

November 21, 2005

**Via Electronic Mail (rule-comments@sec.gov)**

U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549  
Attention: Jonathan G. Katz, Secretary

**Re: File No. S7-09-05 — Commission Guidance Regarding Client  
Commission Practices Under Section 28(e) of the Securities Exchange  
Act of 1934, SEC Release No. 34-52635 (November 19, 2005)**

Ladies and gentlemen:

We are responding to the Commission's request for comments in the above-captioned release (the "Release"). We commend the Commission for presenting a discussion that is at once comprehensive and sensible. The interpretive positions the Commission has expressed are, in the main, well taken and we believe are consistent with the congressional intent expressed in Section 28(e). By emphasizing the investment manager's duty of best execution and looking toward greater disclosure in the use of client commissions, we believe the Commission's proposed interpretation correctly articulates and advances the goals of Section 28(e).

**Use of Client Commission to Pay for the BLOOMBERG PROFESSIONAL Service**

The SEC has proposed that physical items, such as computer hardware, will be outside the safe harbor, while computer software used in research would fall within the safe harbor. We applaud this "bright line".

As the Commission knows, the BLOOMBERG PROFESSIONAL Service is a software research tool that incorporates more than 14,000 complementary and integrated functions that not only provide market, financial, and economic data but also organize that data using proprietary methodology, presented in proprietary analytics. Portfolio managers benefit from the depth and range of our data and analytics, facilitating their own analyses and informing their investment decisions.

At one time, Bloomberg terminals were just that — dedicated hardware delivering a closed-architecture system that provided data and performed data analysis. Several years ago, however, Bloomberg abandoned hardware and the closed-architecture model and opted instead to provide its media, data and securities platform services on the client's own hardware. Although some still refer to Bloomberg "terminals", that term is outmoded today. Computer hardware is no longer part of the core BLOOMBERG PROFESSIONAL Service product. Bloomberg L.P., on customer request, will provide hardware in connection with providing the BLOOMBERG PROFESSIONAL Service, but Bloomberg bills separately for any hardware provided, whether it be flat panels or personal computers.

Hardware is not covered by the basic charge for the BLOOMBERG PROFESSIONAL Service. The small percentage of clients who use commission to pay for their separate hardware charges should be prepared to discontinue that practice under the SEC's new guidance if they seek to avail themselves of the Section 28(e) safe harbor. By contrast, the Commission's interpretive statements under Section 28(e) should reassure the vast majority of our clients who use commission. Our clients who have historically been using commission to pay for research or brokerage on the BLOOMBERG PROFESSIONAL Service software should feel comfortable in continuing that practice.

**Equal treatment of proprietary and third-party research  
under Section 28(e) benefits investors**

The Commission's new interpretation of Section 28(e) is a welcome clarification and reaffirmation of the Commission's guidance in the 1986 interpretive release on Section 28(e), of the text of the statute itself and of the clear intent of the Congress. The Commission's emphasis on best execution is timely in that it coincides with both recent advances in technology and the evolution in market structure that give the buy side greater effective control over execution. We believe the broad discretion provided to money managers to identify and select the most efficient execution and high quality research is enormously positive.

We believe the Commission got the basic structure "right" in 1986, and we applaud the Commission for re-affirming that basic structure. We particularly wish to congratulate the Commission for clearly reiterating its longstanding position that Section 28(e) applies equally to full-service broker-dealers that provide their customers with brokerage and research services and to third-party research arrangements where a broker-dealer provides its customers with research products and services produced by third parties.

We believe the Commission's interpretation will encourage the development of what we call the "Best of Breed". What is the "Best of Breed"? For years, investors purchasing research might have been locked-into purchasing sub-par execution. The traditional third-party payment programs and Commission Sharing Arrangements (CSA) facilitated by the SEC's interpretive guidance will empower investors to obtain not only the best research to suit their needs, but also the best execution as well.

The Commission's actions come at a moment when advances in technology — and changes in market structure like Regulation NMS — promise to revolutionize execution. Indeed, the Commission's actions in creating an environment in which these technologies can flourish is worthy of praise. The technology that is now available via electronic trading platforms such as the Bloomberg Tradebook System enables investment managers to fulfill their best-execution duties quickly and efficiently. The Commission's interpretation has the effect of encouraging investors to purchase research services from third-party brokers independent of the broker used for execution — thus promoting investor choice in a more competitive environment. It frees investment managers to purchase high-quality research without having to put up with what may be mediocre or worse executions. Over the past five years, institutions have gained a better understanding of transaction costs and their negative effect on portfolio alpha. Buy-side traders have more execution choices such as direct market access, algorithmic trading, crossing networks, and more. They also have execution analytics such as Bloomberg's Execution Management System that enable traders to monitor transaction costs at each stage of the investment process — pre-trade for appropriate broker/strategy selection; working trade to monitor if the implementation is consistent with the expected goals of the execution strategy; and post-trade for research and evaluation to improve upon the execution process. The investment manager is thus able to look solely to best-execution considerations in choosing among executing brokers and at the same time to obtain, through the executing broker it has selected, the research it regards as best.

