INVESTMENT COMPANY INSTITUTE

PAUL SCHOTT STEVENS
PRESIDENT

November 25, 2005

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934 – File No. S7-09-05

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on the Commission's proposed interpretive guidance on the use of soft dollars under Section 28(e) of the Securities Exchange Act of 1934.[2] Investment advisers' use of soft dollars raises complex policy and practical issues that have been the subject of widespread debate and divergent opinions for many years. The Institute and its members are keenly interested in this important topic and especially in assuring that the regulatory framework governing soft dollar practices continues to operate in the interests of investors. Given the significance and complexity of the issues associated with soft dollars, we applaud the Commission's decision to invite and consider public comment before issuing final guidance.

Congress' adoption of Section 28(e) and the Commission's issuance of additional guidance reflect the conclusion that "client commission arrangements" can and do benefit investors and the securities markets.[3] Many smaller money managers rely on the Section 28(e)

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[1] The Investment Company Institute is the national association of the U.S. investment company industry. More information about the Institute is available at the end of this letter.

[2] *See* SEC Release No. 34-52635 (Oct. 19, 2005), 70 Fed. Reg. 61700 (Oct. 25, 2005) ("Release"). Like the Release, this letter also uses the term "client commission" practices or arrangements to refer to soft dollar practices under Section 28(e).

[3] The extent to which investment advisers use client commissions to pay for brokerage and research services varies from firm to firm. Some advisers, for example, choose to pay for some or all research products and services with hard dollars. As a permissive safe harbor, Section 28(e) allows investment advisers to exercise discretion in this area.

We understand that hard dollar payments for research may raise issues as to whether the broker-dealer receiving the payments is acting as an investment adviser and therefore subject to the registration and regulatory requirements of the Investment Advisers Act of 1940. The Institute believes that the Commission should address this issue and remove any potential obstacles that might discourage hard dollar payments for research. In this regard, the form of a money manager's payment for research (*i.e.*, hard vs. soft dollars) should not be the sole factor determining which regulatory framework applies to the broker-dealer who provides the research.

safe harbor because client commission arrangements provide a cost-effective way for them to gain access to sophisticated and specialized research that they might not otherwise have the resources to obtain.

Notwithstanding their potential benefits, the Commission has recognized that client commission arrangements pose conflicts of interest that must be addressed through disclosure and other means – including, in the case of mutual funds, the oversight of these arrangements by fund boards. Concerns about such conflicts have prompted many in the mutual fund business, among them independent fund directors, to recommend that soft dollar practices be curtailed.[4] The Institute in 2003, for example, recommended that the Commission narrow the scope of the Section 28(e) safe harbor to exclude third-party research, among other items.[5] Consistent with other pronouncements since 2003, the Release makes clear that the Commission has decided not to distinguish between proprietary and third-party research for purposes of the safe harbor. Accordingly, our comments address those issues raised by the guidance in the form proposed by the Commission.

Based on the proposed interpretation, it appears that the Commission has concluded that the Section 28(e) safe harbor and related guidance remain an acceptable way to preserve the benefits of client commission arrangements for investors, while subjecting these arrangements to appropriate safeguards.[6] At the same time, the Commission's proposed interpretive guidance reflects the broad consensus – one we share – that there is a need to tighten existing standards concerning the types of expenses that qualify for the Section 28(e) safe harbor.[7] Additional guidance on client commission practices that tightens the safe harbor will benefit investors in several ways. For example, it will clarify the application of the safe harbor. In addition, it will interpret Section 28(e) in a manner that we believe more closely reflects its original purpose as a narrowly-tailored provision that allows a money manager to take into account available research products and services, as well as execution capabilities, in determining how to allocate trades.

For these reasons, the Institute supports the proposed guidance, subject to the following comments:

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[4] *See, e.g.*, Independent Directors Council, Statement of Policy Concerning Soft Dollars (December 23, 2004). Independent fund directors also have expressed concern that there may be unrealistic and inappropriate expectations about the nature and extent of oversight that boards are able to exercise in this area.

[5] *See* Letter from Matthew P. Fink, President, Investment Company Institute, to The Honorable William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, dated Dec. 16, 2003 ("2003 ICI Letter").

[6] The Release indicates that the Commission "also is considering whether at a later time to propose requirements for disclosure and recordkeeping of client commission arrangements." 70 Fed. Reg. at n.7. The Institute agrees that disclosure concerning client commission arrangements can be improved, and believes that the recommendations of the NASD Mutual Fund Task Force in this area are worthy of serious consideration. *See* NASD, Report of the Mutual Fund Task Force, Soft Dollars and Portfolio Transaction Costs (Nov. 11, 2004) ("NASD Task Force Report").

