

**THE ALLIANCE IN SUPPORT OF INDEPENDENT RESEARCH**

c/o Pickard and Djinis LLP  
1990 M Street, N.W.  
Washington, D.C. 20036

Telephone  
(202) 223-4418

Telecopier  
(202) 331-3813

February 23, 2004

Mr. Jonathan G. Katz  
Office of the Secretary  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-0609

Re: File No. S7-29-03

Dear Mr. Katz:

The Alliance in Support of Independent Research (“Alliance”) is pleased to have this opportunity to comment on File No. S7-29-03 (the “Concept Release”), a release discussing issues related to disclosure of mutual fund transaction costs. As a group of broker-dealers furnishing research and other support services to advisers and their clients, including mutual funds, we focus our comments on the issues regarding disclosure of, and accounting for, research-commission arrangements under Section 28(e) of the Securities Exchange Act of 1934.

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

E\*TRADE Institutional Securities  
Susan Holgate, VP of Institutional Brokerage

The Interstate Group,

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

Knight Equity Markets L.P.  
James P. Smyth, Managing Director  
Joanne Mascellino, President, Donaldson & Co. Division

LaBranche Financial Services, Inc.  
Richard Fremont, Vice President

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

We believe our members are involved in a significant portion of the arrangements 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 Section 28(e) of the Securities Exchange Act of 1934 provides to fiduciaries who receive all forms of investment research. A primary goal of the Alliance is to promote 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 mutual fund transaction costs.

### **Introduction**

As noted, this comment letter focuses principally on issues concerning the disclosure and accounting of research-commission arrangements under Section 28(e) involving mutual funds. The Alliance supports measures which would provide mutual fund boards with information necessary to evaluate the quality of executions received by a fund and the efficacy of research-commission arrangements entered into by a fund's adviser. The Alliance believes, however, that in some instances the Concept Release's discussion of these matters unfairly casts aspersions on the practice of advisers obtaining research services for commissions and may have the unintended consequence of discouraging mutual funds from participating in such arrangements. Certain questions raised in the Concept Release are based in part on perceptions about conflicts of interest between advisers and their mutual fund clients that, in some cases, may be mistaken. Moreover, the Concept Release suggests the possibility of disparate treatment of independent third party research arrangements as compared to proprietary research arrangements. Because many of the questions raised in the Concept Release are based on assumptions that do not reflect actual industry practice with respect to independent third party research arrangements, we believe it helpful to the Commission to first set forth the current standards for the provision of research and other services under such arrangements, as well as the manner in which they are provided. Following this, we provide specific comment on certain issues discussed in the Concept Release.

**A. The Provision Of Research And Other Services And Their Benefits To Investors**

**History of Research-Commission Arrangements and Section 28(e)**

Because broker-dealers are deeply involved in the investment decision-making process through their execution and trading activities, it follows that they would also provide research and other advisory services to investors. Indeed, the practice of providing both trade execution and investment research in exchange for commissions may go all the way back to the opening of the New York Stock Exchange in 1792. Several large full-service broker-dealers have annual budgets of several hundred million dollars or more devoted to research analysts and evaluation of investment opportunities. Other firms service their institutional accounts by providing research services and analytical tools developed or authored by organizations that are independent of the broker-dealer furnishing the service. Arrangements for the provision of independent research are estimated to involve approximately \$1 billion of institutional commissions on an annual basis. Commissions committed to proprietary research and execution-only trades are estimated to be about \$9 billion annually.

**The Origins Of Research-Commission Arrangements**

Fiduciaries such as investment advisers and mutual fund portfolio managers, as well as investors acting on their own behalf, are inclined to give a portion of their order flow to broker-dealers who can assist in the investment decision-making process by providing valuable investment ideas or tools. Brokers receive commissions or other forms of compensation on securities transactions, instead of cash, as payment for the execution and research services they furnish to investors. For some time, investors have preferred this bundled approach for acquiring investment

research. Like many other types of businesses, securities market participants have elected for reasons of economic efficiency and competitive pressures to transact business for combined services ( executions and research) for one charge.

