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Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Attention: Ms. Nancy M. Morris
Secretary

Re: Commission Guidance Regarding Client Commission Practices under Section 28(e) of the Securities Exchange Act of 1934 (File Number S7-13-06)

Ladies and Gentlemen:

On behalf of the Federal Regulation of Securities Committee of the Business Law Section of the American Bar Association (the "Committee"), we are writing to express our views on Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") issued by the Securities and Exchange Commission ("Commission").[1] This letter was drafted by a task force of members of the Committee whose names are set forth below, and the members are available to discuss the matters discussed herein with the Commission and its staff.

The comments expressed in this letter represent the views of the Committee only and have not been approved by the American Bar Association's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, they do

[1] Securities Exchange Act Release No. 54165 (July 18, 2006), 71 FR 41978.

not represent the position of the ABA Section of Business Law, nor do they necessarily reflect the views of all members of the Committee on every comment herein.

The Committee commends the Commission for issuing final interpretive guidance on the scope of Exchange Act Section 28(e) (the "Interpretation").[2] In particular, the Committee favors the increased flexibility provided by the Interpretation, which enhances asset managers' ability to structure client commission arrangements using a variety of broker-dealers and providers of research products and services to obtain quality trade executions and valued research services for their clients' benefit.

The Interpretation differs significantly from the Commission's proposal with respect to the "effecting" and "provided by" elements of client commission arrangements. We appreciate the Commission's request for comment on this portion of the Interpretation, and we suggest below some additional areas where we believe the Interpretation would benefit from Commission guidance.

In its discussion of client commission arrangements in Section III.I of the Release, the Commission observes that "Section 28(e) requires that the broker-dealer providing the research also be involved in effecting the trade. The statutory linkage of the 'provided by' and 'effecting' elements in Section 28(e) was principally intended to preclude the practice of paying 'give-ups.'"[3] The Release further describes "give-ups" as "mechanisms for the manager to use client commissions to make concealed payments to a broker-dealer that did not provide any services to benefit the advised accounts."[4] The Commission stated that a functional separation between trade execution and supply of research is beneficial to the clients of money managers, and that "Section 28(e) arrangements that promote functional allocation of these services are not the same as 'give-ups.'"[5] The release then describes the Commission's modified interpretations of the "effecting" and "provided by" elements of the safe harbor. While the interpretation greatly advances the Commission's goal of providing money managers and broker-dealers with flexibility to "functionally separate trade execution from access to valuable research," we believe it would be beneficial if the Commission clarified a few points related to the implementation of the interpretation.

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2 Release No. 34-54165 (July 18, 2006), 71 FR 41978 (the "Release").

3 Release in text accompanying nn. 163 & 164.

4 *Id.*

5 *Id.*

"Effecting"

The Interpretation states: "[T]o use the safe harbor, a broker-dealer that is 'effecting' the trade must perform at least one of four minimum functions and take steps to see that the other functions have been reasonably allocated to one or another of the broker-dealers in the arrangement in a manner that is fully consistent with their obligations under self-regulatory organization ("SRO") and Commission rules."[6] The Release notes that a broker-dealer is also "effecting" trades within the meaning of the safe harbor when it executes, clears, or settles an asset manager's trades. In contrast to the proposed interpretation, which would have required an introducing broker-dealer to satisfy *all four* of the identified functions in order to "effect" trades, the Interpretation provides that a broker-dealer needs to perform *one or more* of the four identified functions (and to see that the other functions are allocated). By this change, the Commission has introduced significant flexibility into client commission sharing arrangements.

The Release includes a discussion of these functions in the context of introducing and clearing broker-dealer arrangements, and earlier Commission descriptions of "normal and legitimate correspondent relationships." The Release notes that introducing/clearing broker arrangements are governed by SRO rules that require allocation of specific functions.[7] The Release also notes that, to qualify for Section 28(e), "introducing brokers would be expected to be engaged in securities activities of a more extensive nature than merely the receipt of commissions paid to [them] by other broker-dealers for 'research services' provided to money managers."[8] The Release's discussion of introducing/clearing arrangements in this context, however, has created some uncertainty that we urge the Commission to dispel.

