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Morgan Stanley

April 21, 2006

Nancy Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: Release No. 34-52635; File No. S7-09-05

Dear Ms. Morris:

We commend the SEC for addressing the important topic of client commission arrangements. The primary objective of the SEC's guidance regarding client commission practices should be to promulgate clear, consistent, and practical principles to govern the activities of fiduciaries in their use of commissions on behalf of their advised accounts. We believe these principles should not focus on the name ascribed to a specific client commission activity but rather should be based upon the substance of what is occurring. Once the SEC establishes such broad principles and guidelines equally applicable to all client commission practices it can then let market forces shape the activities within that framework. This is far preferable to rules and guidelines based on artificial, outdated, or arbitrary distinctions. Morgan Stanley & Co. Incorporated ("Morgan Stanley")[1] believes that the SEC's proposed interpretive release on client commission practices partially accomplishes these objectives, with a few important caveats and constructive comments detailed in this submission.[2] Following are more detailed views of Morgan Stanley on specific aspects of the Release.[3]

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1 Morgan Stanley & Co. Incorporated is a SEC-registered broker-dealer and a member of the NASD and all U.S. stock exchanges.

2 Securities Exchange Act Release No. 52635 (October 19, 2005) (the "Release").

3 In addition to the views expressed herein, representatives of Morgan Stanley met with members of the Securities and Exchange Commission's Soft Dollar Task Force on May 18, 2004 and on October 12, 2004. We also have had several other conversations with various members of the Task Force to assist them as they performed their review.

I. Introduction

Morgan Stanley urges the SEC to use this evaluation of client commission arrangements as an opportunity to accomplish five objectives, each of which are discussed in more detail below:

1. Provide explicit affirmation of a money manager's ability to transact with full service executing brokers and use client commission dollars to purchase eligible research and brokerage services from such executing brokers.

2. Promote standards that encourage the use of client commissions for value-added research and brokerage services that can be used to enhance investment returns.

3. Establish one set of clear, consistent standards to govern all client commission arrangements and preclude the use of arrangements that diminish transparency and increase the potential for misuse of client commissions.

4. Affirm flexible standards for determining the eligibility of research and brokerage services under the safe harbor that recognize the importance of a money manger's good faith determination as a fiduciary.

5. Seek global regulatory consistency regarding client commission arrangements to the greatest extent possible.

II. SEC Must Make Clear Advisers Can Pay Full Service Brokerage Rates for Appropriate Value

First, the SEC should explicitly reaffirm a money manager's ability to pay a full service commission rate to an executing broker for eligible research and brokerage services provided as part of a proprietary bundle. As the Release notes, the statutory safe harbor contained in Section 28(e) explicitly "protects money managers from liability for a breach of fiduciary duty solely on the basis that they paid more than the lowest available commission rate ..." for eligible research and brokerage services (emphasis added).[4] This language reflects a Congressional understanding of the value of research and brokerage services offered to money managers and a willingness to allow money managers to obtain this value with client commissions.

The Release also reiterates that money managers have an obligation to obtain best execution of their client's transactions.[5] Best execution, however, does not automatically require the lowest available commission. The SEC has long recognized and emphasized the multi-faceted nature of a fiduciary's best execution obligations. The SEC recently repeated the following factors as important in a best execution analysis: (i) price, (ii)

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4 See Release at pp. 3-4.

5 See Release at p. 4, footnote 5.

speed of execution, (iii) trading characteristics of the specific security, (iv) availability of accurate market data, (v) technology; and (vi) cost and difficulty of executing with a specific venue.[6] The SEC has also stated that "A broker must take price (including opportunities for price improvement) into consideration in determining where to route its orders for execution, but price is not the only criteria that a broker may consider. It may also consider factors such as the trading characteristics of the security involved and the cost and difficulty of obtaining an execution in a particular market center, among other factors" (emphasis added).[7]

Explicit Transaction Costs, Including Commissions, Are a Small Piece of the Overall Cost to Investors