### **Legal Underpinnings Of Research-Commission Arrangements**

Federal law, regulations and interpretations of the SEC and other governmental bodies are the foundation for research-commission arrangements or “Section 28(e)” arrangements.

### **Provision Of Research Under Section 28(e) Of The Securities Exchange Act Of 1934**

A research-commission arrangement under Section 28(e) of the Securities Exchange Act of 1934 is one in which a broker-dealer provides research services to a fiduciary, such as an investment adviser or bank, who manages other people’s money. In such an arrangement, the fiduciary seeks and uses the research to assist in the investment decision-making process on behalf of account beneficiaries. The beneficiary pays for the research indirectly with commissions on portfolio transactions that the broker-dealer effects for its account.

Commission rates on exchanges have been competitive only since 1975. Before that time, commission rates on portfolio transactions generally were fixed by law and had been throughout the history of the New York Stock Exchange. Under the old fixed rate system, money managers were able to obtain research through expenditure of their accounts’ commissions without incurring additional costs to the accounts, since commission rates were the same regardless of whether the broker-dealer provided research. Because commission rates were fixed by law, the practice of providing research services to fiduciary accounts eventually was prevalent, as much as brokers

recognized the need to compete for orders on the basis of services rendered. In this way, brokers came to provide necessary support for the professional fiduciaries' internally-developed advisory functions. These business relationships and expectations that evolved between fiduciaries and their accounts continue today in the era of competitive commission rates.<sup>1</sup>

When commission rates on exchanges were made competitive in 1975, a large segment of the investment community was concerned that the flow of research would be restricted. Money managers feared that fiduciary principles would or could require fiduciaries to operate under the principle that "cheapest is best" and that only the lowest cost execution would avert a lawsuit for failure to obtain best execution. In response to these concerns, Congress passed Section 28(e) of the Securities Exchange Act of 1934, a safe harbor for fiduciaries who receive research services in consideration of portfolio commissions, to ensure the continued availability and quality of research in the competitive commission rate environment. The Congressional hearings on this provision reflect the notion that without Section 28(e) protection, the flow of research previously furnished to institutions under a fixed commission rate structure could be cut off to the detriment of investors.<sup>2</sup>

Both Congress and the SEC have taken steps to ensure that the legal standards under which brokers provide research to fiduciaries protect the interests of investors. Section 28(e) itself limits

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<sup>1</sup>According to the Senate Committee Report accompanying the Securities Act Amendments of 1975, which included Section 28(e), existing investment management relationships, including the size of the management fee, were based, in part, on an environment that enabled the manager to obtain research and other services from broker-dealers, which services were paid out of portfolio brokerage and were not an expense of management. In addition, certain state laws, regulations, and customs regulated the maximum administrative expenses chargeable to a trust estate, mutual fund, or other managed portfolio in contemplation of the fixed rate environment.

<sup>2</sup> Securities Act Amendments of 1975, Report of Comm. 75, No. f 1994o th

the definition of “research” that can be obtained for commissions, and requires the fiduciary to determine that the commissions paid are reasonable in relation to the research and brokerage services provided. The SEC also has placed limits on the manner in which broker-dealers may provide research under Section 28(e) by, for example, limiting the use of compensation on principal transactions to pay for research.<sup>3</sup> In addition, the law requires investment advisers and mutual funds to disclose their brokerage arrangements to investors.<sup>4</sup>

### **Benefits To Investors From Research-Commission Arrangements**

Investors reap a number of benefits from the research-commission arrangements described above:

#### § Flow of Research Services to Money Managers

One of Congress’s principal objectives in adopting Section 28(e) was to ensure “the future availability and quality of research and other services” to the investment community.<sup>5</sup> Congress adopted Section 28(e) to address the concern that investors would suffer if competitive commission rates were to impede the flow of research services to money managers. Events over the past 25 years demonstrate that Section 28(e) has indeed facilitated the flow of research to investment managers.

