Committee supports full and clear disclosure of the expenses charged to mutual fund purchasers and continuing investors and there is no effective way to determine expenses paid for with soft dollars, it believes that the safe harbor provision (Section 28 (e)) should be repealed. Repeal of 28(e), in conjunction with Section 17(e)(1) of the Investment Company Act of 1948, will prevent investment management companies from using soft dollars.

Even if Congress does not repeal the Section 28(e) safe harbor, the SEC should narrow its definition of "research" and confine it to third-party research, because the payment to third parties is clearly identified. At the least, this will reduce the opportunity for investment companies to obscure other expenses that should be disclosed in expense ratios.