

THE ALLIANCE IN SUPPORT OF INDEPENDENT RESEARCH

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Ms. Florence Harmon  
Acting Secretary  
Office of the Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549-1090

Re: File No. S7-22-08

Dear Ms. Harmon:

The Alliance in Support of Independent Research (“Alliance”) ([www.alliance-research.org](http://www.alliance-research.org)) is pleased to have this opportunity to comment on File No S7-22-08,<sup>1</sup> entitled “Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices.”

The proposed SEC guidance focuses on the role of an investment company board in overseeing the best execution obligations of the investment adviser hired to manage the fund, including conflicts of interest which may exist when an investment adviser uses fund brokerage to acquire services such as brokerage and research services. As a group of broker-dealers furnishing research, brokerage and other support services to institutional funds and other fiduciary accounts, we welcome further SEC guidance about proper execution practices, particularly as they relate to the dissemination of research services. In this letter, we offer suggestions as to how the guidance should be refined to assist fund boards in fulfilling their responsibilities.

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<sup>1</sup> SEC Rel. Nos. 34-58264; IC-28345; IA-2763 (July 30, 2008) (hereinafter the “Release”).

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

BNY ConvergeX Group, LLC  
John D. Meserve, Executive Managing Director

Capital Institutional Services, Inc.  
Kristi P. Wetherington, President and CEO

Knight Capital Group, Inc.  
Timothy J. Conway, Director  
Thomas M. Merritt, Esq., Chief Legal Officer  
Paul Wagenbach, Esq., Vice President, Assistant General Counsel

The Interstate Group Division of Morgan Keegan & Co., Inc.  
Grady G. Thomas, Jr., President  
Jay Thomas, Chief Operating Officer

State Street Global Markets, LLC  
Jeffrey Grossman, Senior Managing Director  
Michael X. Richey, Vice 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 independent 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 independent 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 the observance of proper standards under the securities laws for disseminating research and achieving best execution of portfolio transactions for managed accounts.

## Introduction

The Release addresses a fund board's obligation to oversee trading practices of fund advisers, and suggests the type of review a fund board should conduct to satisfy this obligation. In the process, the SEC emphasizes that the proposed guidance does not impose any new or additional requirements on trading practices or soft dollar arrangements but rather assists fund directors in fulfilling their responsibilities in overseeing trading of securities by funds.

## Fund Board Oversight of Best Execution

Consistent with earlier pronouncements on best execution,<sup>2</sup> the SEC states that an investment adviser seeking to execute securities transactions for clients must do so in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances. Citing factors involved in seeking to maintain best execution, the SEC notes that commissions and the full range and quality of a broker's services, including the value of research provided in connection with the execution process, are important in fulfilling this objective. As providers of research for portfolio commissions, we appreciate the SEC's acknowledgement of the provision of research as value added in assessing best execution.

The Release acknowledges that investment advisers with clients that are funds employ a wide range of procedures in selecting broker-dealers for fund transactions and that each adviser must determine which trading intermediary selection process is most appropriate for its circumstances. Here, we appreciate the SEC's explanation that best execution does not impose a single set of universally applicable required elements for the portfolio execution process because advisers are too varied in their operations.

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<sup>2</sup> See SEC Release No. 34-23170 (April 23, 1986).

Fund Board Oversight of an Adviser's Use of Fund  
Brokerage for Research and Other Services

The Release describes in some detail the methodologies by which an investment adviser may use a portion of fund brokerage commissions to benefit the fund beyond execution of securities transactions. First, a fund adviser may use fund brokerage commissions to purchase research and/or research-related services in accordance with Section 28(e) of the Exchange Act. The research may be “proprietary” research, produced by the broker-dealer executing the securities transaction or its affiliates, or it may be “third-party” research, produced or provided by someone other than the executing broker-dealer. Furthermore, the SEC notes that investment advisers may obtain proprietary and third-party research through a “client commission arrangement.” The SEC goes on to define a client commission arrangement as an arrangement in which an investment adviser agrees with a broker-dealer effecting trades for the adviser’s client accounts that a portion of the commissions paid by the accounts will be credited to purchase research either from the executing broker or another broker, as directed by the adviser.<sup>3</sup>

Further, the SEC says that in addition to obtaining research and research-related services with fund brokerage commissions, an adviser may use fund brokerage commissions in other ways. For example, an adviser may utilize a commission recapture arrangement (pursuant to direction of the fund), whereby the fund receives a portion, or rebate, of the brokerage commission (or spread) charged by the broker-dealer handling the trade. Additionally, an investment adviser may use fund brokerage to pay certain providers for services utilized by the fund through an expense reimbursement arrangement with a broker-dealer. The description of

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<sup>3</sup> See SEC Rel. No. 34-54165 (July 18, 2006 – sometimes referred to hereinafter as the “2006 Release”) at Section III (interpreting Section 28(e) to permit the industry flexibility to structure arrangements that are consistent with the statute and best serve investors).

these permissible soft dollar activities provide helpful guidance to fund directors in assessing the proper use of fund commissions for obtaining research services.

