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January 27, 2004

The Honorable William H. Donaldson
Chairman
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Comments of the Alliance in Support of Independent Research Regarding
Investment Company Institute Comment Letter of December 16, 2003

Dear Chairman Donaldson:

The Alliance in Support of Independent Research is pleased to have this opportunity to address several issues raised in the Investment Company Institute's ("ICI") December 16, 2003 letter to you which have a bearing on an interpretation issued by the SEC in 1986.¹ We believe that the ICI's suggestion that the Commission significantly narrow the scope of the Section 28(e) safe harbor by excluding certain products and services, including all third-party research services, from the safe harbor would hurt investors and the U.S. equity markets by significantly upsetting the competitive balance between research providers, investment managers and broker-dealers. Specifically, the ICI's proposal would grant a significant and unwarranted competitive advantage to research produced in-house by Wall Street firms at the expense of independent research. The timing of the ICI's proposal is especially incongruous as it

¹ SEC Rel. No. 34-23170 (April 28, 1986) (hereinafter 1986 Release).

comes when other regulatory initiatives seem to be aimed at supporting a vibrant market for independent research. We believe it is important for the ICI to respond to the recent announcements of late trading and market timing abuses involving mutual funds, but it remains a mystery as to why the ICI has chosen to attack Section 28(e) arrangements, an area which was not implicated by such abuses and in fact received a relatively clean bill of health the last time it was comprehensively examined by the SEC Staff.²

Members of the Alliance in Support of Independent Research 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 Section 28(e) of the Securities Exchange Act 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, including the use of portfolio commissions to obtain research.

The leading members of the Alliance in Support of Independent Research 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

² See SEC Office of Compliance, Inspections and Examinations' "Inspection Report on The Soft-Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds," (September 22, 1998).

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

Knight Equity Markets L.P.
James P. Smyth, Managing Director

Westminster Research Associates, Inc.,
A BNY Securities Group Co.
John D. Meserve, President

Our members are involved in a significant portion of the arrangements under which fiduciaries such as mutual fund managers, investment advisers, banks and other fiduciaries are provided with independent research services and products for the benefit of their managed 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 first 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 customers has a long history and tradition. Because broker-dealers are so deeply involved in the investment decision making process through their execution and trading functions, it naturally follows that they would also provide research and other advisory services to investors. While some firms provide these services through internal research departments, and have budgets exceeding a hundred million dollars per year

devoted to research analysts and the evaluation of investment opportunities, many other firms have elected to service their 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. Indeed, the Commission has recognized that the provision of third-party research by broker-dealers predates the adoption of the Section 28(e) safe harbor, and that the elimination of the practice would be anti-competitive.³

The ICI's Proposal To Exclude Third-Party Research Services From The Section 28(e) Safe Harbor Would Harm Independent Research, Competition And Investors

Restricting the coverage of the Section 28(e) safe harbor to proprietary research would significantly harm the ability of independent research firms to provide their innovative research to the securities markets. It would also impair the ability of small money managers to compete with their larger peers. Finally it would limit the ability of small and mid-size broker-dealers to compete with large Wall Street firms. The resulting diminution in the amount of research available would harm the price discovery process, and the inability of smaller advisers and broker-dealers to compete with their larger peers would lead to higher advisory fees and commission costs to investors.

³ See 1986 Release (". . . it seems unlikely that Congress intended to forbid certain common practices [i.e. third party research] that were then considered permissible and whose elimination would be anti-competitive."). In a recent telephone press conference an ICI official attempted to justify the ICI's proposal to ban the use of commissions to obtain independent research by claiming that such research could not be purchased for soft dollars until 1986 "when most of the abuses of using soft dollars appeared." See *fund action*, www.fundaction.com, (January 15, 2004). This assertion is legally and factually incorrect. Shortly after Section 28(e) was adopted in 1975, the SEC issued an interpretation confirming the safe harbor's applicability to third-party research. SEC Rel. No. 34-12251 (March 24, 1976). Further the ICI's December 16, 2003 letter admitted that the 1998 OCIE report "did not report any significant shortcomings on the part of mutual fund advisers."