The Commission's interpretation also supports the continued existence and growth of independent research producers that are not susceptible to the pressures and conflicts that can arise from being part of a firm that engages in investment banking, market making or proprietary trading. As brokerage and research are each assessed by money managers on their own merits, it is investors who will benefit most.

Some have suggested the Commission depart from the 1986 interpretation, such as by banning third-party research. The Commission has wisely resisted those calls. The availability of third-party research — including third-party research tools like the BLOOMBERG PROFESSIONAL Service — has increased competition and diversity of opinion. It has meant that larger, integrated brokerage firms have been exposed to competition by middle-market and smaller research firms that, using commission, have been able to buy research from independent producers and use tools like the BLOOMBERG PROFESSIONAL Service to approximate the capacity of large research staffs. Money managers have availed themselves of this independent research and research tools and have no longer been so dependent on "Street" research, that is, the research produced in-house by the brokers with which they deal. The ability to pay with commission for third-party research and research tools has also dramatically lowered barriers to entry, permitting research analysts employed by the major brokerage firms to strike out on their own and provide independent analysis, despite an initial lack of resources. The equal availability of independent research permits investors to avail themselves of the data and analytics Bloomberg and other vendors provide, empowering investors not only to evaluate the research they receive from others, but also to formulate their own investment ideas and strategies.

In short, the structure the Commission has reaffirmed should provide a deeper, more diverse pool of research which will encourage a more efficient allocation of capital. Research providers, competing on a level-playing field in terms of ability to rely on commission, will help balance industry “cheerleading” and remedy potential conflicts of interest while encouraging independent corporate oversight and competition among asset managers.

The Commission has evaluated these issues over the course of many years and has wisely chosen a balanced approach, one that favors investor choice. We commend the Commission, therefore, for emphasizing the priority of best execution in this context; reiterating its view that third-party research should be treated the same as in-house research under Section 28(e); and rejecting self-interested calls to ban third-party research.

There are two proposed positions advanced in the Release, however, which we respectfully recommend that the Commission reconsider.

**The Commission’s proposed interpretation of  
post-trade analytics is inconsistent with Section 28(e)**

The first area where we respectfully suggest that the Commission should reconsider its proposed interpretive position is post-trade analytics. The Commission takes the position, quite sensibly in our view, that compliance-based products and services are not part of brokerage and research, but we believe it should not have concluded that post-trade analytics should be placed into that category. It is true also that post-trade analytics can be of help in an investment adviser’s review of its execution policies to meet best-execution duties. Nonetheless, many investment advisers in our experience conduct — or engage third-party consultants to assist them in conducting — analyses of the implicit costs of transacting, that is to say, the market impact of their trading and whether a particular broker, market venue or execution technique resulted in optimally low implicit transaction costs. Controlling implicit trading costs is vitally important to overall account performance. Analyses of those costs and the conclusions drawn from them, if sensibly used, can have significant impacts on future order-handling decisions the investment adviser makes. Indeed, in an increasingly electronic environment, it is rapidly becoming commonplace that data and analytics measuring market impact on immediately past transactions will immediately be taken into account by “smart routers”, operating on the basis of heuristic or “pathway” logic — measuring in real time the performance of an execution just completed in determining how to direct future order flow. These factors have important consequences for account performance and many investment advisers fully realize that today.

The Commission suggests in the release, erroneously we believe, that post-trade analytics are a mixed-use item because they assist a money manager in fulfilling its existing duty of best execution.<sup>1</sup> That proposition is at odds with the very purpose of Section 28(e) and, if anything, proves too much. After all, research itself helps the money manager fulfill its duty to

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<sup>1</sup> Release at n.98.

manage the money skillfully. Is there really a meaningful distinction between the duty of skillful management and the duty of best execution? We think not. Should that then imply in turn that research itself also be regarded as a mixed-use item? That surely would stand Section 28(e) on its head.