The SEC in its proposed guidance then identifies several examples of what it perceives to be conflicts of interest that may arise when investment advisers use fund assets to obtain services.

### Use of Fund Brokerage Commissions to Obtain Research

The Release states that the use of fund brokerage commissions to buy research may relieve an adviser of having to produce the research itself or having to pay for the research with “hard dollars” from its own resources.

#### **Comment:**

*The stated conflict of interest is neither universally true nor accurate. Client accounts, and not advisers, are the beneficiaries of research provided under Section 28(e). The safe harbor requires that advisers use research in the investment decision making process for their clients. We also note that it is usually not the case that the research would be paid for or produced by the adviser if not obtained for soft dollars because in many instances the adviser does not have the capacity to produce the research itself or the resources to pay for the research from others.<sup>4</sup> Research services received under Section 28(e) arrangements supplement the investment decision process of advisers rather than substitute for their own efforts.*

### Incentives to Trade and Broker-Dealer Selection

The Release says that advisers using soft dollars may have an incentive to trade the fund’s portfolio in order to earn soft dollar credits and to use broker-dealers on the basis of their research services provided to advisers rather than the quality of executions.

#### **Comment:**

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<sup>4</sup> Indeed, in adopting Section 28(e), Congress noted that the provision would assist smaller advisers, without the resources to commit to financing research, in competing with larger advisers, to the benefit of investors. See Securities Act Amendments of 1975, Report of Comm. On Banking, Housing and Urban Affairs, S. Rep. No. 75, 94<sup>th</sup> Cong., 1<sup>st</sup> Session (1975) (hereinafter S. Rep. No. 75).

*It is a misconception that advisers who participate in soft dollar arrangements might sacrifice best execution. We see no evidence that advisers compromise or disregard execution quality in submitting portfolio transactions to broker-dealers who provide research. Indeed it is our members' experience that execution quality is a primary consideration of fiduciaries in the broker selection process. Of importance, we note that because of the flexibility provided by the 2006 Release an adviser may now select a broker solely on its execution capabilities and still receive the research it desires from another broker-dealer or non-broker-dealer research preparer. Thus, the conflicts of interest identified by the Release would not appear relevant to the operations of an adviser participating in a client commission arrangement. Finally, the SEC has repeatedly stated that the value of research services is an important part of a best execution analysis<sup>5</sup> and thus it is logically inconsistent to suggest that an adviser must decide between research and best execution.*

### Allocation of Research Benefits to Commission Payments

In the proposed guidance, the SEC identifies as a conflict of interest an adviser seeking to use fund brokerage to obtain research that benefits the adviser's other clients who may not have generated commissions or have paid lower commissions.

#### **Comment:**

*The safe harbor of Section 28(e) includes a statutory recognition that research cannot be allocated in proportion to the soft dollar credits utilized to obtain the research. Few if any advisers allocate or are capable of allocating soft dollar benefits proportionately. Suggesting that advisers be judged on whether they allocate soft dollar benefits to clients proportionately is unrealistic and contrary to the premise of Section 28(e).<sup>6</sup> Evaluating an adviser's use of fund brokerage commissions on whether they allocate soft-dollar benefits in proportion to credits from specific client accounts suggests that credits can be allocated in this manner and implies that the adviser who does not allocate credits proportionately is not fulfilling its responsibilities. In this regard, we believe that fund directors should instead review the adviser's disclosure (note, disclosing that soft dollars may not benefit all accounts is current practice) and confirm the accuracy of the disclosure.*

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<sup>5</sup> See SEC Rel. No. 34-2323170 (Apr. 23, 1986) at 32 ("A money manager should consider the full range and quality of a broker's services in placing brokerage including, among other things, the value of research provided as well as execution capability, commission rate, financial responsibility, and responsiveness to the money manager.")

<sup>6</sup> S. Rep. No. 75.

The Release Suggests that Advisers Consider Commission Recapture  
as a Substitute for Obtaining Research with Commissions

The Release identifies as a conflict of interest that using fund commissions to obtain research could cause an adviser to avoid other uses of fund brokerage commissions such as establishing a commission recapture program.

**Comment:**

*Commission recapture arrangements are entered into by clients, not investment advisers, and it has never been suggested that an adviser has any duty to recommend or suggest commission recapture arrangements to clients.*

Approval by Fund Boards of Advisory Contracts

The SEC maintains that a fund board should consider an adviser's receipt of soft dollar "benefits" on reviewing the adviser's compensation in connection with the approval of the advisory contract under Section 15(c) of the Investment Company Act.

