Bill George
Encino, CA

September 5, 2008

Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Subject: File No. S7-22-08 Proposed Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Advisor Portfolio Trading Practices

Dear Secretary and SEC:

At the “Sunshine Meeting” on July 12, 2006 statements made by the Chairman, Commissioners, and staff of the SEC left the public with the common impression that a proposal for a “second wing” of Commission Guidance on disclosure and transparency of *all* institutional brokerage commission arrangements would be forthcoming before the end of 2006. Evidence of this general understanding seems to be supported by a letter from U.S. Senator Charles Schumer to Chairman Cox, dated July 20, 2007 (attached), questioning Chairman Cox about the status of this agreed upon proposed guidance on brokerage commission disclosure and transparency.

Since the July 12, 2006 “Sunshine Meeting” the SEC has issued two more proposals which relate to institutional advisors uses of their clients’ brokerage commissions and advisors’ portfolio trading practices. They are (1) Amendments to Form ADV, File Number S7-10-00 released March 3, 2008 and (2) this release (S7-22-08) dealing with the responsibilities of investment company boards of directors for portfolio trading oversight.

It seems it may be impossible or unrealistically complicated to obtain the objectives of the July 12, 2006 Commission Guidance and the other two (above cited) instances of proposed guidance in the absence of detailed guidance and *universal* requirements for institutional brokerage commission disclosure and transparency. It also seems that issuing general guidance with some specificity of required disclosures - particularly in the case of what are now known as the research and “other services” provided by full-service brokers in bundles of undisclosed brokerage services - should be preferred to continually talking about disclosure, transparency and the identification of brokerage services as if they are totally abstract concepts. It seems under the SEC’s mandate for investor protection such guidance is long past-due.

Also, I’ve noticed there seems to be a general lack of awareness of the history and the relationships between May Day 1975, fully-negotiated brokerage commissions, Section 28(e), third-party institutional brokerage, and the poorly understood term “soft dollars”. For those who may have an interest in this part of U.S. brokerage history I’m attaching a synopsis which I’ve titled, **Thirty-Three Years Later**, the footnotes of this document substantiate its content.

Thank you,

Bill George

CHARLES E. SCHUMER
NEW YORK

COMMITTEES:
BANKING
JUDICIARY
RULES
FINANCE

United States Senate

WASHINGTON, DC 20510

July 20, 2007

The Honorable Christopher Cox
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Mr. Chairman:

I write to follow up on our conversation last week about the status of the Securities and Exchange Commission (SEC)'s guidance on Exchange Act Section 28(e). As you know, the purpose of my call was to seek clarification of your view of the safe harbor for certain "soft dollar" client commission practices, in which client commission dollars are used to procure research services.

After more than three years of studying all of the relevant issues surrounding client commission practices, the SEC released unanimous interpretative guidance on Section 28(e) in July 2006. This July Release was extremely well received, as market participants actively responded to, and relied upon, this interpretative release, which went into effect in January 2007. It was also helpful in bringing regulatory convergence with the UK's Financial Services Authority policy on the same subject.

The July 2006 Release was lauded as an excellent first step towards addressing potential abuses of soft dollar practices, but its goals will only be fully realized with the necessary disclosure regime in place. So I was encouraged when, contemporaneously with the July 2006 Release, you publicly agreed to create proposed disclosure rules for public comment by the end of 2006. Rules on transparency and disclosure are not only desirable, but necessary, as fund boards and trustees have requested such guidance to properly discharge their fiduciary duties. Section 28(e) explicitly provides the SEC with authority to establish an appropriate disclosure regime for client commission practices, so these rules are both appropriate and necessary.

I have been outspoken over the past three years about the importance of a vibrant investment research industry with appropriate protections for investors. I believe the appropriate route to address this issue is the issuance of SEC rules as planned. In contrast, I believe there are significant drawbacks to an approach that includes drastic legislative changes which may create far-reaching negative effects on the investment research industry. This may be particularly true when those legislative changes are made without first fully exploring available agency-level solutions. In light of these concerns, please provide responses to the follow questions about the SEC's position on Section 28(e):

- The SEC's Guidance has only been fully in place for six months. What circumstances, if any, have changed in that time frame to warrant a change in your view of the appropriate treatment for the continued use of client commission arrangements?
- You recently stated that Congressional legislation may be necessary to address the problems associated with soft dollar commission practices. In light of the SEC's rulemaking authority and the fact that disclosure rules were recommended by the SEC's own Soft Dollar Task Force, what factors support additional legislation at this point in time?
- When do you expect the SEC to issue its Section 28(e) disclosure rules for public comment?

I look forward to hearing from you and to bringing closure on the issue of soft dollar guidance.