Broker-dealers now provide literally hundreds of research services to money managers to assist in the investment decision-making process. The vast majority of these research services have only become available to money managers since Congress adopted Section 28(e) in 1975. These

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<sup>3</sup> See SEC Rel. No. 34-45194 (Dec. 27, 2001).

<sup>4</sup> See e.g., Part II of Form ADV, Items 12 and 13; Form N-1A Item 16.

<sup>5</sup> Report of the Comm. On Banking, Housing and Urban Affairs, S. Rep. 94-75 (1975).

services include not only investment information but fundamental databases, portfolio modeling, and strategy software. Equally significant, the technology for the delivery, formatting, and use of information has made research more accessible to the investor and has added greatly 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.

The Section 28(e) safe harbor has been particularly useful in fostering the development of independent research providers. 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. Often independent research providers generate research through innovative and unique methodologies. It is extremely difficult for a small independent research provider with a limited marketing budget to gain a foothold in the market for investment research. Section 28(e) 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 investors.

§ Competition Among Broker-Dealers Providing Research Has Reduced Execution Costs

By becoming major competitors for institutional order flow, research brokers have exerted downward pressure on commission rates. Since commission rates became unfixed in 1975, execution costs have declined significantly. The SEC Staff's 1998 Inspection Report on the Soft Dollar Practices, of Broker-Dealers, Investment Advisers and Mutual Funds (the "1998 Inspection Report"), found commission rates of about \$0.06 per share for those institutional accounts examined

by the SEC Staff. The Alliance's belief is that commission rates have fallen even further in the six years that have elapsed since the 1998 Inspection Report.

§ Smaller Asset Managers Have Benefited From The Favorable Regulatory Environment For Providing Research In Conjunction With Execution

In its deliberations on Section 28(e), Congress recognized that without highly developed internal research resources, smaller money management firms might be required to rely entirely on Wall Street research. According to the congressional record on 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.<sup>6</sup>

What was true in 1975 is still 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. Section 28(e) 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 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. 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.

**How Investors Are Assisted By Research-Commission Arrangements**

A money manager's receipt of research services from a broker-dealer for commissions occurs under the statutory guidelines of Section 28(e). The conditions of Section 28(e) coverage were fashioned so as to protect investor assets and insure that research obtained with client commissions is used for the benefit of the investor.

§ Statutory Guidelines for Use of Commission Dollars

Under a proper Section 28(e) arrangement, a fiduciary may use commissions only to acquire services that are useful in the investment decision-making process. A fiduciary may not, for example, use commissions for administrative expenses without being exposed to liability under various laws. If a research service to be obtained for portfolio commissions has the potential to provide administrative or non-research assistance to the money manager, Section 28(e) guidelines require the money manager to allocate the cost of the service according to its use. Where a research service has a "mixed-use," only that percentage of the service attributable to the investment decision-making process may be paid for with commission dollars. The fiduciary must use its own resources to pay for that portion of the service that provides non-research assistance to the fiduciary. Further, a fiduciary may not use commissions to acquire research unless it has investment authority over the account.

A fiduciary who uses commissions to obtain research must determine in good faith that the commissions are reasonable in relation to the brokerage and research services received. In this way, Section 28(e) provides protection only where the beneficiary receives fair value for its commissions. Moreover, the SEC has determined that only commissions on agency securities transactions and

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<sup>6</sup> Report of the Comm. On Banking, Housing and Urban Affairs, S. Rep. 94-75 (1975).

compensation earned on certain riskless principal transactions support a proper arrangement under Section 28(e).<sup>7</sup> A money manager may not obtain research with trades where the compensation the broker-dealer earns is not readily identifiable.

§ Current Disclosure Requirements

Current SEC disclosure requirements for advisers have also worked to protect investors' assets in research-commission arrangements. Even where such an arrangement falls within Section 28(e), the SEC requires a registered investment adviser to disclose its brokerage allocation practices on its Form ADV. Registered investment companies are required to make similar disclosures in their registration statements.<sup>8</sup>

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 its clients all potential or actual conflicts of interest that might influence it, 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 advisers and mutual funds disclose all basic information about the provision of research to investors. Through these disclosures, investors are given sufficient information to judge whether the use of their commissions for research is in their best interest and whether they are being properly served by their adviser.