In addition to the above statements, the SEC itself has recently conceded the relative insignificance of explicit transaction costs. For example, the SEC has cited approvingly studies which estimated implicit transaction costs in the U.S. equity markets at anywhere from approximately $30 billion to $120 billion per year.[8] This dwarfs the estimated annual explicit commission payments made in the U.S. equity markets of approximately $9.1 billion.[9] The SEC went on to note that explicit costs constitute only a "small part of total transaction costs" and estimated [implicit] transaction costs for "Nasdaq and NYSE stocks during the fourth quarter of 2003 [were], respectively, 83 basis points and 55 basis points" compared to "explicit" transaction costs of only 12 basis points for large capitalization stocks.[10] Measuring these numbers against the estimated $8 trillion of assets under management further underscores their relative importance.[11]

Therefore, when one reads both the statutory language of Section 28(e) and reviews the SEC's guidance on a money manager's fiduciary duties when executing client transactions, it seems quite clear that an adviser's duty is not to obtain the lowest possible explicit cost (i.e. commission). Instead, the money manager's primary investment objective is to enhance returns to its investors. Accordingly, an adviser should be free to pay a full service commission to an executing broker that is providing that adviser with a bundled product that includes both research and execution, presuming

6 Securities Exchange Act Release No. 49325 (February 26, 2004).

7 Securities Exchange Act Release No. 42450 (February 23, 2000).

8 Securities Exchange Act Release No. 51808 (June 9, 2005) ("Regulation NMS Adopting Release").

9 This reflects data collected from an independent industry survey in 2005 covering the 2003 calendar year.

10 See Regulation NMS Adopting Release at 76, fn 146.

11 See 2005 Greenwich Associates United States Equity Survey.

of course that the adviser reasonably believes that the value received is commensurate with the commission paid.[12]

Morgan Stanley believes that this relatively straightforward and well settled proposition has been obscured. We believe that the SEC should use this interpretive release to affirm that money managers may pay a commission commensurate with the value of the research and brokerage services that they receive, even if that commission is more than the lowest commission available. We also encourage the SEC to request its Office of Compliance Inspections and Examinations to focus its reviews not primarily on the commission rate paid by a money manager, but rather on the value that such money manager believes it received in return for their commission dollars. The right question for an examination is not "why are you not paying lower commissions" but rather "what is the value you are receiving in return for your commissions and how has that helped enhance the returns of your advised accounts?" This will create an environment in which advisers are encouraged to pay for value. Indeed, in this market environment advisers should cultivate relationships with those providers of research and brokerage services who can help them achieve the greatest return for their investors.

For example, envision two comparable funds of similar size and strategy where Fund A's adviser has negotiated a commission rate of 3 cents per share and Fund B's adviser has negotiated a commission rate of 5 cents per share. Let's assume that Fund B's higher commission rate provides it with a more in-depth level of access than Fund A to Morgan Stanley's valuable (and scarce) research and brokerage services, and that Fund B's adviser determines that the value of these research and brokerage services is reasonable in relation to its commission rate. Presumably, Fund B's adviser can make this determination if it also reasonably believes that its utilization of Morgan Stanley's research and brokerage services will enhance its investment performance.[13] Accordingly, even though Fund A may have saved 2 cents per share on the front end (i.e., in its commission rate), it may have also failed to receive valuable research and brokerage services that it could have used to improve its investment performance.

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12 Section 28(e) explicitly and specifically states commission payments are reasonable "...if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion".

13 While Fund B's adviser may more easily defend its use of commissions where its investment performance is superior to Fund A, this should not be the dispositive factor. For example, if Fund B's adviser obtained valuable research and brokerage services on a particular market sector covered by a Firm (e.g., emerging market technology companies), the determination of whether it was reasonable to pay for these services should not be based solely on the relevant fund's investment performance. The sophistication and demand for the resources obtained by the adviser, as well as how they fit into the adviser's investment objectives, should be the primary factors in analyzing the reasonableness of the commission rate paid.