[7] *See, e.g.*, the NASD Task Force Report and the 2003 ICI Letter.

- The Commission should take steps to level the playing field by prohibiting the use of client commissions outside the safe harbor by *all* investment advisers, regardless of the type of client account involved. This change will ensure that all advisers treat investors equitably in connection with the adviser's use of brokerage, and that broker-dealers do not have an incentive to favor hedge fund and other advisers who are permitted to use client commissions outside the safe harbor.

- The Commission should modify the proposed guidance to exclude from the safe harbor publications that are marketed to the general public and to clarify that money managers may treat order management systems and proxy voting services as mixed use items in appropriate circumstances.

- The Commission should clarify that the proposed guidance concerning commission-sharing arrangements does not place any affirmative obligations on money managers with respect to the responsibilities of introducing brokers under the guidance and applicable law, and should ensure that any responsibilities placed on brokers are appropriate and workable.

- The Commission should make clear that any final guidance applies on a prospective basis, and should provide an appropriate transition period for money managers to conform their practices to the new requirements.

Our comments are discussed further below.

Level Playing Field for All Investment Advisers

The proposed guidance addresses the scope and application of the Section 28(e) safe harbor but does not limit the use of client commissions outside the safe harbor. As noted in the 2003 ICI Letter, under current law, the ability to use client commissions to pay for products and services outside the safe harbor depends on the type of advisory account that generates the commissions. Advisers to investment companies and advisers to pension funds under ERISA may be prohibited from using commissions outside the safe harbor,[8] while advisers to other types of accounts are free to do so as long as they provide appropriate disclosure in Form ADV. This regulatory disparity, especially when combined with other forces exerting downward pressure on overall commissions,[9] may create strong financial incentives for broker-dealers to favor hedge fund and other advisers who are permitted to use client commissions to make payments outside the Section 28(e) safe harbor.

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[8] The Release states that "money managers of registered investment companies and pension funds subject to ERISA may violate Section 17(e)(1) of the Investment Company Act, or ERISA, respectively, unless they satisfy the requirements of the Section 28(e) safe harbor." 70 Fed. Reg. at 61702 (footnote omitted).

[9] Client commissions paid to broker-dealers have decreased in recent years due to several factors, including the advent of decimalization and the proliferation of alternative trading venues.

For example, broker-dealers sometimes provide important benefits by performing "functions incidental" to effecting securities transactions, such as providing access to initial public offerings, access to corporate management and committing the broker-dealer's capital to complete client trades. These valuable benefits, while within the safe harbor, may tend to bypass mutual funds and ERISA retirement plans in favor of hedge funds and other accounts whose commission payments, due to a regulatory anomaly, can be more lucrative to the broker-dealer. The tightening of the Section 28(e) safe harbor – which we strongly support – will exacerbate this highly undesirable (and unintended) result, to the detriment of mutual fund shareholders and ERISA retirement plan participants.

There is little justification for treating certain investment advisory clients differently from others with regard to permissible uses of their commissions. The Commission should adopt a rule under Section 206(4) of the Investment Advisers Act that will prohibit an investment adviser from using client commissions to pay for any products or services that fall outside the safe harbor.[10] The Commission also should pursue the NASD Task Force's recommendation to urge the Department of Labor (with respect to non-ERISA retirement accounts) and the federal banking agencies to require all discretionary investment advisers not subject to the Commission's jurisdiction to comply with the standards of the safe harbor.

Eligible Brokerage and Research Services

The Institute generally supports the Commission's proposed guidance concerning the eligibility criteria for "research services" and "brokerage" under Section 28(e). We believe that the guidance, for the most part, appropriately narrows the scope of the safe harbor by establishing new content standards for research and a new temporal standard for brokerage. The guidance will assist money managers and broker-dealers in determining whether particular products or services fall within the safe harbor.

We recommend that the Commission modify the guidance concerning certain items, as discussed below.

<u>Publications Marketed to the General Public</u>

The Release requests comment on whether the Commission should provide further guidance on the use of client commissions to pay for mass-marketed publications. In the 2003 ICI Letter, the Institute urged the Commission to exclude from the safe harbor certain items that have the attributes of traditional overhead and routine expenditures of investment managers, including publications that are available to the general public. As we said at that time, it is our understanding that many investment advisers already pay directly for most or all of the expenses of widely available publications. Nevertheless, removing books, periodicals, newspapers and electronic publications that are marketed to the general public from the safe

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[10] As indicated in the 2003 ICI Letter, this recommendation is not intended to affect traditional directed brokerage arrangements, in which a client directs its adviser to use commissions to obtain products or services that are used by the *client*. For these arrangements, the adviser does not need to rely upon Section 28(e).

harbor will provide greater assurance that client commission practices in this area conform with the intent of Section 28(e).

