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October 2, 2008

Ms. Florence Harmon
Acting Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices [File No. S7-22-08]

Dear Ms. Harmon,

Integrity Research[1] supports the provision of additional guidance to directors of registered investment companies, particularly on the subject of brokerage commissions, where there remains significant confusion. We believe that this guidance should be accompanied by new disclosure requirements to investment company shareholders and investment advisory clients concerning the use of client commissions.

The proposed guidance provides useful clarification on a complex topic, namely 'soft dollars'. Given the rise of low-cost electronic trading and the increasing adoption of broker voting and client commission arrangements, there is increasing transparency on the cost of execution, the implicit costs of research, and the overall spending on research. Guidance is therefore timely.

We also commend the Commission's clarification that soft dollar spending includes spending on proprietary research. It is surprising to us the persistent level of misunderstanding, despite the Commission's previous clarification in its soft dollar guidance issued in July 2006.

While we believe that the proposed guidance to directors is worthwhile, we do not believe it goes far enough. The market for investment research is dysfunctional, primarily because of

[1] Integrity Research Associates LLC is an information and solutions provider specializing in the alternative (third party) research industry. The firm provides advisory services to mutual funds, hedge funds and investment advisors evaluating and recommending sources of research. Integrity covers over 1,900 research firms in the U.S., Europe and Asia. Additional information about Integrity can be found at www.integrity-research.com.

distortions created by bundled research commissions. Portfolio managers complain of a glut of investment research. There is a simple explanation for this: bundled commissions provide a subsidy for research which has resulted in overcapacity.

As the regulator for both the brokerage industry and the mutual fund industry, the SEC has the ability, and we argue the obligation, to require more transparency in the payment of research commissions. At a minimum, this should include regular disclosure of the amounts of commissions paid, both in aggregate and by broker. Investment clients should also receive an accounting of how their brokerage commissions are being spent.

Guidance to Boards of Registered Investment Companies

The proposed guidance is timely. Electronic trading has provided greater transparency on the cost of execution which is often less than 1 cent per trade and nearly always less than 2 cents. This suggests an imputed cost of 2 to 3 cents for research in bundled commissions. Since research represents a significant portion of commission spending, it is certainly worthwhile for directors to understand how this is being spent.

Client commission arrangements (CCAs) also provide more transparency on research spending since a portion of the bundled commission for each trade is set aside for the payment of research. As such, the Commission should be commended for facilitating the adoption of CCAs. As an aside, we would urge the Commission to address any obstacles to payment for proprietary research through CCAs.[2] There does not appear to be a similar impediment to paying for proprietary research through commission sharing arrangements (CSAs) in the United Kingdom and continental Europe.

Broker voting processes assist in valuing research, providing transparency on how commissions are allocated by broker. Unfortunately, broker voting does not establish a price for research since it apportions commissions spent across brokers. Brokers have attempted to set 'minimums' for commission spending in order to receive certain levels of research services. Nevertheless, the challenge of this mechanism is that it fluctuates with the levels of commission spending, providing windfalls to brokers during periods of high commission volume.

We believe that it makes sense for boards to review brokerage commissions in the context of Section 15(c) of the Investment Company Act. Soft dollars are a material benefit to the advisor, which would otherwise need to pay for research out of its management fees rather than fund expenses.

Proprietary Research

One of the major benefits of the proposed guidance is to clarify (again) that soft dollars include payments for proprietary research, not just third party research. There continues to be

[2] Some broker dealers have indicated that they refuse to permit the payment for their proprietary research because of concerns that proprietary trading would require them to register as investment advisors.

widespread misunderstanding of this.[3] Most soft dollar scrutiny is of third party research. This is partly from habit, and partly because third party arrangements are easier to audit. Ironically, the focus on third party soft dollars misses the bulk of soft dollar spending.

The SEC itself appears to struggle at times with this issue.[4] For example, the Commission's July 2008 *ComplianceAlert* publication reported that on average soft dollars represented 20% of overall commission dollars spent (with a range of 3% to 100%) in the SEC's recent examinations. However, the newsletter also reported that the average commission rate advisors were paying was $0.05 per share (with a range of $0.01 to $0.08 per share). Since the cost of execution averages around $0.015 per share (at most), either these advisers overpaid for execution (which is highly unlikely), or else they paid close to 70% of their commissions as "soft dollars" to pay for proprietary research. It is hard for us to reconcile an average of 20% spent on soft dollars with an average commission of $0.05. It prompts the question about how diligently SEC examiners are probing this issue. If the SEC's own examiners are not pursuing this aggressively, how can the SEC expect fund directors to do so?

Policy Issues

Part of the problem may be difficulty in developing a clear and consistent policy regarding soft dollars. SEC Chairman Christopher Cox has publicly called for the abolition of soft dollars, and the proposed guidance stresses in a few places that the 28(e) safe harbor should not be construed by fund boards as requiring them to approve soft dollars. It appears that some elements of the SEC (including the current Chairman) wish to eliminate soft dollars, and other elements seek better regulation.

A consistent policy approach is badly needed because the current regulation is creating significant distortions in the market for investment research. There is no pricing mechanism for the majority of investment research since it is bundled into 'full-service' commissions.