In addition to required disclosures, competitive pressures and business practices have led broker-dealers who provide independent research services to fiduciaries to produce and deliver customer statements indicating the cash value of the research provided to the customer and the

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<sup>7</sup> See SEC Rel. No. 34-45194 (Dec. 27, 2001).

aggregate commissions used to pay for the research. This type of accountability has made the research dissemination process more efficient and has benefited the fiduciary and its accounts by bringing them accurate cost and benefit information.

### **The Concept Release's Discussion Of Transparency Of Research-Commission Arrangements**

The Concept Release indicates that: “[t]he limited transparency of soft dollar arrangements may provide incentives for managers to misuse soft dollar services.” The Alliance disagrees with the factual predicate for this statement, as well as its conclusion. With respect to the transparency of independent third-party research arrangements, it is our view that virtually all broker-dealers participating in such arrangements 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. With this information investment managers can select the research most suited to their needs and can also determine the most cost-effective arrangement with broker-dealers. Fiduciaries in turn disclose their commission-research practices to their accounts pursuant to SEC requirements. Moreover, specific information regarding research-commission arrangements is readily available to the managed accounts, allowing them to monitor the activities of the investment manager if they so choose. Finally, there has been relatively little abuse found in regard to Section 28(e) arrangements, particularly with respect to mutual funds, as confirmed by the SEC’s 1998 Inspection Report.

The Alliance also does not agree with the Concept Release’s statement that money managers have incentive to misuse research-commission arrangements. The implied premise of this statement

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<sup>8</sup> See Form N-1A Item 16.

is that research benefits the adviser instead of its account, whereas in fact the research is obtained for the benefit of the accounts. Moreover, an adviser has a direct interest in using its clients' commissions wisely in obtaining investment research. To the extent the account manager is successful in maximizing the value of research services obtained and minimizing commission costs, its managed accounts expand in value. Superior account performance not only increases an adviser's assets under management, and thus its management fee, but also serves as a marketing advantage in obtaining additional business. Thus a money manager's primary incentive (not to mention its fiduciary duty) under the current regulatory structure is to use its client's commissions efficiently to obtain the most cost-effective investment research available.

### **Comments On Specific Questions Raised In The Concept Release**

#### **General Questions about Quantifying Transaction Costs**

Is investor decision-making harmed because investors lack numerical information about mutual fund transaction costs? [**Comment:** The Alliance believes that the current level of quantifiable information about mutual fund transaction costs is adequately disclosed to investors in the fund's prospectus and statement of additional information. Mutual fund investors have chosen to invest in a managed investment vehicle. The day-to-day monitoring of such costs as commissions, spreads, market impact costs, opportunity costs, etc., which are difficult to understand and not agreed upon even by experts, is better left to fund boards who are in a superior position to monitor such costs. The Alliance supports provisions which would assist fund boards in obtaining the information they need to perform this monitoring function, and believes that its members, and the

vast majority of broker-dealers involved in independent research arrangements, currently provide necessary information to fund advisers for the purpose of evaluating whether fund investors are properly served through such arrangements.]

### **Questions about Quantifying Commissions and Spreads**

Would a requirement to quantify and disclose brokerage commissions, but not other transaction costs, provide useful information to fund investors? What effect, if any, would a requirement to quantify commissions have on the incentive of fund managers with respect to (1) use of principal versus agency transactions; and (2) use of soft dollar transactions? [**Comment:** As noted in the Concept Release, commission costs are already disclosed to mutual fund advisers on a transaction-by-transaction basis through confirmations, and to mutual fund investors through the fund's statement of additional information. The disclosure of commissions has provided an additional data point which may be helpful to a fiduciary in making his determination of the reasonableness of a commission-research arrangement. As discussed below, the Alliance believes that any further disclosure or accounting provisions adopted by the Commission in respect of commissions should be applied equally to all research-commission arrangements, independent and proprietary alike.]