Changing Investment Objectives Will Increase the Need for Superior Research and Brokerage Services

Morgan Stanley believes that current market trends have also increased the need for sophisticated research and brokerage services. Investment advisers to registered investment companies are exploring strategies outside of their long only focus in an attempt to enhance investment performance. For example, more funds are now seeking to engage in limited short selling as part of a predominantly long biased portfolio.[14] In addition, advisers to unregistered funds continue to explore opportunities beyond the traditional equity and fixed income markets. These areas include equity and fixed income various derivative products, bank debt, and other multi-asset class initiatives. Advisers are also moving between multiple strategies as opportunities arise or retreat.[15] Accordingly, it is no longer possible for many advisers to focus on a limited investment or product mix to achieve their desired investment returns.

In this environment, the ability to rely upon the substantial research and/or brokerage services of the sell-side providers is crucial to a money manager's success. While Morgan Stanley can offer a range of services and expertise across many markets, products, and regions, few of our clients are similarly organized.[16] We stand ready to service their needs across all of the various investment objectives they may possess. Not surprisingly, our clients' strategies are becoming more sophisticated, more global, and more fluid. The SEC should carefully consider and evaluate these market trends as it promulgates its guidance regarding client commission arrangements.

III. SEC Should Generally Retain their Proposed Interpretation of Eligible Research and Brokerage Services under the Section 28(e) Safe Harbor

Morgan Stanley generally agrees with the SEC's interpretation of (i) the framework for analyzing whether a particular service falls within the "brokerage and research services" safe harbor, (ii) the appropriate treatment of mixed-use items, (iii) the eligibility criteria for "research" and "brokerage services".

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14 See Financial Times, December 12, 2005, "Portable Alpha – the Next Big Wave", by Stephen Schurr; and Morgan Stanley Equity Research, January 18, 2006, "Short Extension Portfolios: An Exploration of the 120/20 Concept", by Martin Leibowitz and Anthony Bova.

15 For example, the value of written research (arguably the most structured of research products) varies by client depending on their investment strategy, holdings, preference for the authoring analyst, and interest in the focal issue of the note. A client may read everything an analyst writes for several months and then its need changes.

16 For example, smaller managers tend to employ fewer analysts than do larger managers and may be more dependent on the sell-side for research.

Specifically, Morgan Stanley agrees that safe harbor protection should require money managers to determine research and brokerage services they obtain provide them with "lawful and appropriate assistance" in their investment decision making responsibilities. This is a clear, flexible, and workable standard that emphasizes whether the manager is able to make better investment decisions. Similarly, requiring advisers to make a "good faith determination" that the value received is reasonable in relation to the commission paid continues to be the appropriate standard. This standard recognizes that the value determination can only be made by the adviser and may be subject to a number of factors known only to the adviser. While there must be a standard, it needs to be flexible enough to allow the adviser to obtain and pay for the research and brokerage services the adviser determines he or she needs. Finally, the SEC is also correct in supporting the mixed-use concept. Given the complexity of an adviser's responsibilities and the research and brokerage offerings today, the adviser should be given the discretion to evaluate what they are purchasing and how they are using it, and make an appropriate allocation.

Morgan Stanley also generally supports the SEC's proposed definitions of research and brokerage services. We think the emphasis should continue to be on offering flexible standards and focusing on whether the research or brokerage service is being used by advisers to help manage their advised accounts. The SEC's focus on the statutory language for defining research offers an appropriate framework, and will allow advisers to purchase the research and brokerage services they need to advise their accounts.

