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December 9, 2005

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: Release No. 34-52635, File No. S7-09-05
Proposed Interpretative Release Regarding Client Commission
Practices under Section 28(e) of the Exchange Act

Dear Mr. Katz:

Instinet, LLC ("Instinet") welcomes the opportunity to provide the Securities and Exchange Commission (the "Commission" or "SEC") with its comments on the proposed interpretive guidance (the "Proposed Guidance") with respect to client commission practices under Section 28(e) of the Securities Act of 1934, as amended (the "Exchange Act").

A. Instinet

Instinet, headquartered in New York City, is an institutional global electronic agency securities broker-dealer that provides its customers with sophisticated electronic and sales trading execution services that enable buyers and sellers to seek best execution and lower transaction costs either by trading directly and anonymously with one another or by executing trades in global securities markets. Through Instinet's electronic platforms, customers can access major U.S. trading venues, as well as more than thirty securities markets throughout the world. Instinet's customers primarily consist of institutional investors, such as mutual funds and pension funds. More information about Instinet and its activities is available on its website at www.instinet.com.

B. Instinet's Commission Management Services

1. Soft Dollar Program

Instinet is one of the largest independent providers of research and other brokerage services through soft dollar or similar arrangements, and has offered soft dollar programs for over fifteen years. Institutional investors often allocate a portion of their gross brokerage transaction fees for the purchase of independent third-party research products, as well as other brokerage services. Instinet offers soft dollar programs in order to increase the amount of business institutional customers conduct through Instinet, thereby increasing its transaction volumes and the depth of its institutional liquidity pool. In 2004, more than one-third of Instinet's U.S. customers obtained third-party research services from us on a soft dollar basis.

2. *BrokerShare℠.*

Instinet's patent pending BrokerShare℠ offering allows institutional customers to execute trades at Instinet and allocate a portion of their gross brokerage transaction fees to third party broker-dealers, chosen by the customer, for the purchase of the broker-dealer's proprietary research products, as well as other brokerage services. BrokerShare enables Instinet customers to enter orders directly with Instinet, without acting through a third party broker-dealer, which gives customers the ability to execute trades without revealing their trading strategies to other broker-dealers, which may act in a proprietary manner. This also gives the customers a wide selection of independent and specialized research choices, while at the same time minimizing commissions.

Under BrokerShare, money managers who trade with Instinet accrue soft dollar credits which are recorded in a BrokerShare account. At the money manager's discretion, Instinet allocates these commission dollars to a participating broker-dealer that has provided research to the money manager. The value of the research and thus the amount that is allocated to a participating broker-dealer is determined by the money manager. This allows the money manger to determine the usefulness and value of the research after it has been provided. Money managers and broker-dealers that participate in BrokerShare are not required to pay a fee to Instinet to participate in the program. We note similar programs are offered by other broker-dealers in the United States and the United Kingdom.

C. The Proposed Guidance

According to the Commission, the Proposed Guidance is meant to help define what soft dollars can and cannot be used to purchase.[1] Specifically, the Proposed Guidance covers six aspects of the Section 28(e) safe harbor: (i) the appropriate framework for analyzing whether a service falls within the "brokerage and research services" safe harbor; (ii) the eligibility criteria for "research"; (iii) the eligibility criteria for "brokerage"; (iv) the appropriate treatment of "mixed-use" items; (v) the money manager's duty to make a good faith determination as to reasonableness under Section 28(e); and (vi) third-party research and commission-sharing arrangements.[2]

Instinet's comment will be limited to discussing the final area – third party research and commission sharing arrangements.

1. Third-Party Research Arrangements

With regard to third-party research arrangements, the Proposed Guidance clarifies that research provided under these arrangements is eligible under Section 28(e) so long as the broker-dealer "*effecting*" the trade is legally obligated to pay for any third party research provided to a money manager.

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[1] SEC Release No. 34-52635 (Oct. 19, 2005).

[2] Proposed Guidance at 20-21.