We recommend that the Commission revise the proposed guidance to clarify that publications marketed to the general public are not within the scope of the safe harbor. Our recommendation is consistent with the NASD Task Force's recommendation that the Commission exclude magazines, newspapers, journals and on-line news services from the definition of research services.

To implement our recommendation, we suggest that the Commission adopt a standard along the lines described in its request for comments, *i.e.*, the safe harbor should not be available for "mass-marketed publications that are widely circulated to the general public and intended for a broad, public audience."[11] The Institute recognizes that questions may arise in distinguishing between ineligible publications and *bona fide* research products. We believe, however, that even if the Commission's guidance does not eliminate all gray areas, a reasonable standard that specifically addresses publications marketed to the general public will serve the interests of investors. At a minimum, the guidance should leave no doubt that publications of general circulation and available at most newsstands are not eligible for the safe harbor.

Order Management Systems

The Institute recommends that the Commission revise the proposed guidance concerning the use of client commissions to pay for order management systems. The Release does not define what "order management systems" are, but it implies that this term has a single, well-defined and commonly recognized meaning. We understand that, in practice, the term "order management systems" encompasses a variety of different systems with different features. Money managers use order management systems for a range of purposes, many of which should qualify for the safe harbor as either brokerage or research.[12] With new developments in technology and the proliferation of new ways to trade securities, order management systems are evolving and likely will continue to change over time.

The proposed guidance excludes from eligibility for the safe harbor "order management systems used by money managers to manage their orders," because these systems "are not sufficiently related to order execution and fall outside the temporal standard for 'brokerage'."[13] The Institute believes that many order management systems perform functions that *are* sufficiently related to order execution to be eligible for the safe harbor.

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[11] Conversely, publications or subscriptions tailored and marketed to the institutional investment community for the purpose of providing information or opinions helpful to an adviser's investment decision-making process should constitute permissible research.

[12] The Institute agrees that certain functions and uses of order management systems (*e.g.*, compliance) should not be eligible for safe harbor protection.

[13] *Id*.

While we support the establishment of a temporal standard, we are concerned that the standard as currently contemplated is too restrictive in defining the starting point for activities that constitute eligible brokerage under Section 28(e). Instead of commencing when a money manager communicates with a broker-dealer for the purpose of transmitting an order for execution, the temporal standard should provide that brokerage begins when the money manager makes an investment or trading decision. This change would recognize that certain functions performed by the money manager (often through an order management system) before transmitting an order, including order entry and building a trade to include all eligible accounts, are part of, or incidental to, the execution process for purposes of Section 28(e). Revising the temporal standard in this way would better accommodate order management systems that enable straight-through processing.

We also recommend that the guidance expressly permit money managers to treat order management systems as mixed-use items. Our members have indicated, for example, that components of an order management system may perform connectivity or routing functions that facilitate the execution process.[14] These systems may include direct market access (DMA) features that provide a money manager with connectivity to multiple trading venues. Order management systems also can provide analytic tools that assist the money manager in making investment decisions. For these reasons, in addition to revising the temporal standard, the Commission should clarify that money managers are permitted to make a reasonable allocation of client commissions to pay for components of an order management system that meet the criteria for eligible brokerage or research services.

<u>Proxy Voting Services</u>

In response to the Commission's request for comment, we recommend clarifying that the guidance will permit money managers to treat proxy voting services as a mixed-use item in appropriate circumstances. Proxy voting firms typically provide two types of services: (1) research and analysis of matters to be voted on, with a recommendation on how to vote; and (2) the administrative functions of receiving, voting and returning ballots, and reporting on votes cast. The first category can include research eligible under Section 28(e). For example, we understand that proxy voting services often provide money managers with background information about issuers in connection with analysis of proxy proposals. If such information is provided to and used by a money manager's investment personnel to assist with investment decision-making, and it otherwise meets the eligibility requirements for research under the safe harbor, it should qualify for safe harbor protection.

Similarly, advice on how to vote proxies might properly be deemed to qualify as research, to the extent it assists the manager in making investment decisions. For example, advice with respect to voting on a company's merger proposal may be relevant to a manager's decision whether to continue holding, sell, or buy more shares of that company.

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[14] The guidance provides that dedicated lines between the broker-dealer and the money manager's order management system, as well as lines between the broker-dealer and order management systems operated by a third-party vendor, are eligible "brokerage." 70 Fed. Reg. at 61708.

