

THE ALLIANCE IN SUPPORT OF INDEPENDENT RESEARCH

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Ashley Kovis
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The Financial Services Authority
21 The North Colonnade, Canary Wharf
London, U.K. E14 5HS

Re: Consultation Paper 176 – Financial Services Authority –
“Bundled Brokerage And Soft Commission Arrangements”

Ladies and Gentlemen:

The Alliance in Support of Independent Research is pleased to have this opportunity to submit its comment on Consultation Paper 176, issued by The Financial Services Authority (the “FSA”), entitled “Bundled Brokerage And Soft Commission Arrangements.”

As a group of U.S. registered broker-dealers which furnish independent research services to investment advisers and other money managers, we focus our comment on that feature of Consultation Paper 176 that proposes to limit the services beyond trade execution that could be bought with commissions or portfolio transaction order flow. Specifically, the FSA proposes to

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exclude market pricing and information services and in that regard references dealing screens, computer hardware and software and other equipment and custody.^{1/}

The leading members of the Alliance in Support of Independent Research ("Alliance") include the following broker-dealers:

Boston Institutional Services, Incorporated
D. Ward Blodgett, President

Capital Institutional Services, Inc.
Don C. Potts, Chief Executive Officer and
Kristi Wetherington, President

Fidelity Capital Markets

^{1/} The second feature of Consultation Paper 176 upon which comment is requested by the FSA is the proposal that the cost of acquiring research services (third party or proprietary research services) for commissions should ultimately be borne by the fund manager even though such research services would be permitted to be softed in the first instance. The FSA's Consultation Paper would assign the cost of all investment research to the fund manager. The Alliance views this second proposal as a fundamental shift in the manner in which brokerage and research services are rendered to the investment community. From a U.S. perspective, where for several decades the provision of research for commissions has been openly conducted under established standards, relatively free of abuses, and in the best interest of the investment community, this restriction seems unwarranted.

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Richard W. Collett, Vice President

The Interstate Group,
A Division of Morgan Keegan & Company, Inc.
Grady G. Thomas, Jr., President

Westminster Research Associates, Inc.,
Part of BNY Securities Group
John D. Meserve, President

Our members are involved in a significant portion of the arrangements in the United States under which fiduciaries such as mutual funds, investment advisers, banks and other money managers are provided with research services and products for the benefit of their managed accounts.

Members of the Alliance share a common interest in fostering a favorable regulatory environment in which research services and products may be furnished to the money management community, and in preserving the umbrella of protection which Section 28(e) of the Securities Exchange Act of 1934, a United States law, provides to fiduciaries who receive all forms of investment research. Another primary goal of the Alliance is to promote the observance of proper standards under the securities laws for disseminating research and achieving best execution of portfolio transactions for managed accounts. In accordance with this objective, the Alliance is committed to the principle of full and fair disclosure of advisory practices.

***The Financial Services Authority's Proposal To Restrict The Provision Of
Market Pricing And Information Services From Softing Arrangements***

As noted, our comment letter focuses principally on the first measure proposed by the FSA's Consultation Paper to limit the range of services a broker can offer for commissions in addition to trade execution. This would preclude the use of commission payments to acquire goods or services for which "demand is reasonably predictable" (i.e., fund managers are able to forecast with reasonable certainty their demand for such services). According to the Consultation Paper, this restriction would cover market pricing and information services and perhaps custody services, computer hardware, and the payment of fees for seminars and publications.

The FSA bases this proposal to limit the range of services on the premise that these specific services are more properly characterized as management expenses as distinguished from other types of research services deployed in the investment decision process and that account beneficiaries have difficulty in identifying which of these services are being acquired with commissions as opposed to being obtained from the fund manager's own assets. The Consultation Paper maintains that there would be more of an incentive on the part of fund managers ("fund manager" meaning managers of accounts such as mutual funds, trust accounts, separate accounts and similar entities) to ensure that they are getting best value for money if these specific services were acquired directly by the fund manager. The Consultation Paper acknowledges that this shifting of costs to fund managers would lead to higher management fees payable by the accounts.