2. Commission Sharing Arrangements

With regard to commission sharing arrangements, per the Proposed Guidance, the roles assumed by each broker-dealer will determine whether a commission-sharing arrangement is permissible under Section 28(e).[3] Specifically, the Proposed Guidance clarifies that in order to fall within the safe harbor, a commission sharing arrangement must be part of a "*normal and legitimate correspondent relationship*" whereby each broker-dealer's involvement is more significant than the mere receipt of commissions paid for research services provided to money managers. According to the Commission, at a minimum, the introducing broker-dealer must: (1) be financially responsible to the clearing broker-dealer for all customer trades until the clearing broker-dealer has received payment (or securities), *i.e.,* the introducing broker-dealer must be at risk to the clearing broker-dealer for its customers' failure to pay; (2) make and/or maintain records relating to its customer trades required by Commission and self-regulatory organization ("SRO") rules, including blotters and memoranda of orders; (3) monitor and respond to customer comments concerning the trading process; and (4) generally monitor trades and settlements.[4]

Additionally, the broker-dealer effecting the trade must be legally obligated to pay for any third party research or brokerage services or products provided to a money manager.[5]

D. Focus of Instinet's Comment

Instinet believes the Proposed Guidance relating to commission sharing arrangements should be revised. Instinet is concerned that the "minimum" requirements imposed on introducing broker-dealers in commission sharing arrangements, if enacted, could result in a *de facto* regulatory prohibition of certain commission sharing arrangements and would substantially change existing law interpreting the "effecting" element of Section 28(e) without a basis in the legislative history of that Section, prior precedent interpreting Section 28(e), and other relevant precedent interpreting when a broker-dealer is deemed to "effect" a trade for a customer. Instinet also believes that the proposed "minimum" requirements imposed on introducing broker-dealers could have unwarranted and harmful policy consequences, such as reducing independent research and increasing the costs that the clients of money managers pay for soft dollar arrangements.

E. The "Effecting" Element of Section 28(e) Does Not Require the Proposed Four Additional "Minimum" Elements

The Proposed Guidance correctly notes that the "effecting" language in Section 28(e) was inserted to prevent a practice known as "give-ups" which had developed under the system of fixed brokerage commissions that existed prior to May 1, 1976.[6] A leading commentator and former

[3] Proposed Guidance at 45.

[4] Proposed Guidance at 46.

[5] Proposed Guidance at 46.

[6] Proposed Guidance at 41 – 42. See also Securities Acts Amendments of 1975, Conference Report to Accompany S. 249, Joint Explanatory Statement of Comm. of Conference, H.R. Rep. No. 229, 94th Cong., 1st Sess. 108 (1975) (Section 28(e) has "no application whatsoever to a situation in which payment is made by a money manager to one

senior SEC official has offered the following widely accepted definition and examples of "give-ups":

> brokers and investment company managers worked out a technique by which brokers who executed transactions surrendered a part of their commissions to other brokers designated by the investment company through its manager. In this way, the manager could use commissions on portfolio transactions to reward the brokers who had been helpful in selling shares or in giving research, although these brokers had nothing to do with the execution of the portfolio transactions. As the practice of give-ups developed, it was used by the less scrupulous managers not only to reward brokers for the sale of investment company shares or for advice, but also to channel payments to the managers themselves, or to their families, or to cover the managers' expenses.[7]

Thus, the major concern regarding "give-ups" was that commission dollars were shared with a broker-dealer in exchange for providing services that benefited the money manager but had no benefit for his clients. Examples of some these inappropriate "give-ups" included: (i) giving-up a portion of the commission to a broker-dealer affiliated with the money manager; (ii) giving-up a portion of the commission to broker-dealers that sold a fund's shares;[8] and (iii) giving-up a portion of the commission to a broker-dealer whose only participation was steering more clients to the institutional broker-dealer.[9] Customers of the money manager derived no benefit from these "give-ups" and, thus, a portion of their commission was benefiting the money manager but not the manager's clients. It is important to note, however, that although give-ups were criticized, they were determined not to be illegal, provided that clients did not pay higher commissions in the arrangements.[10] The SEC proposed a rule that would have required confirmation disclosure of give-up arrangements, but withdrew the rule.[11]

The SEC staff has addressed the "effecting" requirement under Section 28(e) several times, and on each occasion has found that the "effecting" element of Section 28(e) does not apply to

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broker or dealer for services rendered by another broker or dealer. The give-up was a regrettable chapter in the history of the securities industry and the limited definition of fiduciary responsibility added to the law by this bill will in no way permit its return.").