### **Questions about Accounting Issues**

Would it be feasible to account for some or all transaction costs as an expense in fund financial statements? If it is not feasible to reliably measure market impact and opportunity costs should we still require that commission costs be expensed? If yes, should the requirement apply to all commission costs or only those commission and spread costs that do not relate to the execution and clearing of portfolio transactions (i.e., soft dollars)? If it is not feasible to reliably measure all research costs, should we still expense those costs that can be reliably measured (i.e., payments to third parties for research)? **[Comment:** The Alliance does not believe it is necessary to require a mutual fund to break out execution costs from other services rendered by a broker-dealer for a commission and in the instance of many services (e.g. proprietary research) it may not be feasible to do so. Furthermore, the Alliance believes that assigning special accounting treatment to commissions used to obtain independent third party research would provide an incomplete and misleading picture to investors regarding a fund's use of commissions to obtain research, especially given the fact that the substantial majority of research-commission arrangements involve proprietary research where the research cost is not separately stated. Finally, requiring mutual funds to expense the cost of independent research, but not proprietary research, would have the consequence of discouraging the use of independent research arrangements.]

Since soft dollars are earned based on complex-wide trading activity, how should research and other non-execution costs be allocated among funds? Can soft dollars be traced to individual portfolio transactions? (This would entail adjusting the basis of the securities purchased in those transactions for the portion of the commission cost that was used to purchase research services.)

[**Comment:** The Alliance believes that requiring fiduciaries or accounts to allocate research costs to individual portfolio transactions or accounts would be inconsistent with one of the primary tenants of Section 28(e), which is that the value of the brokerage and research services provided by a broker-dealer in a Section 28(e) arrangement may be viewed in terms of either a transaction or the fiduciary's overall responsibilities with respect to all accounts as to which he exercises investment discretion. Indeed, a fundamental premise of Section 28(e) is that the tracing of research benefits to specific accounts is not feasible or practical and that holding a fiduciary to such a calculation would mean uncertainty and potential liability. In addition, as a practical matter research use and commission expenditures over the long run tend to match off and Section 28(e)'s coverage is reflective of this condition.]

### **Questions about Board Review of Transaction Costs**

Should boards be required to receive reports with mandated information regarding soft dollars and directed brokerage payments? [**Comment:** As noted above, the Alliance supports provisions which would assist fund boards in obtaining the information they need to monitor the execution quality received by the fund and the efficacy of research-commission arrangements entered into by the fund's adviser. We believe this type of information is already being provided to mutual fund advisers with respect to independent research arrangements, and is available to fund boards. The Alliance believes that the format of the information to be reviewed by a fund board regarding such arrangements would be best determined by the fund board based upon the particulars of each arrangement. If mandated reporting provisions are adopted, they should apply equally to

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all research-commission arrangements, including arrangements for the provision of proprietary research.]

Should fund advisers be required to provide fund boards with an internal allocation of their uses of brokerage commissions, indicating the amounts and percentage used by the adviser to obtain execution services and soft dollar benefits, specifically detailing the types and amounts of various kinds of benefits? Should there be separate allocations among types of research, such as research produced by underwriters, or other broker-dealer affiliates? [**Comment:** As discussed above, the Alliance believes that the format of the information provided by a mutual fund adviser to a mutual fund board regarding the adviser's allocation of fund commissions would be best determined by the fund board based upon the particulars of each arrangement.]

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We hope these comments assist the Commission and its Staff in considering measures to improve disclosure of mutual fund transaction costs. Members of the Alliance would welcome the opportunity to further communicate with members of the Commission or the Commission Staff regarding our comments. Please call Lee A. Pickard or William D. Edick at 202-223-4418 if you have any questions.

Sincerely,

The Alliance In Support Of Independent Research

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By: Lee A. Pickard, Esq.  
William D. Edick, Esq.  
Pickard and Djinis LLP  
Counsel to The Alliance  
In Support Of Independent Research

cc: Hon. William H. Donaldson  
Hon. Paul S. Atkins  
Hon. Roel C. Campos  
Hon. Cynthia A. Glassman  
Hon. Harvey J. Goldschmid

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Division of Investment Management

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