We think, however, that the SEC should reconsider three points: the temporal standard for defining eligible "brokerage services", its categorization of order management systems ("OMSs"), and its treatment of custody services. First, we do not believe the temporal standard is a sound method for evaluating qualifying brokerage services. The statutory language states that "brokerage services" are provided when one:

> "effects securities transactions and performs functions incidental thereto (such as clearance, settlement, and custody) or required in connection therewith by rules of the Commission or a self-regulatory organization of which such person is a member or in which such person is a participant."[17]

This language does not provide any express time limitations. Rather, its explicit terms recognize the need for an expansive standard. Importantly, the statute remains focused on the substance of the service being provided and not the time when it occurred. The SEC should not deviate from this key principle in favor of an arbitrary time standard. For example, if an adviser's use of an OMS fell outside the proposed temporal standard, we do not believe it would make the adviser's use of such service any less worthy of the protection of the safe harbor. The focus should remain on the substance of the brokerage service, whether it fits within the statutory definition, and the adviser's good faith determination, not on a finite time period.

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17 See Section 28(e) (3) (C) of the Exchange Act.

In addition, the Release states that "trade analytics" should be excluded from safe-harbor protection because they are not integral to the execution of the orders and they fall outside the proposed temporal standard.[18] We disagree with both justifications. First, post-trade analytics are integral to an adviser's review of the execution quality of its portfolio transactions (i.e., its required best execution review). These analytics enable the adviser to determine how and where to execute its order flow and these decisions clearly have a material impact on the fund's performance. Second, this is another example of the proposed temporal standard elevating form (i.e., when something occurred) over substance (i.e., what the adviser is receiving). While post-trade analytics by definition occur after the conclusion of a trade, they still directly assist the adviser in its investment advisory responsibilities. Accordingly, the SEC should make clear that trade analytics are eligible for the protection of the safe harbor.

Second, the Release indicates that OMSs are not eligible brokerage services under the safe harbor. The Release does, however, allow that "connectivity services and trading software" would be permitted brokerage services because the transmission of orders has always been considered a core part of the brokerage function. Since OMSs today are frequently both order execution and order management systems, the proposed standard is too narrow and simplistic. We do not believe that the SEC's standard should single out OMSs as a unique category based upon its name. Rather, the SEC's should evaluate the propriety of OMSs and order execution systems as it would any other brokerage service. The SEC's proposed standard should allow advisers to use commission dollars to pay for these systems if they satisfy the statutory language detailed above. If necessary, advisers can make a mixed use allocation of their use of such systems, although we believe that most functionality found in OMSs today would completely satisfy the statutory standard.[19]

Third, we note that the SEC proposes to remove custody services from the definition of permitted brokerage services under the safe harbor. As noted above, the statute explicitly provides that "clearance, settlement, and custody" (emphasis added) are considered eligible brokerage service. The Release is silent on the SEC's legal justification for proposing an interpretation that directly contravenes the express statutory language. We believe that such an interpretation would be both unwise and unenforceable, and would not serve any policy objectives.

As a final point, we strongly believe that the a crucial part of the interpretation of eligible research and brokerage services is proper oversight of the use of client

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18 See Release at p. 35.

19 For example, the Soft Dollar Task Force witnessed a demonstration of Morgan Stanley's Passport system during their visit to our offices on May 18, 2004. While Passport would technically be considered an order management system, it also contains extensive execution related components as the Staff witnessed. We think it was clear then, and remains today, that Passport is an invaluable execution tool for our clients. There should be no question that such tools constitute 28(e) eligible brokerage services.

commission arrangements by fund boards and trustees and the SEC. Clear, workable standards and documented adherence to these standards should ensure that money managers are making proper use of client commissions and receiving legitimate value in return.

IV. The SEC Should Focus on the Substance of Client Commission Arrangements and Ignore Existing and Arbitrary Naming Conventions

Morgan Stanley strongly believes the SEC's current review of client commission arrangements provides it with a unique opportunity to address and clarify many of the issues that have arisen over time with client commission arrangements. These issues include, but are not limited to, a lack of transparency surrounding many such arrangements and a preponderance of arrangements where the value proposition being provided by certain participants is questionable (e.g., introducing broker and step-out arrangements). We believe the SEC's regulatory framework should (i) eliminate all client commission arrangements where advisers' payments for services are either non-transparent or for insufficient (or no) value, (ii) permit and encourage money managers to use commission dollars to purchase legitimate research and brokerage services in a fully transparent manner consistent with their best execution obligations, and (iii) be simple, transparent, and easy to interpret and administer.