[7] II Tamar Frankel, The Regulation of Money Managers 610 (1st ed. 1978).

[8] Thomas P. Lemke and Gerald T. Lins, Soft Dollars and Other Brokerage Arrangements §4.07 (2004); Proposed Guidance at 41 fn. 121.

[9] See Exchange Act Release No. 8239 (Jan. 26, 1968).

[10] See Tannenbaum v. Zeller, 552 F.2d 402 (2d Cir. 1976) (give-ups are permissible if, *inter alia*, fund shareholders benefit from them).

[11] See Proposed Rule 10b-10, 34-8239 (1968), withdrawn, 34-8743 (1969).

legitimate introducing-clearing arrangements.[12] For example, a leading commentator on Section 28(e) has summarized these no-action letters in the following way:

> The SEC and its staff believe that Section 28(e) is available where commissions are paid in good faith to an introducing broker-dealer for execution and clearing services performed in whole or in part by the introducing broker-dealer's normal and legitimate correspondent. If the money manager bypasses the order desk of the introducing broker-dealer and forwards the orders directly to the clearing broker-dealer, the protection of Section 28(e) is not necessarily lost.[13]

Each of the no-action letters interpreting the "effecting" element of Section 28(e) confirms this summary of existing law.[14]

This understanding is consistent with a well developed body of law interpreting the relationship between introducing and executing and clearing broker-dealers. This body of law relies upon rules of the SROs which have been approved by the SEC.[15] Under these rules, every introducing-clearing agreement must be filed with the required SRO and approved by that organization.[16] The SRO rules, however, do not specify that certain functions must be assigned to the introducing firm in order for the arrangement to be legitimate. We believe that SROs have

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[12] See SEI Financial Services, SEC No-Action Letter (pub. avail. Dec. 14, 1983) ("SEI"); Data Exchange Securities, SEC No-Action Letter (pub. avail. May 20, 1981) ("Data Exchange"); Becker Securities Corp., SEC No-Action Letter (pub. avail. June 28, 1976) ("Becker").

[13] Thomas P. Lemke and Gerald T. Lins, Soft Dollars and Other Brokerage Arrangements 3-23 (2004) (footnotes omitted).

[14] See, for example, Becker: "Although [the legislative history of Section 28(e)] might conceivably be thought to make Section 28(e) inapplicable to the portion of a commission used by a broker to engage other broker-dealers to assist it in effecting transactions for the first broker's customers, it does not appear that the Congress intended that result. If the coverage of Section 28(e) were to be construed as so restricted, an institution wishing to be within the coverage of Section 28(e) might have to insure that its brokers did not retain an independent 'two dollar' broker or specialist on any of the institutions transactions. We do not believe that such an interpretation would reflect the intention of the Congress in adopting Section 28(e). I would also agree that the protections of Section 28(e), if otherwise available with respect to commission payments made by an institution to an introducing broker for which Becker is a normal and legitimate correspondent, would not be lost merely because the fiduciary by-passed the order desk of the introducing broker and called orders directly to Becker."

[15] See, for example Rule 3230 of the NASD Rules of Fair Practice: "a) All clearing or carrying agreements entered into by a member, except where any party to the agreement is also subject to a comparable rule of a national securities exchange, shall specify the respective functions and responsibilities of each party to the agreement and shall, at a minimum, specify the responsibility of each party with respect to each of the following matters: (1) opening, approving and monitoring customer accounts; (2) extension of credit; (3) maintenance of books and records; (4) receipt and delivery of funds and securities; (5) safeguarding of funds and securities; (6) confirmations and statements; (7) acceptance of orders and execution of transactions; (8) whether, for purposes of the Commission's financial responsibility rules adopted under the Act, and the Securities Investor Protection Act, as amended, and regulations adopted thereunder, customers are customers of the clearing member; and (9) the requirement to provide customer notification under paragraph (g) of this Rule."

See also NYSE Rule 382.