***Background Of The Provision Of Research Services
For Commissions In The United States***

The practice of providing advice or research to investors may well have its origins in the very first trade done under the buttonwood tree at the foot of Wall Street in 1792 when the New York Stock Exchange opened for business. It is highly probable that the first client asked his broker whether it was a good idea to buy or sell and the broker may well have given advice when he executed the trade and charged a commission that reflected both services.

The furnishing of research services by broker-dealers as part of their execution services to institutional and retail accounts has had a long history and tradition in the United States. Because broker-dealers are so deeply involved in the investment decision-making process through their execution, trading and investment banking services, it naturally follows that they would also provide research and other advisory services to investors. Indeed, the research-advisory component of the broker-dealer industry exceeds several billion dollars a year in outlays for research and financial tools disseminated to investors for use in the investment decision process. Several large broker-dealers have internal budgets exceeding a hundred million dollars per year devoted to research analysts and the evaluation of investment opportunities. Other firms in the United States have elected to service their institutional accounts by arranging to provide an array of research services and analytical tools developed or authored by organizations totally independent of the broker-dealer furnishing the service (some of the type which the FSA's proposal would ban for commissions). Regardless of whether research services are produced in-house by a broker-dealer ("proprietary research") or acquired externally for distribution to the institutional community ("third party" or

“independent research”), the vast preponderance of research and financial services disseminated by the Street has traditionally occurred as part of the portfolio execution process. The FSA’s proposal would upend this traditional practice.

Payment For Research Services

Fiduciaries, such as investment advisers and portfolio managers, on behalf of their managed accounts, and other investors are inclined to give a portion of their order flow to those broker-dealers who are capable of assisting in the investment decision-making process by providing valuable investment ideas or tools which seek to maximize investment results. Instead of outright cash payments for the research, commissions or other forms of compensation on securities transactions are paid to brokers for the execution and research services furnished to the investors.

Because the compensation to the broker-dealer for research takes the form of commissions rather than cash, the notion that “softing” or “soft dollars” are being used to acquire the service has undoubtedly been fostered. Yet, the dollars used to acquire research of all types are real. For some time this bundled approach for acquiring investment research has been almost universally the preferred choice of investors. Like many other types of business, securities market participants have elected for reasons of economic efficiency and because of competitive pressures to transact business for combined services (i.e., executions and research) for one charge. And, in the United States the laws do not differentiate between proprietary and independent research. Instead, the law provides a level playing field for both full service broker-dealers and smaller or specialized broker-dealers, the latter of which do not have internal research staffs and products, by allowing these specialized firms

to compete by acquiring independent research and furnishing such research to money managers as a means to add value to the investment decision making process. The policy of treating independent and proprietary research similarly under United State law does not discriminate against independent research producers. As a result, the dissemination of research services has become far more competitive to the ultimate benefit of investors.

***Type Of Services Being Provided To Assist
In The Investment Decision Process***

Literally hundreds of research services are now provided to money managers to assist in the investment decision-making process. The vast preponderance of these research services have become available to the financial community only since Section 28(e) of the Securities Exchange Act was adopted in 1975, and a good portion of these services are produced by independent sources. Due to technological innovations, the types of research being provided have expanded to include not only investment information but fundamental databases, analytics, portfolio modeling and strategy software. Of equal significance, the technology of the delivery, formatting and use of information has made research more available and more meaningful to the investor and has greatly added to market efficiencies. Technology decisions relating to the investment process have become extremely important as money managers today face growing market complexities and information needs.

Much of these quantitative and qualitative improvements in research services broker-dealers offer to the investment community can be directly attributed to the regulatory setting established by the U.S. Congress when in 1975 it adopted Section 28(e) and to the SEC's express recognition

eleven years later of the value of computerized services and real-time financial information as a legitimate component of research.^{1/} This regulatory setting has permitted the rapid growth of technologically-based research, in many instances supplanting the inefficiencies and slowness of paper and other forms of communication. Integrated with the movement toward technologically-driven research is the deployment in virtually all securities markets of electronic trading, clearing, settlement and straight-through processing (“STP”), all of which have enhanced the investment decision process.

Because investors are now able to select from a broad menu of research services specifically suited to their requirements, United States securities markets have become more efficient. Contrast this with the research services available to market participants in some foreign markets, where often investment information is only available on a limited basis. As a consequence, market volatility and investor confidence in those places do not compare favorably with U.S. markets.