Specifically, the SEC should promulgate one uniform standard capable of covering all client commission arrangements regardless of the name or whether multiple broker-dealers are involved. This Release lists five distinct client commission arrangements[20]:

1. Proprietary research and brokerage arrangements,
2. Third-party research and brokerage service arrangements,
3. Commission sharing arrangements,
4. Introducing Broker-Clearing Broker (or Correspondent) arrangements, and
5. Step-out arrangements

Since all five arrangements involve an adviser using a client commission to pay for services, they should all be regulated consistently. Rather than using this Release to take this more rational approach to client commission arrangements, however, the SEC has unfortunately merely tweaked the status quo. The SEC's proposed approach perpetuates a veritable maze of regulations that views each arrangement uniquely. The Release continues to focus on the name, not the substance, of the client commission arrangement. In addition, the SEC continues to ignore transparency in that it purports to approve the

20 We note that while the Release also discussed "give-up" arrangements, this was generally in the context of the historical significance of give-ups. Accordingly, our discussion will focus on the other arrangements listed in the Release.

continuation of existing non-transparent arrangements such as step-outs and introducing brokerage arrangements.[21]

Multiple Broker-Dealers Arrangements Should be Governed the Same as All Other Client Commission Arrangements

There is no regulatory purpose served by regulating multiple broker-dealer client commission arrangements differently than other client commission arrangements. This is true whether these arrangements are introducing broker, commission sharing, or step-out arrangements. While the Release defines a step-out as "different from a commission sharing arrangement", it offers no support for this proposition.[22] Nor does the Release meaningfully explain why arrangements between multiple brokers that happen to be called introducing broker arrangements should be analyzed differently. We are hard pressed to understand these distinctions or any regulatory basis for the SEC's rather complex approach. In the absence of a meaningful difference between client commission arrangements, they should all be subject to the same regulatory framework.

Another troubling section of the Release is its position that "...each party to the [commission sharing] arrangement must determine if it is contributing to a violation of law, including whether the involvement of multiple parties to the trade is necessary to effecting the trade, beneficial to the client, and appropriate in light of all applicable duties".[23] While the Release distinguishes, without meaningful explanation, step-outs from commission sharing arrangements for this purpose, it does not make clear how we are supposed to satisfy this standard across all arrangements. Although Morgan Stanley is comfortable it can undertake reasonable efforts to satisfy this standard in the general third party client commission arrangement, as noted in more detail below, we have no ability to satisfy this standard with step-out transactions.[24]

We believe that the Release's reaffirmation of the SEC's historical interpretation of the "provided by" and "effecting" statutory language maintains artificial and illogical distinctions.[25] While we understand the statutory importance of the "provided by" and

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21 The SEC should recognize that it would have no easy way today to determine what an adviser is purchasing in many of today's client commission arrangements.

22 See Release at p. 43, footnote 125.

23 See Release at p. 45.

24 In the general third-party client commission situation, we have the ability to enter into agreements with our clients and their vendors, and perform meaningful due diligence. We have a team of professionals in our commission management group that oversee our third party program and due diligence process. We described this process for the Soft Dollar Task Force in detail during our May 18, 2004 meeting.

25 See Release at pp. 40-41, 42, and 46. The SEC has long stated that "provided by" means that the executing broker-dealer must have the direct legal obligation to pay for the research provided to an adviser, although the adviser can still both select the research and receive it directly themselves from the third party. As a result, the essence of this requirement is that the executing broker-dealer be invoiced

"effecting" requirements, we believe the SEC should adopt a more substantive and less technical interpretation of these terms that relies on the "lawful and appropriate assistance" and "good faith determination" standards.[26] This will focus investment advisers on whether they have satisfied these standards, which would always operate to preclude advisers from legitimately paying a party that did not provide any value in connection with the transaction.