Sincerely,

Chuck Schumer

Charles E. Schumer
United States Senator

<u>Thirty-Three Years Later</u>

From the beginning of the U.S. brokerage industry, under the terms of the Buttonwood Agreement,[1] the industry strictly enforced rules of conduct stipulating that brokers could not engage in price competition. The rules mandated the use of fixed commission rates. So, as an approach to non-price competition, brokerage firms soon began to provide additional services to clients at no additional charge. Examples of the kinds of additional services provided under the fixed commission structure prior to 1975 were investment research, "block positioning" and the exchange of non-public or "inside" information.[2] [3]

Then, in the early 1970's the U.S. Department of Justice filed a brief with the Securities and Exchange Commission requiring the SEC put an end to the securities industry's collusive anti-competitive fixed-price commissions. As a result of this Department of Justice brief the SEC mandated that, as of May 1, 1975, brokers would be required to fully-negotiate all brokerage commissions with their clients.

It's important to realize that in the fixed commission era, prior to May Day 1975, there was no such thing as fully-negotiated "execution only" brokerage, and <u>there was no such thing as third-party brokerage</u>. And, it's also important to realize that in the pre-1975 environment, institutional investment advisors took advantage of the "additional services" competition that grew out of the brokerage industry's fixed-price commission structure. Simply stated, the institutional investment advisory industry preferred to use the artificially high fixed-rate commission structure and the resulting additional services competition to facilitate the use of their clients' brokerage commissions to buy investment research and other brokerage services. This arrangement allowed advisors to use their clients' brokerage commissions to buy undisclosed services without any increase in the advisors' overhead costs.

Before May Day 1975 the availability of brokerage firms' proprietary investment research at no out-of-pocket cost discouraged most potential independent research producers from attempting to compete with broker dealer provided proprietary research. (The few truly viable "independent" research producers I recall from the pre-May Day era were Standard and Poor's, Argus, Value-Line and Vickers Research). And, it's important to realize that, in most cases, these "independent" research producers received the bulk of their revenue from the sale of research and research related products to brokerage firms. The brokerage firms in turn passed-on the research and research products (*e.g.* S&P Stock Guides, S&P "Tear Sheets", and / or Value-Line Investment Reviews) to their most valuable clients. Or, alternatively, brokerage firms incorporated the content of these research providers' research into their own research offerings. Obviously, this approach to the re-offering of investment research gave brokerage firms significant control over the content of the research that actually got distributed. And, this approach could also obviously lead to research "screening" and bias favoring a brokerage firms' investment banking efforts, or favoring investments which were sponsored by the broker dealer (*e.g.* market making activities).

---

[1] For more on The Buttonwood Agreement , see> http://en.wikipedia.org/wiki/Buttonwood_Agreement

[2] See, **Occasional Papers** – <u>Reflections on a Lifetime in the Securities Industry</u> section titled. "Competition Comes to the NYSE" *by* John Freund, published September 2002 > http://www.pace.edu/emplibrary/FreundPaper.doc

[3] See, **Insider Trading, Chinese Walls, and Brokerage Commissions: The Origins of Modern Regulation of Information Flows in Securities Markets** *by* Stanislav Dolgopolov at >
http://www.isnie.org/ISNIE06/Papers06/02.3/dolgopolov.pdf

In spite of this anti-competitive environment, in the late 1960's and early 1970's, there were emerging signs that *independently* produced investment research might become commercially viable if a level competitive playing field could be created by reducing some of the implicit and undisclosed advantages of brokerage firms' pre-1975 bundled services brokerage arrangements.

One of the more important signs of potential economic viability of independent research was the emergence of academics' interest in studying the behavior of financial markets. Retrospectively, it seems the first solid evidence of this academic interest and involvement was the establishment of the Center for Research in Security Pricing (CRSP). CRSP was initially funded in 1960 by a $300,000 grant from Merrill Lynch, Pierce, Fenner & Smith (now, Merrill Lynch). The original objective of the CRSP project was to create a process that could be used to compare stock market returns relative to the returns of other types of investments. By the early 1960's the economics and the capabilities of computing had arrived at a point where large data files could be constructed and studied to answer such questions somewhat economically. The CRSP study was led by Professors James H. Lorie and Lawrence Fisher at the University of Chicago, Graduate School of Business. Professors Lorie and Fisher began the work of accumulating and organizing the historic stock market data in a manner that would facilitate the objectives of the CRSP study. The CRSP stock market database was completed in 1964. It was estimated to contain between two and three million verified data items. The database allowed researchers, for the first time in history, to give accurate estimates of stock market returns over selected time periods.[4] After the release of the CRSP database there was a revolution in investment research. In the words of Rex A. Sinquefield,[5] "The entire field of finance has been changed and developed through that database".