The provision of technologically based research services by broker-dealers to the investment community as part of their execution services has largely revolutionized the manner in which investment decisions are made, leading to more efficient markets for the investors who have entrusted their assets to fiduciaries.

***The Proposal To Exclude Market Pricing And Information Services
From Softing Fails To Recognize The Important Contribution***

^{2/} See Securities Exchange Act Release No. 34-23170 (April 23, 1986).

These Services Make To The Investment Decision Process

Implicit in Consultation Paper 176's proposal to exclude market pricing and information services from being obtained for commissions is the notion that these services are distinguishable from and are of a lesser use to investors than other research services utilized in the investment decision process.^{1/} Our experience in the United States is that market pricing and information systems are an integral part of the investment decision process, allowing fund managers to make informed and timely investment decisions. These market data and information systems provide the platform upon which fund managers conduct research of issuer companies, industries and economic and market trends. These systems support momentum and quantitative investment and execution strategies. In large measure, these information gathering and analytical systems have evolved into

^{3/} The FSA's proposal for excluding certain research on the premise that demand for such research services is "reasonably predictable," while demand for others is not, appears arbitrary. Our experience in the U.S. is that fund managers can and do budget and allocate the use of portfolio commissions from their managed accounts to obtain all types of research, not just those kinds identified in the FSA's proposal. Accordingly, there is no rational basis to distinguish the services the proposal seeks to exclude from softing arrangement from other research services which would remain eligible.

research tools as important to the investment decision process as the forms of research which the FSA continues to view as acceptable for softing under Consultation Paper 176.

We believe it would be inappropriate to formulate regulations which have the effect of discriminating against technologically-based research rendered on a real-time basis. Further, we believe that the test for eligibility for softing of a service or product should not be grounded in whether it reflects a mode of delivery or a type of information (e.g., market data versus a description of a company's income statement), but rather whether the service or product represents a useful tool to the fund manager in his investment decision making responsibilities.

Market Pricing And Information Services Are Not More Costly Or Excessively Consumed When Acquired For Portfolio Commissions

The experience of Alliance members in providing analytically based information systems as part of the portfolio execution process in the United States is that fund managers scrupulously review their commission outlays for both execution and research services, maintain strict budgets for such purposes, and demand competitive rates and low ratios for the services being provided.^{4/} Indeed, over the past few years commission rates have fallen and ratios (i.e., the amount of the commission allocated to research) have fallen dramatically. In our view, it is exceedingly unlikely

^{4/} As the Oxford Economic Research Associates study of soft commissions concluded, competition gives fund managers an incentive to perform, and this provides an incentive to limit commission costs as they affect the performance of their managed accounts (Section 4.4.4).

that these type of research products could be obtained for less if the execution and research products were independently offered and separately priced.

To facilitate cost accountability for these third party services, through business practices developed in the U.S. and competitive pressures, virtually all broker-dealers providing third party research services indicate on their customers' statements the dollar value of research provided to the customer, the aggregate commissions used to pay for the research, and an identification of the research provided. This method of accountability has made the third party or independent research dissemination process precise and transparent and has benefitted the fiduciary and its accounts by bringing to them accurate cost and benefit information. With this information in hand, money managers are able to not only select research services most suited to their needs, but also determine the most cost-effective arrangement with broker-dealers. Moreover, this information is readily available to the fund manager's accounts should they chose to see it.

Small Fund Managers Would Likely Suffer Disproportionately Should Market Pricing And Information Services Be Unavailable For Portfolio Commissions

In its deliberations on Section 28(e) of the Securities Exchange Act of 1934, the law under which softing arrangements occur in the U.S., Congress recognized that without highly developed internal research departments, smaller money management firms might be required to rely entirely on "Street" research. According to the legislative history of Section 28(e), by gaining access to

research that broker-dealers provide, small investment managers could serve their clients without feeling pressure to charge higher fees than a large money manager would charge.^{1/}

What was true in 1975 is true today. Many startup investment advisers cannot establish their businesses and compete against larger money managers (who command large fee bases from which they can sustain in-house research) without access to the research services that broker-dealers provide for portfolio commissions. Current U.S. law, permitting fund managers to obtain information services and market data for commissions, has facilitated small firms' entry into the investment advisory business. Included in this category are firms that may not have significant capital resources but have been able to obtain the necessary technology-oriented research and other investment services with which to compete with larger fiduciaries for access to ideas and strategies. These observations were confirmed by the SEC staff's 1998 Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds. Smaller advisers generating less than \$100,000 in commissions used over 50% of their commissions for soft dollar research, contrasted with larger money managers generating more than \$100 million in commissions, which used only 8% of their commissions for soft dollar research.