Many independent research providers depend upon Section 28(e) arrangements to expose their ideas to a broad range of clients and as a payment mechanism for their research activities. Independent research providers are often small operations targeted at a specific segment of the market which is not given sufficient coverage by full service firms by reasons of lack of interest, resources, perceived demand or otherwise. Often independent research providers generate research through innovative and unique methodologies not in use by Wall Street firms. It is extremely difficult for a small independent research provider with a limited marketing budget to market itself directly to a large number of investment managers. Third party soft dollar arrangements allow independent research providers to rely upon and obtain assistance from broker-dealers. In turn these broker-dealers provide independent research and execution services to many institutional investors. The loss of this efficient marketing mechanism alone would make it extremely difficult for independent research providers to compete with their better financed and more recognizable Wall Street peers. The ICI's proposal would go further, however, effectively providing a regulatory subsidy to proprietary research by allowing portfolio commissions to finance such research while requiring that independent research be paid for in cash. Under such a scenario, few independent research firms would survive and even fewer would be created, denying investors an important source of fresh and unbiased information concerning securities.⁴

The timing of the ICI's proposal seems especially ironic, coming so soon after the global research analyst settlement pursuant to which full service firms agreed to provide

⁴ The ICI's Chairman has conceded that independent research providers would be harmed by its proposal. See Wall Street Journal, December 18, 2003 page D9.

independent research to their retail brokerage customers. Although the ICI's letter indicates that they would recommend that the research provided under the global settlement could continue to be provided under the Section 28(e) safe harbor, their rationale for this distinction is nonsensical,⁵ and their recommendation to exclude the provision of third party research from the Section 28(e) safe harbor would in fact preclude brokerage firms from providing the independent research embraced by the global settlement to their institutional accounts for commissions.

Small investment managers would likewise be harmed by the ICI's proposal. While it is likely that large investment management firms would be able to retain some independent research arrangements by spreading the cost of the cash payments for such research over their larger client base, smaller managers would be forced either to raise their advisory fees or to limit their use of independent research. In either case, investors would suffer, either through higher costs or a less informed investment manager. Furthermore, the ICI's proposal would likely result in further consolidation in the investment management industry. Consolidation would lead to less choice and competition which in turn could lead to higher asset management fees.

Finally, the ICI's proposal would impair the ability of small and medium size broker-dealers to compete for securities execution business with larger firms. As discussed above, the ICI's proposal would provide an economic advantage to broker-dealers with a proprietary research department by allowing them a payment mechanism

⁵ The ICI states that they would recommend that research provided under the global settlement continue to fall under the safe harbor because "the availability of such research is not dependent on the receipt of any particular level of commissions." ICI Letter at fn 10. As the ICI should know, the Section 28(e) safe harbor is not implicated only in circumstances where a fiduciary commits to a particular level of commissions in order to receive research, but rather can apply to any situation where a fiduciary receives research in respect of client portfolio transactions.

not available to firms offering independent research. Many smaller broker-dealers lack the resources to employ an internal research staff. The only way these firms can compete with their larger peers for institutional order flow is to contract to purchase the research of independent research providers. Competition between brokers lowers securities transaction costs. Eliminating the ability of smaller broker-dealers to compete with their larger peers will ultimately result in higher transaction costs to funds and other investors.

The Alliance Supports Transparency In All Section 28(e) Research Arrangements

The experience of Alliance members in providing independent research under the Section 28(e) safe harbor is that investment managers scrupulously review their commission outlays for both execution and research services, maintain strict budgets for such purposes, and demand competitive commission rates and low ratios for the services being provided. Over the past few years, commission rates have fallen and ratios (i.e., the amount of commissions required to obtain a given level of independent research) have fallen dramatically. In our view it is unlikely that the research and execution services used by investment managers could be obtained for less if they were independently offered and separately priced.⁶

We believe that regulatory initiatives should be focused on ensuring that investment managers, and those who oversee their work (e.g., mutual fund boards) continue to receive all of the information necessary to determine whether portfolio commissions are being put to good use. In contrast, the ICI's proposal would retain the Section 28(e) safe harbor only for broker-dealers which provide proprietary research,

⁶ In fact, the U.K. Financial Services Authority in Consultation Paper N. 176 (April, 2003) stated that bundling can reduce transactions costs, that is, overall it is cheaper for consumers (i.e. investors) to buy in a bundle rather than seeking out services from several different suppliers.

where traditionally separate and detailed financial information is not provided to assist the fiduciary in analyzing the cost of the services purchased in a bundled arrangement.