After the release of the CRSP database curious academics and several small non-broker affiliated boutique investment research firms like O'Brien & Associates (now known as Wilshire Associates), Ibbotson & Associates, Callan Associates, and etc. began to use the CRSP database to develop mathematic and statistical approaches to investment analysis, portfolio performance analysis and stock selection. However, because of the tradition fixed-commissions and "free" additional services the distribution of these firms' research output was through broker dealers and these non-affiliated research boutiques almost always received payment for their research services from the brokerage firms who executed trades for the institutional advisors who were the end users of the research (the relationship was controlled by the broker dealer).

As the May 1, 1975 deadline for the implementation of fully-negotiated brokerage commissions approached, the brokerage industry began to adjust and adapt to the anticipated consequences of fully-negotiated brokerage commissions. Most brokerage professionals believed their proprietary investment research would not be as appealing to institutional clients if the clients had to pay for the research with "hard dollars" (*i.e.* cash). Brokerage firms' proprietary investment research had always been a "loss leader" and brokerage firm research departments were not considered profit centers. Therefore, in anticipation of May Day many brokerage firms began to disband or sell their research departments. In many cases, because of the loss of perceived value, the only potential buyers of brokerage research departments were those employed in the research department, consequently many research department sales were structured as employee buy-outs. Suddenly, just prior to May Day there was explosive growth in the number research producers which were not controlled by brokerage affiliation.

---

[4] See, About CRSP - Center For Research in Security Pricing > http://www.crsp.com/crsp/about/history.html
And see, Wikipedia about CRSP at> http://en.wikipedia.org/wiki/Center_for_Research_in_Security_Prices

[5] For more on Rex Sinquefield see> http://en.wikipedia.org/wiki/Rex_Sinquefield

Then, a few weeks after May Day 1975, in response the strong urging and intense lobbying of the securities industry, the U. S. Congress passed an amendment to the Securities Exchange Act of 1934; the amendment is Section 28(e). Section 28(e) provides a "safe harbor" for investment advisors to "pay-up" from the fully-negotiated execution related costs of their securities transactions, and in exchange for the amount "paid-up" receive qualifying investment research.

Within weeks of Congress passing of Section 28(e) third-party institutional brokerage was conceived. Independent research providers found stock exchange members who were willing to offer fully-negotiated execution services, and add a "paid-up" commission premium to be used to compensate independent research providers for the Section 28(e) qualified research they produced. Because there are three unrelated parties in these arrangements it's necessary for the arrangements to include documentation of the details of the execution-related brokerage costs and the research provision aspects of the arrangements. This documentation of the execution related costs and the documentation of the amounts of commissions "paid-up" for independently produced research provides valuable brokerage commission disclosure information for institutional clients, and it greatly simplifies (required) SEC inspections by providing valuable evidence of Section 28(e) compliance. It's obvious the commercial vitalization of independent research was an unintended consequence of May Day 1975, and Section 28(e). It's also obvious that investment research objectivity, market efficiency and brokerage commission price competition have benefitted significantly from the growth of a research industry that can be independent of the sales and marketing influences which have sometimes created conflicts of interest and bias which seem so prevalent in the full-service brokerage industry.[6]

But, surveying the institutional brokerage environment in September 2008, thirty-three plus years after May Day 1975, and thirty-three plus years after Congress' passed Section 28(e), a few questions come to mind. Questions such as:

- In the current environment, does independent research really enjoy a level competitive playing field, as compared to brokerage firms' proprietary research?
- Do brokers and institutional investment advisors* now engage in a process which leads to fully-negotiated brokerage commissions?
- Do institutional investment advisors, for some reason, still prefer to use their clients' brokerage commissions to purchase bundled undisclosed proprietary services provided by full-service brokerage firms?
- How does the U.S. Securities and Exchange Commission measure compliance with its mandate for fully-negotiated brokerage commissions and how does the SEC measure compliance with Section 28(e) in situations where there is no disclosure of information relating to the pricing of the execution related costs of brokerage transactions, and / or the identification and pricing of the other services exchanged for advisors' clients' commissions in undisclosed bundled brokerage transactions?

* **Institutional investment advisors who are registered with the SEC and who have a fiduciary obligation to their clients.**

[6] For more descriptive information on the nature of the potential conflicts of interest in full service brokerage arrangements see SEC **Fact Sheet On The Global Analyst Research Settlement** at > http://www.sec.gov/news/speech/factsheet.htm and Wikipedia entry on the GARS at > http://en.wikipedia.org/wiki/Global_settlement