^{1/} Report of the Comm. On Banking, Housing and Urban Affairs, S. Rep. 94-75 (1975).

If fund managers are precluded from obtaining market data and information services through the portfolio execution process, it is highly probable that smaller fund managers will be competitively disadvantaged by such proposal.

***Under U.S. Law The Account Is Informed Of The Use Of
Commissions To Acquire Information Based Systems And
Has The Option To Elect To Restrict Use of Its Commissions***

The use of commissions on portfolio transactions to compensate broker-dealers for investment tools may be viewed as an election on the part of the fund manager and his accounts to allocate responsibility for the cost of the service on the accounts and to pursue their acquisition through the softing process. Presumably, the decision to allocate costs and elect this mode of acquisition is based upon a number of factors including the level of management fees, the efficiencies and cost-effectiveness of bundled services, as well as custom and practice. To the extent the election by the accounts and the fund manager is an informed choice, no public purpose is served by restricting the parties from allocating their responsibilities in this manner. In other words, to the extent the account investor is made aware of the practice of obtaining information systems and related services (computer hardware, software) with commissions and the nature of the services obtained, the account investor is in a position to judge whether the practice is in his best interest, and if deemed appropriate, opt out of the arrangement. We are of the view that a sufficient level of information exists in the United States to support informed decisions by investors regarding soft dollar arrangements and believe such to be the case in the U.K. as well.

In the United States, regulations call for disclosure to the accounts of the use of client account commissions for research and execution services. Under U.S. law an investment adviser has a fiduciary duty to act in the best interest of its clients. As a fiduciary, an adviser has a duty to disclose to his investor clients all potential or actual conflicts of interest that might influence him, consciously or unconsciously, to render advice that is not disinterested. The potential conflict of interest that arises when an adviser receives research as a result of allocating brokerage on behalf of investors led to the SEC's requirement that an adviser disclose all basic information about the provision of research to investors. Through such disclosure, the investor is given sufficient information to judge whether the use of his commissions for research is in his best interest and whether he is being properly served by his adviser.

Another important disclosure requirement is found in Rule 10b-10 under the Securities Exchange Act of 1934. This rule requires brokers to indicate the capacity in which they act when executing a transaction for an investor. When a broker acts as agent, Rule 10b-10 requires disclosure of the amount of commission. When the broker acts in a principal capacity, the rule in some cases requires disclosure of the markup. Through these disclosures on confirmations, money managers and clients are given the opportunity to monitor the reasonableness of the transaction charges they pay.

In addition to required legal disclosures, most broker-dealers who provide third party research service to accounts furnish account statements indicating the value of the research provided to the account and the aggregate commissions used to pay for the research.

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In short, there currently is a great deal of information available in the U.S. to fiduciaries and investors regarding brokerage commission arrangements and research services. Moreover, in evaluating the sufficiency of disclosures regarding soft dollar arrangements, it is important to recognize that these soft dollar arrangements involve the institutional portion of the securities business in which highly informed fund managers have the experience and sophistication to assess the information and weigh the costs and benefits of a specific arrangement on behalf of their investors.

We submit that in an informed setting, where relevant information about the fund manager's soft dollar practices is made available to account investors, it is preferable to permit private sector decisions as to whether commissions may be used by the fund manager for execution and research services.

Conclusion

We hope these comments assist The Financial Services Authority in concluding that it is not desirable to promulgate regulations which exclude market pricing and information services from softing arrangements where the parties have otherwise elected to permit such arrangements. Members of the Alliance would welcome the opportunity to further communicate with the staff of the FSA regarding Consultation Paper 176.

Please call Lee A. Pickard or William D. Edick at 202-223-4418 if you have any questions concerning this matter.

Sincerely,

The Alliance In Support Of Independent Research

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