In this regard, the SEC should be cognizant of the answers to a few simple questions for each arrangement. These questions include: (i) what function is each participant in a client commission activity performing, (ii) are all participants in a client commission activity adding value proportionate to the commission they receive; (iii) what is the transparency of the client commission arrangement to third parties (i.e. asset owners, regulators), (iv) are there other, more transparent means for the money manager to accomplish the same objective than the method they are using; and (v) is the adviser's best execution duty compromised in any way by the arrangement. We think it's clear that in connection with step-outs and certain introducing brokerage arrangements the answers to these questions would raise serious regulatory concerns.

The Substance of Introducing Broker and Commission Sharing Arrangements Should be Closely Scrutinized

First, introducing brokerage arrangements that are established to capture soft dollar payments should be distinguished from introducing brokerage relationships that legitimately involve the allocation of clearing functions by a broker-dealer that is not a self-clearing firm. In the latter example there is a clear need for the clearing services that are being obtained by an introducing broker.[27] This arrangement differs markedly from a situation where an adviser is purchasing research and brokerage services through an introducing brokerage "network". In these arrangements two broker-dealers label and document their relationship as an "introducing broker-clearing broker" arrangement to qualify as a legitimate soft dollar arrangement. This typically does not involve, however, one broker acting as a traditional clearing broker. Rather, it simply means that an adviser will trade with an "executing" or "clearing" broker and direct that a portion of the commission be credited to the introducing broker. While these arrangements may be named and documented as introducing-clearing arrangements, we believe that many may involve the non-transparent payment of commissions for questionable value.

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directly from the third party provider and make payments to such third-party on behalf of the adviser. The Release also indicates that "effecting" would require satisfaction of a four-part test, requiring an "introducing" broker to be financially responsible for the trades, record and retain certain records, respond to customer comments, and monitor the trading and settlement process.

26 See Section 28(e) (1) and Exchange Act Release No. 23170 (April 23, 1986).

27 These agreements are generally quite complex given the nature of the allocation of responsibilities and they must be approved by the clearing broker's designated self-regulatory organization.

We would encourage the SEC to examine the "clearing" arrangements that exist today to govern the provision of such services. The mere fact that these arrangements are denominated in this manner, or subject to a written clearing agreement, does not ensure that they automatically involve 28(e) eligible research or brokerage services or in the language of the Release "...whether the involvement of multiple parties to the trade is necessary to effecting the trade, beneficial to the client, and appropriate in light of all the applicable duties."[28] The SEC should carefully examine the multiple parties to these arrangements to ensure that each party is adding value commensurate to the payment received, and that there are not more efficient and transparent means to accomplish the same objective.

Step-Outs Are Non-Transparent and Should be Discouraged as a Means for Purchasing Eligible Research and Brokerage Services

We strongly believe that the SEC must recognize and address the many issues inherent in step-out transactions, and discourage money managers from using them as a permissible client commission arrangement. As the Release notes, "the executing broker may not know what commission is paid to the stepped-in broker or what services (other than clearance and settlement) are provided by the stepped-in broker". In fact, as we have discussed with the Soft Dollar Task Force, when Morgan Stanley executes an order for a client and is then asked to step-out all or part of that transaction, we do not know the purpose for which the adviser is stepping out and there are no controls around this process that would enable the executing broker to obtain this information.[29]

Step-outs also can result in mismatched and non-transparent audit trails. This is because once a stepped-in broker clears and confirms the transaction it can be difficult for someone (e.g., a regulator) looking at the audit trail to recognize that the original execution was performed by another broker-dealer. For the same reasons, step-outs allow the "stepped-in" broker to market the executing broker's execution quality. Although we have invested enormous resources in our execution capabilities to create a best of class worldwide trading operation capable of offering our clients best execution; step-outs allow other broker-dealers to advertise our execution quality as their own. Although this practice may be quite common, very few people (if any) would be able to recognize this misleading information without additional due diligence to look beyond the statistics. This practice could also result in fiduciaries directing order flow to such brokers in mistaken belief they will obtain Morgan Stanley quality executions. In addition, when fund boards are looking at the execution quality of the brokers handling the fund's order flow, they may be evaluating execution quality of broker-dealers based upon orders that were executed by other firms.