[16] NASD Rule 3230(e), NYSE Rule 382(a).

approved thousands of introducing-clearing agreements that assign minimal responsibilities to the introducing firm. This is consistent with the traditional role of the introducing broker as the "salesman" who brings the order to the firm that executes, settles, confirms, and clears the trade. It would represent a radical departure from existing law and industry practice to suggest that the introducing firm must assume a particular set of responsibilities, such as the four minimum elements set forth in the Proposed Guidance, to be deemed a legitimate introducing broker-dealer. Unless the legitimate role of the introducing broker is redefined and expanded,[17] there is no basis to read Section 28(e) as requiring an introducing broker-dealer to perform some special set of tasks in order to be deemed to have "effected" a trade.

In conversations with the SEC staff, it was indicated that the SEI no-action letter embodies the conditions included in the Proposed Guidance. We do not read the SEI letter in this way. Rather, the SEI letter includes a set of facts that relate to the arrangement at issue and the staff granted the no-action relief based upon those facts. Nowhere in the SEI letter does the staff suggest that an introducing broker-dealer would not be deemed to be "effecting" a trade for purposes of Section 28(e) if it was performing functions slightly different from those set forth by the requesting party in the SEI letter. Moreover, why would the Commission need to issue the Proposed Guidance if the issue had been settled twenty-two years ago with the issuance of the SEI letter?

F. Harm to Investors

While we applaud the Commission's attempt to prevent soft dollar abuses, it is Instinet's belief that the minimum obligations required of introducing broker-dealers in commission sharing arrangements will harm investors rather than protect them. Specifically, as noted above, such obligations may likely result in the regulatory prohibition of certain commission sharing arrangements which are beneficial to money managers and their clients. Specifically, the harms this could cause include: (i) a limiting of the depth and breadth of available research; (ii) an increase in commission costs; (iii) a reduction in competition; (iv) a reduction in transparency; and (v) a resulting regulatory scheme which encourages and protects more costly and less efficient soft dollar arrangements, while at the same time potentially barring more low-cost, efficient soft-dollar arrangements.

1. Limiting the Breadth and Depth of Available Research

There can be little doubt about the importance of research in the market place. Indeed, Congress enacted Section 28(e) because it recognized the value of research in managing client accounts.[18] The same can be said for research provided by third parties. Indeed, as the Proposed Guidance observes:

> Third-party research arrangement can benefit advised accounts by providing greater breadth and depth of research. First, these arrangements can provide

[17] This could easily be accomplished by amending the existing SRO rules governing introducing-clearing agreements to provide that certain functions must be assigned to the introducing broker-dealer.

[18] Proposed Guidance at 3.

> money managers with the ability to choose from a broad array of independent research products and services. Second, the manager can use third-party arrangements to obtain specialized research that is particularly beneficial to their advised accounts.[19]

It is clear that technologies, which have developed since the Commission's last major soft dollar release in 1986, have allowed for the development of innovative commission sharing arrangements that are cheaper, more convenient, and more flexible.[20] It is also clear that many third-party research providers that participate in these commission sharing arrangements have registered as broker-dealers because it allows them receive commissions under relevant SRO rules.[21] However, many of these introducing broker-dealers do not have the capacity to satisfy the minimum requirements set forth in the Proposed Guidance to qualify as a "normal and legitimate correspondent." For example, some of these introducing broker-dealers may not be able to be financially responsible to the clearing broker-dealer for all customer trades until the clearing broker-dealer has received payment.

Indeed, the Proposed Guidance will have disproportionately severe effect on smaller "boutique" broker-dealers that often offer specialized research. Many of them simply may not have the capacity to satisfy the requirements set forth in the Proposed Guidance. This could lead to less available research options in the market place. Such an outcome would seem antithetical to the intent of Section 28(e), and as suggested by the quotation set forth above, the Proposed Guidance itself.

2. Price, Execution, Convenience and Confidentiality

In addition to supplying greater access to research, commission sharing arrangements offered by Instinet and others allow money managers to pay lower commissions, obtain better execution, and still maintain the confidentiality and convenience that Instinet and similar trading platforms provide. This is accomplished in two ways: (1) by, in effect, unbundling the services provided by the research provider and the executing broker, and sharing the commissions accordingly; and (2) by allowing the money managers to determine the value, if any, of the research provided. Moreover, as is discussed below, the reduction in costs and increased efficiencies also mitigate any interpositioning concerns that the Commission may have regarding such commission sharing arrangements.