In response to competitive pressures, and best practices developed by the SIA, AIMR and the Alliance, virtually all broker-dealers providing third party research services in the U.S. 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 independent research dissemination process precise and transparent and has benefited fiduciaries and their accounts by bringing them accurate cost and benefit information. With this information in hand, investment managers can not only select research most suited to their needs, but can also determine the most cost-effective arrangement with broker-dealers. Moreover, this information is readily available to the managed accounts.

We support disclosure provisions, such as those found in The Mutual Funds Integrity and Fee Transparency Act, H.R. 2420, which would allow fund managers and directors to assess the value of research provided under Section 28(e) arrangements. We believe that such information is already made available in the vast majority of third party research arrangements in effect today. We ask only that any such requirements be applied uniformly to all research arrangements under Section 28(e), and not just to independent third party research arrangements

The ICI's Proposal To Exclude Computer Hardware And Software And Other Electronic Communication Facilities From The Section 28(e) Safe Harbor Ignores The Important Contribution These Services Make To The Investment Decision Process

Due to technological innovations, the types of research being provided to the investment management community have expanded to include not only investment information but also 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. Many of these quantitative and qualitative improvements in services can be directly attributed to Section 28(e) and to the Commission's express recognition in 1986 of the value of computerized research services and real-time financial information as a legitimate component of research.⁷ Eliminating this type of research from the Section 28(e) safe harbor, as the ICI suggests, would turn back the clock on these technological innovations. Furthermore, it would discriminate against investment managers who rely on technical analysis, rather than traditional investment research, to provide advice to their clients.

The regulatory setting fostered by the Commission 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 development in virtually all securities markets of electronic trading, clearing, settlement and straight-through-processing, all of which have enhanced the investment decision process.

⁷ See 1986 Release.

Because investors are now able to select from a broad menu of research services specifically suited to their requirements, the U.S. securities markets are the most efficient in the world. 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 investors.

We believe that 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 of a particular product or service for the Section 28(e) safe harbor should not be grounded in whether it reflects a mode of delivery or a type of information (e.g., market data versus an analysis of a company's sales prospects), but rather whether the service or product represents a useful tool to the fund manager in the investment decision making process.

The Alliance Opposes The ICI's Recommendation That The Commission Preclude Investment Advisers From Using Client Commissions To Purchase Products Or Services Outside The Section 28(e) Safe Harbor

The ICI has asked the Commission to adopt a rule under Section 206(4) of the Investment Advisers Act that would prohibit any investment adviser from using client commissions to pay for any products or services used by the adviser that fall outside the Section 28(e) safe harbor. Similar to many of its proposals in the December 16, 2003 letter, this ICI proposal contains no factual basis or evidence of investor harm which would support such a prohibition on otherwise legitimate conduct. We believe that existing principles of fiduciary law provide more than adequate protection to clients of

investment advisers involved in such arrangements. We further submit that the ICI's suggestion would be an unwarranted intrusion on the right to contract, and would significantly alter the economics of arrangements that are already in place. For these reasons, we oppose the ICI's suggestion.

Existing state fiduciary laws typically require an investment adviser who wishes to obtain a product or service for its own use and to pay for it with client portfolio commissions to fully disclose the arrangement and receive the consent of its client(s). In reliance on such laws many investment advisers, particularly advisers to hedge funds, have entered into contractual arrangements with their clients which allow the adviser to use portfolio commissions to pay for products and services outside the Section 28(e) safe harbor. Such arrangements represent an informed decision by the parties to allocate the costs of their relationship in a particular way, and should not be disturbed. An adviser who fails to fully disclose the parameters of such an arrangement, or who violates some other fiduciary principle, would be subject to liability under general fiduciary law and under the anti-fraud provisions of the Investment Advisers Act of 1940. Given the fact that adequate investor protections exist, we see no reason to call upon the government to dictate the manner in which private parties interact with each other in this instance.

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We hope that these comments assist you in concluding that the ICI proposals discussed above would harm independent research, competition and investors. Members of the Alliance would welcome the opportunity to further communicate with you, other members of the Commission or the Commission Staff regarding our comments.

The Hon. William H. Donaldson

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Please do not hesitate to contact 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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