The Interpretation makes it clear that the presence of a clearing arrangement conforming to SRO rules (*e.g.*, New York Stock Exchange Rule 382 or NASD Rule 3230) would not necessarily assure that the broker-dealers in the arrangement were "effecting" transactions within the meaning of Section 28(e).[9] Conversely, the Interpretation also suggests that a broker-

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6 71 FR at 41994. The four functions are: (1) taking financial responsibility for all customer trades until the clearing broker-dealer has received payment (or securities), i.e., one of the broker-dealers in the arrangement must be at risk for the customer's failure to pay; (2) making and/or maintaining records relating to customer trades required by Commission and SRO rules, including blotters and memoranda of orders; (3) monitoring and responding to customer comments concerning the trading process; and (4) generally monitoring trades and settlements. In addition, of course, a broker-dealer is effecting securities transactions if it is executing, clearing, or settling the trade.

7 *Id.* nn. 172-173.

8 *Id*. quoting 1986 release.

9 Release No. 34-52635, 70 FR at 61711, 34-54165, 71 FR at 41993-41994. For example, it is possible that the parties to an introducing/clearing agreement could allocate all of the functions specified in the SRO rules to the clearing broker and none of the functions to the introducing broker.

dealer that introduces its customers' trades to a clearing broker may be deemed to participate in "effecting" trades even if it does not have a clearing agreement conforming to those SRO rules.[10] We believe it would be helpful to broker-dealers if the Commission clarified that a formal introducing/clearing agreement is not a *sine qua non* of a client commission arrangement that qualifies for the Section 28(e) safe harbor. Rather, what is required is that a broker-dealer in a client commission arrangement be allocated (and perform) one or more of the four functions identified in the Release, and that all four functions are allocated to one or more of the broker-dealers in the arrangement.[11]

"Provided by"

The interpretation has significantly expanded the scope of arrangements under which a broker-dealer will be deemed to be "providing" research within the safe harbor. Before the Interpretation, the Commission had maintained that the broker-dealer in Section 28(e) arrangements must have the *legal obligation to pay* for the research that is made available to the manager.[12] The Interpretation, however, states that the safe harbor is available where a broker-dealer uses client commissions to pay for eligible research and brokerage services for which the broker-dealer is *not* directly obligated to pay if (1) the broker-dealers pays the research preparer directly, and (2) takes steps to assure itself that the client commissions that the manager directs it

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10 The Commission does not expressly state that an SRO-compliant clearing agreement is unnecessary, but it appears that result is implied by the seven functions that create eligibility under Section 28(e), as contrasted with the seven functions that must be allocated under SRO rules. Execution, clearance, and settlement are included in the SRO rules. Of the remaining four functions enumerated in the Release, only one — maintenance of records (function (2)) — is explicitly covered in the SRO rules. Of the other three, function (1), taking financial responsibility for trades is not explicitly covered by the SRO rules, although some have thought it to be implied; function (4), generally monitoring trades and settlements, is somewhat similar to "monitoring of accounts" in the SRO rules, but appears to be narrower; but function (3), "monitoring and responding to customer comments concerning the trading process," has no parallel in the SRO rules. While a broker-dealer performing function (3) provides a client relationship service in connection with transactions that qualifies for the safe harbor, this function does not require the broker-dealer to be a party to an introducing/clearing agreement. It would be helpful if the Commission would clarify that, if a broker is relying on performing one of these latter four functions, the broker has to assure itself that the other three (execution, clearance, and settlement) have been allocated to other broker-dealers. Presumably, that allocation would be pursuant to the SRO rules.

11 The requirement *vel non* of a clearing agreement complying with the SRO rules appears to have grown out of the Commission staff's earlier statement that Section 28(e) would be available to participants in a "normal and legitimate" clearing arrangement notwithstanding congressional statements in the legislative history of Section 28(e) to the effect that the safe harbor would not protect "give up" arrangements. *See* Release No. 34-23170 (April 23, 1986) in text accompanying n. 18. Now that the Commission has moved away from the "normal and legitimate" clearing arrangement approach to the more specific seven-factor test, the presence or absence of a clearing agreement should no longer be relevant.

12 Release in text accompanying n.180.

to use to pay for such services are used only for eligible brokerage and research. This interpretation will provide the manager with flexibility in selecting research products and services that can assist the manager in his or her investment decision-making.