28 See Release at p. 45.

29 See *e.g.* Exchange Act Release No. 29492 (July 26, 1991) (approval of the New York Stock Exchange's Overnight Comparison System that is used to facilitate step-out transactions). In addition, Morgan Stanley discussed its concerns with the step-out process during our May 18, 2004 meeting with the Soft Dollar Task Force.

Notwithstanding the SEC's willingness to allow, and even encourage, the continued use of step-outs for client commission arrangements, we note that the SEC implicitly recognized some of these very problems when it issued a rule prohibiting step-out and similar arrangements as compensation for fund distribution.[30] In that scenario, although the SEC had been aware for years of the lack of transparency and accountability inherent in step-outs, their use was not restricted and these very characteristics prevented the SEC from understanding the services advisers were purchasing with step-outs (i.e., payment for fund distribution).[31]

We believe the SEC should consider extending its ban on step-outs beyond prohibiting their use in connection with sales of mutual fund shares. First, monitoring compliance with this prohibition is still subject to the same transparency and audit trail concerns identified above. Second, and more importantly, we fail to see any benefits for continuing to allow step-outs. Whatever their utility may have been in the past, today there are more transparent and protective means to pay another broker-dealer for providing a legitimate value.[32] More fundamentally, it seems clear that when advisers direct an executing broker to step-out of a transaction, it is doubtful they are compensating the stepped-in broker simply for clearing and settling the stepped-in transaction. In fact, the executing broker stood ready and willing to clear and settle that trade. The adviser is quite clearly paying the stepped-in broker for another service. The issue of course is that this is perhaps the easiest and least transparent way for the adviser to accomplish this objective.

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30 See Release No. IC-26591 (September 9, 2004); Prohibition on the Use of Brokerage Commissions to Finance Distribution; Final Rule. Rule 12b-1(h) (1) prohibits funds from compensating a broker-dealer for promoting or selling fund shares by directing brokerage transactions to that broker. The prohibition applies both to directing transactions to selling brokers, and to indirectly compensating selling brokers by participation in step-out and similar arrangements in which the selling broker receives a portion of the commission. The ban extends to any payment, including any commission, mark-up, mark-down, or other fee (or portion of another fee) received or to be received from the fund's portfolio transactions effected through any broker or dealer (citations omitted).

31 In its 1998 Report, OCIE observed that "...step-out trades have become an additional incentive used by fund advisers to reward broker-dealers for selling fund shares. Advisers who seek to do business with broker-dealers that have sold fund shares must still fulfill their duty of best execution, however, and must disclose the practice if it is a factor considered by the adviser in selecting broker-dealers." In addition, in 1998, Richard H. Walker, then Director of the SEC's Division of Enforcement, stated that "...we are also studying, together with our Office of Compliance Inspections and Examinations, arrangements for the distribution of fund shares where compensation is paid for distribution services, including in 'step out' transactions." (See Speech of Richard H. Walker December 7, 1998, before the Investment Company Institute).

32 As Mike Eisenberg, the former Acting Director of the Division of Investment Management, stated in a 1999 roundtable discussion concerning step-outs "That sounds like a give-up". See Roundtable on the Role of Independent Investment Company Directors; Transcript of the Conference on the Role of Independent Investment Company Directors, U.S. Securities and Exchange Commission, Washington, D.C. February 23, 1999.

V. The SEC's Failure to Set Clear, Consistent, and Workable Standards May Reduce Transparency and Execution Quality

The maintenance of artificial distinctions between these various client commission arrangements may foster inappropriate incentives for money managers. An example of a typical scenario would be instructive in demonstrating this principle. Assume a money manager today receives valuable research from a broker-dealer but is not confident in its execution capacity. Today, the money manager has several choices for compensating this broker-dealer for its research offering. First, he could send order flow directly to that broker to generate commission payments. While this may appear to be a straightforward proprietary arrangement, it is in fact an undesirable outcome because the manager is really executing through that broker to obtain research, not execution. As a result, to purchase valuable research the manager may obtain inferior executions to the detriment of its advised accounts.