On the one hand, producers of research have trouble determining how profitable their research activities truly are. Execution prices ranging from 1 cent to 2 cents per trade give a notional value of the research, ranging from 2 to 4 cents per trade. However, in the bundled world,

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[3] In a recent survey of compliance officers at SEC-registered investment advisors, 82% of the respondents indicated they pay bundled commissions for full-service brokerage research but only 33% of respondents said they rely on 28(e) for soft dollar purchases. Source: 2008 Investment Management Compliance Testing Survey, conducted by ACA Compliance Group. http://www.acacompliancegroup.com/documents/2008%20IM%20Survey%206-30-08.pdf

[4] SEC Chairman Christopher Cox refers to soft dollar spending as almost $1 billion, most recently in his statement during the open meeting when this guidance was discussed [http://www.sec.gov/news/speech/2008/spch073008cc_iaportfolio.htm]. In fact, soft dollar spending, including spending on proprietary research, exceeds $4 billion.

there is considerable argument over which groups get credited. Traders argue they should receive higher allocations; institutional sales requires allocations for the services it provides. Management access is believed to be important to investors, and this also needs an allocation. In the end, what is left for the actual security analysts may be meager scraps. And people wonder why analysts are fleeing to the 'buy side' or to alternative research.

Investors meanwhile are deluged with research. Portfolio managers and investment analysts complain of the volume of emails, calls, and IMs they receive from research providers. They invest in costly mechanisms such as research management systems or alpha networks to filter the research. They conduct more primary research, utilizing expensive tools such as expert networks, channel checkers, surveys and panels. Frustrated with the declining quality of proprietary research, they turn to alternative research.

Alternative research, which for the most part does have pricing mechanisms, has been growing. Despite overall declines in commission spending, spending on alternative research grew to $1.9 billion in 2007 from $1.81 billion in 2006.[5] Growth has been fueled by increasing demand for primary research tools, as well as growing use of alternative fundamental, economic and specialized research.[6]

Unlike proprietary research, alternative research is subject to market mechanisms. It can easily capitalize on new needs and requirements from investors, and it receives precise market feedback on what works and what doesn't. Producers of proprietary research, on the other hand, have little incentive to launch new services because it is difficult to get paid incrementally for the new offering.[7]

One policy option would be to seek the repeal of the 28(e) safe harbor, as previously suggested by Chairman Cox. This would address the potential conflicts which concern the Commission, as well as the research market dislocations. The disadvantage to this approach would be that it would create a significant disruption in the current market for investment research, potentially impacting the functioning of the markets. It was precisely this concern which prompted the creation of the 28(e) safe harbor in 1975 when fixed commissions were eliminated. The market has evolved since then, with a viable market for alternative research, so perhaps with planning and foresight it can be managed. Market participants would at a minimum need a long lead time to prepare.

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[5] The estimates for alternative research spending are from Integrity Research. Greenwich Associates estimates that overall commission spending declined from $12.6 billion in 2002 to $10.3 billion in 2007.

[6] Specialized research includes specialists in a variety of different research approaches, including forensic accounting, earnings quality, ESG (Environmental, Social, Governance), litigation analysis, mergers and arbitrage research, to name a few.

[7] In 2002, when Credit Suisse acquired Holt Value Associates, a well regarded provider of economic value analysis (EVA), Holt suffered a significant defection in subscribers who argued that the Holt subscription fees they previously paid should be included in the bundled commissions paid to Credit Suisse.

The other approach would be to require increased transparency, and, where possible, pricing mechanisms. This appears to be the approach favored by the SEC's UK counterpart, the Financial Services Authority (FSA). The FSA implemented commission disclosure requirements in 2006 and is now preparing second generation modifications to the disclosure regime. CSA adoption in the UK is reportedly at 60-70% of investors. Both investors and research providers laud the increased transparency and dialogue, making it easier for investors to signal which research is valuable and helping providers to focus their resources on research that investors appreciate. In contrast, the US, lacking a similar disclosure regime, has CCA adoption rate of around 20-30%.

Increased Disclosure

If the SEC does not opt for a ban of soft dollars, we believe the SEC should require increased disclosure of commission spending. Brokerage spending should be reported in aggregate and by broker. Disclosure should include the aggregate amounts and the commission rates paid. Also included in the disclosure should be execution-only commission rates. Clients should also receive information on how their fund brokerage commissions are being spent.

We understand that such disclosures would be unpopular with the entities the SEC regulates. However, we believe that only by requiring such disclosures can the SEC ensure that there is a level of transparency to protect against the conflicts inherent in soft dollars. Further, disclosure will also promote dialogue between investors and research suppliers, and between investors and their clients, helping to mitigate the market imbalances currently created by bundled commissions. At worst, if this policy is ineffectual, the market would be better prepared for an outright ban of soft dollars.

Conclusion

We do not believe that fund directors, no matter how well guided, can fully address the challenges posed by soft dollars. While we support the SEC's guidance to directors, it is an insufficient policy response. Even worse, where the proposed guidance appears to urge directors to ban soft dollars, it gives the appearance that the SEC has attempted to abrogate its responsibilities by 'back-dooring' a soft dollar ban. We urge the SEC to step forward with a clear and consistent policy. Either ask Congress for a repeal of the 28(e) safe harbor, or put in place an effective set of disclosures for commission spending.

Sincerely,

Sanford Bragg
President & CEO