We respectfully request clarification, however, of the broker-dealer's responsibility in paying for research as requested by the manager where the broker-dealer does not have the direct legal obligation to pay, *i.e.*, the broker-dealer does not have a contractual relationship with the research provider.[13] The SEC staff previously stated that it did not believe that the Commission intended Section 28(e) to apply when the broker-dealer "was merely used as an alternative means of paying obligations incurred by the fiduciary in its direct dealings with the third party."[14]

A broker-dealer in a client commission arrangement may not know, and has no obligation to inquire, whether the manager has assumed an obligation to the third party to obtain research for which the broker-dealer is being asked to pay. We understand the Interpretation to permit the broker-dealer to pay for research as requested by a manager if the broker pays the research provider directly, and takes steps to assure itself that the payments are used only for eligible products and services.[15] We do not understand the Interpretation to require the broker-dealer to inquire into the manager's relationship with the research provider, and would appreciate Commission confirmation of that understanding.

The Commission's longstanding allowance of third-party research services put in-house and third-party research on an equivalent footing. It made little sense, after all, to distinguish between research products or services created by an employee of a broker-dealer as opposed to research created by an independent consultant of the broker-dealer. The *Funds Monitoring Services* letter preserved that symmetry by requiring the broker — and not the fiduciary — to bear the obligation to pay the third-party research producer. We are uncertain whether the Commission now intends to change that result and we recommend that the Commission clarify its intention.

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13 The Release makes clear that arrangements in which the broker-dealer has a direct legal obligation to pay for third party research continue to be covered by the safe harbor. Release in text accompanying n. 183.

14 *Letter regarding Fund Monitoring Services, Inc.* (December 4, 1978), 1978 SEC No-Act. LEXIS 2286.

15 The Release explains that these steps will be satisfied where the broker-dealer reviews a description of the product or service for "red flags" that indicate that the product or service is not eligible for the safe harbor, and "agrees with the manager to use client commissions only to pay for those items that reasonably fall within the safe harbor." The Release also indicates that the broker-dealer should have procedures to make prompt payment and document the payments. Release in text accompanying n.184.

Footnote 182

Footnote 182 of the Release states: "In Section 28(e) arrangements involving multiple broker-dealers, at least one of the broker-dealers (but not necessarily all) must satisfy the requirements for "effecting" transactions and "providing" research."[16] It is difficult to completely reconcile this statement with the earlier statement in the Release that: "Section 28(e) requires that the broker-dealer providing the research also be involved in effecting the trade."[17] By suggesting that not all of the broker-dealers in a client commission arrangement must satisfy both requirements, the footnote could allow commissions to be shared with broker-dealers although they had no role in effecting transactions. Similarly, unless a broker-dealer in a Section 28(e) arrangement were subject to the "providing" requirement described in the Release, it could use client commissions to pay for products and services that it had not determined were eligible for the safe harbor. We suggest that the Commission consider clarifying the scope of this footnote.

Eligibility of Research and Brokerage Services

The Release states that software that provides analysis of securities portfolios is eligible under the safe harbor because it reflects the expression of reasoning or knowledge relating to subject matter that is included in Section 28(e)(3)(A) and (B).[18] Yet, the Release states that software functionality used for recordkeeping or administrative purposes, such as managing portfolios, and quantitative analytical software used to test "what if" scenarios related to adjusting portfolios, asset allocation, or for portfolio modeling do not qualify as "brokerage" under the safe harbor because the are not integral to the execution of orders by the broker-dealers, i.e., they fall outside the temporal standard.[19] It is possible that certain software used to analyze securities portfolios could be eligible research, but at the same time, if the same software were to be used to evaluate whether a portfolio needs adjustment in a "what if" scenario, it would not qualify as "brokerage".

We believe it would be helpful if the Commission clarified whether it believes that these purposes are not mutually exclusive and can co-exist.

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16 *Id.* at n.182.

17 *Id.* in text accompanying n.163.

18 Release, text accompanying n. 92.

19 Release, 71 FR at 41989.

Disclosure

We suggest that when the Commission develops enhanced disclosure standards in this area, it should focus both on what the fund manager must tell its clients (including registered investment company directors and fund shareholders) and how fiduciaries, such as investment company directors, should evaluate the information. When evaluating investment advisory contracts, investment company boards consider how investment managers benefit from receipt of research or services obtained in reliance on the Section 28(e) safe harbor. Fund boards would welcome guidance to help them understand how to properly discharge their oversight responsibilities in this area. We recommend that the Commission provide greater guidance to put boards in a position to require their advisers to give them pertinent information and for the directors to make sensible use of that information.

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Respectfully submitted,

Committee on Federal Regulation of Securities

/s/ Keith F. Higgins

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