Second, he could execute with a second broker-dealer based upon that broker's execution quality and ask the executing broker to step out all or part of the transaction to the broker-dealer that provided the research. This implicates the many problems inherent in step-out arrangements, as described above.[33]

Third, the research providing broker could enter into an introducing broker arrangement with the executing broker. This seems unlikely and suboptimal as (i) there are easier alternatives available (as already outlined) and, as noted above, (ii) the arrangement the manager really wants (i.e., to execute with one broker and purchase research from another) bears none of the hallmarks of a true introducing broker-clearing broker arrangement. Accordingly, even if it were documented as an introducing broker arrangement, it would be form over substance.

Fourth, the manager could enter into a third party soft dollar arrangement whereby he trades with an executing broker based upon that broker's execution quality and the executing broker pays the research provider with the manager's soft dollar credits, if any. This fourth option carries many benefits. For one, it provides incentives to the manager to route order flow based upon execution quality, not payment of research bills or other ancillary considerations. Second, it is fully transparent in that advisers will provide disclosure of such soft dollar arrangements. Third, it subjects the arrangement to the due diligence process of the soft dollar broker. For example, in this type of situation Morgan Stanley would enter into agreements with both the customer and the research broker-dealer, receive representations and information affirming that 28(e) eligible research is being provided, and make payments directly to the research provider only upon the direction of the money manager and the receipt of an invoice from the research broker-dealer. Fourth, it allows the broker-dealer to pay for only for value received from the research broker-dealer (with no fixed, up-front payment obligation) while still satisfying its best execution obligations.

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33 See supra Section IV.

The SEC should recognize that if a fiduciary is making a good faith determination under the statute that a research provider is providing reasonable value (and otherwise satisfying 28(e) standards) any other limits on the money manager's use of client commissions seem somewhat contrived and artificial.

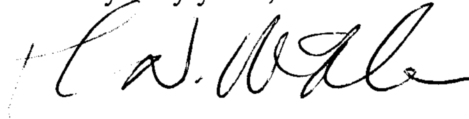
VI. The SEC Should Seek Global Consistency in the Regulation of Client Commission Activity

We agree with the SEC's goal of the greatest possible regulatory consistency across global jurisdictions, especially with respect to the recently issued guidance by the United Kingdom's Financial Services Authority. As the SEC is undoubtedly aware, clients today are becoming more global in nature and cross-border harmonization of the rules governing client commission arrangements will facilitate these global relationships. We believe the SEC should focus on two areas as it seeks this objective. First, it should maintain broad interpretations of "research" and "brokerage services" and encourage other jurisdictions to the same. Second, the SEC should be sensitive to the eligibility of other soft dollar arrangements, such as UK commission sharing arrangements, for the Section 28(e) safe harbor. This is particularly an issue for advisers seeking to implement global soft dollar programs when they are advising either ERISA accounts or investment companies registered under the Investment Company Act of 1940 and therefore need the protection of the Section 28(e) safe harbor with respect to those accounts.

VII. Conclusion

We appreciate the SEC's consideration of our views and are available to meet to discuss in more detail should it be helpful to your evaluation of these issues. If you have any questions concerning our views please contact me at 212.761.3733. We look forward to continuing our dialogue with the Commission and its staff on these critical marketplace issues.

Very truly yours,



Thomas N. McManus
Managing Director and Counsel

cc: The Honorable Christopher Cox, Chairman
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Annette L. Nazareth, Commissioner
Robert L. D. Colby, Acting Director, Division of Market Regulation
Jo Ann Swindler, Assistant Director, Division of Market Regulation
Susan Ferris Wyderko, Acting Director, Division of Investment Management
Lori A. Richards, Director, Office of Compliance Inspections and Examinations