We respectfully suggest, therefore, that the Commission should not treat post-trade analytics as a mixed-use item. There is strong statutory support for treating post-trade analytics as “brokerage and research”. Section 28(e)(3)(A) and (B) define “brokerage and research” to include, *inter alia*, “advice . . . as to the desirability of . . . purchasing, or selling securities and the availability of securities or purchasers or sellers of securities” and “analyses and reports concerning . . . securities . . . and the performance of accounts.” To be sure, those statutory words were written 30 years ago, and there have been vast improvements in the availability of more and more complex and precise, computer-driven, measurement techniques since then. We suggest, in that regard, that the Commission should reinterpret Section 28(e) to include within brokerage and research post-trade analytics to the extent they are used to inform, or to drive, order-handling decisions, including decisions whether to split a block order into randomly sized small pieces, whether to present an order at one or more limit prices or instead as a market order, the selection of market venues for order presentation, how large a discount, or premium, a block order should command, whether to purchase one or more derivatives rather than the underlying physical security.

As stated above, these are important factors that can significantly affect account performance. They go well beyond the monitoring of basic best-execution duties and have considerable impact on investors. They also can be clearly distinguished from the Commission’s proper distinction between a money manager’s use of post-trade analytics to assist in making investment decisions and the use of post-trade analytics as a marketing tool.

We suggest that the Commission should recast its interpretation so that post-trade analytics, if used in order handling, will be regarded as coming within the Section 28(e) safe harbor. Brokers that offer their services to the institutional investment community typically hold themselves out as providing many of these execution-management services through their in-house people, and through VWAP engines and other algorithmic trading vehicles and other proprietary software and they get paid for doing so through commissions. The same level playing field the Commission proposes to secure for the provisions of research should be extended to the provision of brokerage services. To provide for a “level playing field” between a broker’s in-house products and services and those provided by third-parties, the Commission should interpret the safe harbor as including post-trade analytics used in making order-handling decisions.

We believe firms should be encouraged to integrate post-trade analytics into their best execution practices — to learn from their executions and improve upon them for future pre-trade broker/strategy selection or working-trade to spot deviations from expected goals earlier. In this way, the Commission would be encouraging a learning cycle demonstrably linked to the execution process.

**Introducing broker-dealers and clearing brokers should be free to negotiate risk sharing between themselves**

The second area where we respectfully suggest the Commission should amend its proposed interpretation are two statements made in the Release in connection with the discussion of commission-sharing arrangements. The first is the assertion that in a “normal and legitimate correspondent relationship” the introducing broker “must” be at risk to the clearing broker-dealer for its customers’ failure to pay.<sup>2</sup> While it is typically the case in many commercial arrangements between an introducing broker and its clearing broker that the introducing broker accepts financial responsibility for its customers’ defaults, it is by no means universally the case in our experience. The allocation of default risk is a commercial term that, along with the commission split, is negotiated between the parties. In many cases, of course, the clearing broker has a superior bargaining position and can force the typically smaller introducing firm to agree to a number of onerous terms, including accepting full-bore responsibility for customer defaults. Where the bargaining power is more equal, that is not always the case. Clearing firms, in any case, do not need the Commission’s help in oppressing introducing firms. Nor is any legitimate public purpose served by the Commission’s interpretation, which is not commanded or even suggested by the concept of “normal and legitimate correspondent” or otherwise by the legislative purposes underlying Section 28(e).

The second Commission statement we suggest be revised is that the following element must be present for a commission-sharing arrangement to be within the Section 28(e) safe harbor:

A broker-dealer effecting the trade (if not providing research and brokerage services directly) must be legally obligated to a third-party producer of research or brokerage services to pay for the services ultimately provided to a money manager (i.e., “provided by” requirement).<sup>3</sup>

That statement is, we believe, ambiguous and we suggest it be clarified or deleted. If it related solely to the introducing broker’s need to be legally obliged to the third-party research producer, it would be unobjectionable and in fact is fully consistent with other statements in the Release and with the Commission’s longstanding interpretive policy on third-party research arrangements. The reference to “brokerage”, however, is problematic and, as far as we know, goes beyond any prior Commission interpretation of Section 28(e). For the reasons stated above, regulating the commercial allocation of risk between the clearing broker and the introducing broker is unnecessary and, we respectfully suggest, inappropriate. We point out, moreover, that the Commission’s statement itself is logically flawed. The parenthetical phrase “if not providing research and brokerage services directly” is potentially circular and confusing if the word “providing” in that phrase already has the meaning the Commission

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<sup>2</sup> Release in text preceding n. 134.

<sup>3</sup> Release in text at n. 135.

ascribes to it — i.e., being obliged to pay for an item. We suggest in any event that the reference to brokerage services be deleted.