Commission-Sharing Arrangements

In discussing the elements that are necessary for a commission-sharing arrangement to qualify under the safe harbor, the Release states that the arrangement "must be part of a normal and legitimate correspondent relationship in which each broker-dealer is engaged in securities activities of a more extensive nature than merely the receipt of commissions paid to it by other broker-dealers for research services provided to money managers."[15] The Release then lists minimum criteria that introducing brokers must meet to satisfy this standard, including making and/or maintaining records relating to its customer trades required by Commission and SRO rules.[16] The Commission should clarify that the proposed guidance does not place any affirmative obligations on money managers to ensure that introducing brokers comply with these criteria or with applicable law. It would be inappropriate to require money managers to "police" the introducing broker's compliance with the enumerated criteria. A money manager is not a party to the commission-sharing arrangement between two brokers and typically will have no way of knowing, for example, whether an introducing broker is making and/or maintaining required records relating to customer trades.

In addition, in providing guidance on the elements necessary for a commission-sharing arrangement to satisfy the safe harbor, the Commission should take care not to impede true clearing relationships. We understand that, in practice, the nature of "normal and legitimate" correspondent relationships varies, and in many cases the introducing broker in these relationships would not be able to meet the criteria set forth in the Release. For example, the introducing broker may not have the operational infrastructure necessary to create and maintain records for customer trades and would have no legal obligation to do so. We recognize that the Commission faces a challenge in seeking to provide clear guidance on permissible commission-sharing arrangements while precluding "give-ups." We encourage the Commission to work with the broker-dealer community to ensure that any responsibilities imposed on brokers under the guidance are appropriate and workable.

Implementation of the Guidance

As proposed, the Commission's interpretive guidance narrows the Section 28(e) safe harbor in certain respects, including by introducing new content standards for research and a new temporal standard for brokerage. It also clarifies related obligations of investment advisers and broker-dealers. Taking into account that it will change current guidance, the Commission should make clear that any final guidance applies on a prospective basis only and therefore will not result in any retroactive liability for practices that complied with existing standards.

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[15] *Id*. at 61711 (footnote omitted).

[16] According to the Release, the introducing broker in a commission-sharing arrangement must, at a minimum: (1) be financially responsible to the clearing broker for all customer trades until the clearing broker has received payment (or securities); (2) make and/or maintain records relating to its customer trades required by Commission and SRO rules, including blotters and memoranda of orders; (3) monitor and respond to customer comments concerning the trading process; and (4) generally monitor trades and settlements. 70 Fed. Reg. at 61711-12.

The Release requests comment on whether the Commission should afford firms time to implement the interpretation, and it seeks examples of potential implementation issues. The Institute strongly recommends that the Commission provide firms adequate time to implement the new guidance. Any final guidance that the Commission adopts likely will require investment advisers and broker-dealers to modify existing policies and procedures, practices, systems, arrangements and/or disclosures. Investment advisers to investment companies may wish to present proposed policy and disclosure changes to fund directors before finalizing them. In addition, investment advisers may have earned credits under existing arrangements that they should have a reasonable opportunity to use for the benefit of clients.

To facilitate an orderly transition, the Institute recommends that the Commission designate an effective date following the adoption of final guidance (*e.g.*, 60 days after adoption). As of that date, any new (or renewed) client commission arrangements would have to comply with the guidance. The Commission should provide a one-year period for investment advisers to unwind or modify, as necessary, client commission arrangements existing as of the effective date and for investment companies to amend registration statement disclosure if required. We recommend a one-year transition period because many client commission arrangements operate on a calendar or fiscal year basis. During this one-year period, to avoid unduly penalizing firms and their clients, advisers also should be permitted to use credits earned under existing client commission arrangements.

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We greatly appreciate the opportunity to comment on the Commission's proposed guidance. If you have any questions about our comments or need any additional information, please contact me at 202/326-5901 or Elizabeth Krentzman at 202/326-5815.

Sincerely,

/s/ Paul Schott Stevens

Paul Schott Stevens
President

cc: The Honorable Christopher Cox
The Honorable Cynthia A. Glassman
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Annette L. Nazareth

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About the Investment Company Institute

The Investment Company Institute's membership includes 8,518 open-end investment companies (mutual funds), 663 closed-end investment companies, 148 exchange-traded funds, and 5 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately $8.500 trillion (representing more than 95 percent of all assets of US mutual funds); these funds serve approximately 86.7 million shareholders in more than 51.0 million households. Many of the Institute's investment adviser members render investment advice to both investment companies and other clients. In addition, the Institute's membership includes 190 associate members, which render investment management services exclusively to non-investment company clients. A substantial portion of the total assets managed by registered investment advisers is managed by these Institute members and associate members.