**Comment:**

*The notion that the receipt of research by the adviser should be a consideration in his or her level of compensation is troublesome because it implies that research received through client commission arrangements benefits the adviser, rather than the fund and its investors.<sup>7</sup> To the contrary, as discussed above, Section 28(e) requires that the research be used in the investment decision process to benefit client accounts.*

*Research received in a Section 28(e) arrangement cannot be considered as compensation to the adviser. In adopting Section 28(e), Congress found investment managers relied on portfolio activity to generate research from brokers, and specifically sought through the adoption of Section 28(e) to preserve the environment which enables investment managers to obtain research from broker-dealers through the use of portfolio*

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<sup>7</sup> We do not agree that the dicta in Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923 (2d Cir. 1982) can be read to require a fund board to consider soft dollar "benefits" to an adviser when approving an advisory contract under Section 15(c). The Gartenberg case, which rejected a shareholder derivative claim that a mutual fund adviser's fee was excessive under Section 36(b) of the Investment Company Act, did not consider or address research received by an asset manager under Section 28(e) and merely opined that "quantifiable" benefits to an investment manager or its affiliates should be considered to determine whether they were "so substantial" as to render the manager's fee "disproportionately large." 694 F. 2d at 932. As discussed above, research received in Section 28(e) arrangements benefits a manager's accounts, not the manager, and by its very nature is not quantifiable.

*commissions and not at the expense of the investment manager. Indeed, Congress was concerned that the inability of an investment manager to receive investment research by using client commissions would harm investors.<sup>8</sup> Suggesting that there be an offset of the value of research against an adviser's compensation constitutes an indirect way of having the adviser shoulder the cost of the research, contrary to the very purpose of Section 28(e).*

*Without the Section 28(e) safe harbor, Congress found that the future availability and quality of research would be jeopardized with potential harmful consequences to all investors.<sup>9</sup> We submit that similar results would occur if fund boards were required to conduct their oversight responsibilities on the assumption that research benefits the adviser rather than the fund and therefore the adviser's compensation should be effected thereby. Such would have a damaging effect upon the dissemination of research and would be harmful to the investment process.*

### Parity of Treatment Between Third Party and Proprietary Research Arrangements

In the July 2006 Release, the Commission confirmed its long held position that the Section 28(e) safe harbor encompasses third party research and proprietary research on equal terms, and noted that “[t]hird-party research arrangements can benefit advised accounts by providing greater depth and breadth of research.”<sup>10</sup> Our members are concerned that third-party research arrangements under Section 28(e) may be subjected to a higher level of scrutiny by fund boards than are proprietary research arrangements, merely because of the paucity of information available regarding the value of research in proprietary arrangements. We therefore ask that the Commission clarify in its final guidance to fund boards that any board review of soft dollar arrangements entered into by an adviser to the fund include a review of both third-party as well as proprietary research arrangements.

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<sup>8</sup> See S. Rep. No. 75 (indicating that if money managers were not able to use client commissions to pay for research “. . . the future availability and quality of research and other services . . . could be jeopardized, with potentially harmful consequences for investors”)

<sup>9</sup> See *supra* footnote 8.

<sup>10</sup> 2006 Release, 71 Fed. Reg. 41992.

### Conclusion

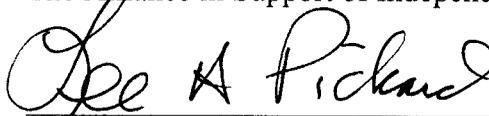
We hope that these comments assist the Commission and its staff in issuing final commission guidance regarding the duties and responsibilities of investment company boards of directors with regard to execution practices of advisers and soft dollar arrangements. We ask, however, that the guidance to fund boards give recognition to the important role research plays in the execution process and that the unwarranted and inaccurate statements in the proposed guidance about conflicts of interest respecting soft dollar arrangements be eliminated. In particular, we do not believe the receipt of research by an adviser under an arrangement that meets the requirements of the Section 28(e) safe harbor calls for a review of the adviser's compensation under Section 15(c) of the Investment Company Act. Congress, in passing Section 28(e), never contemplated that advisers would have to indirectly bear the cost of Section 28(e) research, and such a result is inapposite to fostering the flow of research, a principal purpose of Section 28(e).

Members of the Alliance would welcome the opportunity to further communicate with members of the Commission or the Commission's 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



by: Lee A. Pickard  
William D. Edick  
Pickard and Djinis LLP  
Counsel to the Alliance in Support of Independent Research

cc: The Honorable Christopher Cox  
The Honorable Kathleen L. Casey  
The Honorable Elisse B. Walter  
The Honorable Luis A. Aguilar  
The Honorable Troy A. Paredes  
Andrew J. Donohue, Director, Division of Investment Mangement