### Commission Questions

**Question 1.** Does the Commission’s interpretation offer sufficient guidance with respect to the types of “advice,” “analyses,” and “reports” that are eligible as “research services” under Section 28(e)?

**Answer** — We believe the Commission has provided sufficient guidance.

**Question 2.** How would investors, money managers, broker-dealers, and others be affected by the Commission’s interpretive guidance that client commissions cannot be used to obtain computer equipment as “research” under Section 28 (e)?

**Answer** — We believe the Commission has drawn an appropriate line in deeming that client commissions cannot be used to obtain computer hardware as “research”. We believe Bloomberg’s experience in this regard is instructive.

As the Commission knows, the BLOOMBERG PROFESSIONAL Service consists of integrated research software. While hardware can be acquired ancillary to this core package as an accommodation for clients, hardware is not part of the core BLOOMBERG PROFESSIONAL Service. Indeed, a small percentage of our clients opt to obtain hardware from the vendor.

As is the case with the Financial Service’s Authority’s guidance on use of commission in the U.K., the Commission’s guidance makes clear that research software is “research” while hardware is not. The Commission has drawn a clear and useful distinction, one that certainly furthers the purposes of the soft dollar policy.

**Question 3.** Does the Commission’s interpretation offer appropriate guidance as to the eligibility of market data and trade analytical software under Section 28 (e)?

**Answer** — We believe the Commission has reached the correct conclusion on market data. Our concerns regarding the treatment of post-trade analytical software are discussed above.

**Question 4.** Does the Commission’s interpretation offer sufficient guidance as to the eligibility of “brokerage” services, functions, and products under Section 28 (e)? How would this guidance affect existing arrangements or practices? Is the Commission’s temporal standard sufficiently clear? Are there types of services that should be excluded from the safe harbor, even though they might appear to satisfy the temporal standard? If so, explain why those services should be excluded – for example, is the service unrelated to execution of transactions?

**Answer** — We believe the Commission has provided useful and sufficient guidance on “brokerage” services.

**Question 5.** Does the Commission's interpretation offer sufficient guidance about third-party research and commission-sharing arrangements?

**Answer** — We believe the Commission has offered sufficient guidance about third-party research and, again, we commend the Commission for re-affirming its long-held position on this critical issue. Our concerns on commission sharing arrangements are discussed above.

**Question 6.** How does the Commission's interpretive guidance differ from the approaches that other regulators, SROs, market participants, trade organizations, and investor advocacy groups have adopted or recommended with respect to client commission practices?

**Answer** — The NASD, the Financial Services Authority in the U.K. and the Securities Industry Association have all reached very similar conclusions — stressing the importance of the availability of commission payments for research and the critical importance of providing equality of treatment between research produced by proprietary houses and independent research while underscoring that the means of disseminating research is irrelevant, i.e. that the test of whether a product or service is research is a function of how the practitioner utilizes the product or service. While some in the mutual fund industry have argued in favor of banning use of commission for third-party research, it is interesting to note that — after much systematic consideration — the regulators have all emphatically and correctly rejected this option.

**Question 7.** Are there types of products or services that are commonly paid for with client commissions for which additional guidance would be useful? If so, please provide facts about these products and services and their components, and how they are used. For example, are client commissions commonly used to pay for proxy voting services?

**Answer** — We think the Commission has done a thorough job of providing guidance on products and services that are commonly paid for with client commission.

**Question 8.** Should the Commission provide additional guidance on the allocation and documentation of mixed-use items?

**Answer** — The Commission has provided useful and sufficient guidance on mixed-use items.

**Question 9.** Concerns have been expressed by some industry participants and others that mass-marketed publications (publications that are widely circulated to the general public and intended for a broad public audience) are part of a firm's overhead and should not be paid for with client commissions. Are the purposes and uses of these types of publications distinguishable from those of traditional research products? Should the Commission provide further guidance in this area?

**Answer** — We suspect that the purpose and types of mass-marketed publications are largely distinguishable from those of traditional research products.

**Question 10.** Should the Commission afford firms time to implement the interpretation? In commenting, please provide specific examples of any potential implementation issues.

**Answer** — We are unaware of significant implementation issues, but would defer to others on the question of whether firms are or will encounter difficulties.

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Again, we appreciate the time the Commission has devoted to this subject and we believe the Commission has devised a positive framework which promotes the public interest. If the Commission or any members of the staff would like to discuss these issues with us, we would be pleased to make ourselves available for that purpose.

Respectfully submitted,

*Kim Bang* by R.D.B.

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