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[19] Proposed Guidance at 39-40.

[20] BrokerShare allows money managers to choose among approximately 200 research providers.

[21] For example, IM-2420-1(6) of the NASD Rules of Fair Practice provides that "[a]n Association member may not pay a commission to any non-member broker or dealer for executing a brokerage order for the Association member in the over-the-counter market." There is also a question whether the recipient of commissions in a commission sharing arrangement would need to be registered with the SEC as a broker-dealer because of the requirements imposed by Section 15(a) of the Securities Exchange Act of 1934, as amended.

a. Convenience and Confidentiality

In order to get the research it needs from various broker-dealers, a money manager is often forced to split its trading among various broker-dealers. In other words, in order to generate soft dollar credits, a money manager will often split large trades among different broker-dealers. Of course, sending trades to multiple broker-dealers means more work for the money managers. Additionally, using multiple broker-dealers or using step-out arrangements means that the market sees not one party buying or selling a position, but instead sees multiple sellers or buyers.[22] This can in turn lead to situations where transactions that should have minimal impact on market prices instead produce significant price movements. Moreover, money managers fear that as their trading strategies become more widely known, others may attempt to front-run those strategies.

Under commission sharing arrangements like BrokerShare, a money manger is able to enter orders directly with Instinet, without the assistance of a third party broker-dealer. This gives customers the ability to execute trades without revealing their trading strategies to other broker-dealers while still obtaining the research they need from different sources. Moreover, commission sharing arrangements like Instinet's BrokerShare program provide money managers with the convenience of consolidating their order flow without limiting their research choices.

b. Price and Execution

As is noted above, commission sharing arrangements like BrokerShare are, in reality, simply an unbundling of the services provided by the executing broker-dealer and the research provider. This division of labor benefits the money managers, and ultimately their customers, by allowing access to more research options while at the same time lowering commission rates and ensuring better execution. In other words, by separating the functions, efficiencies and choices are created that benefit the money managers and their customers. The execution is left to the party best able to deliver the best and cheapest execution while the job of providing research is left to the broker-dealers that produce the best research that is most desired by the money managers.

For example, suppose a money manager finds the research it receives from several small broker-dealers to be extremely valuable. However, the money manger may be wary of trading with these broker-dealers because their commission rates are high and their execution services are questionable. Arrangements like BrokerShare divide these two functions and allow broker-dealers like Instinet to provide effective low cost execution and allow the small broker-dealers to provide the desired high quality research.

However, since the commissions under such arrangements are shared with the broker-dealers providing the research, these broker-dealers would be subject to the "minimum" obligations discussed in the Proposed Guidance. Such obligations will likely make the arrangements more expensive and less practical and therefore diminish the reason for creating such arrangements, i.e., access to a greater variety of research and better, less expensive execution. Additionally, as is noted above, some of the introducing broker-dealers may not have the capacity to satisfy the "minimum" obligations discussed in the Proposed Guidance.

[22] It has also been our experience that step out agreements can be taxing on a firm's back office operations.

c. Money Managers Determine the Value of the Research

BrokerShare empowers money managers by giving them the ability to decide the value of research they receive, thereby lowering costs. Under BrokerShare, a money manager obtains research from various firms that participate in the program. As the money managers trade through Instinet, they accumulate soft dollar credits in a BrokerShare account. At the money manager's discretion, they direct Instinet to pay research providers from this account an amount that the money manager believes is reasonable in exchange for the research provided (this is usually done on a monthly basis). Therefore, if a money manager believes that the research provided was only minimally valuable, the manager will direct Instinet to pay an appropriately small amount. This gives the money manager the ability to pay based on the usefulness of the research.

This may lead a research provider to protest. Indeed, going forward, the research provider may refuse to provide the research to the money manager. Of course this would mean that instead of getting less than they wanted for the research they would get nothing. If they do refuse to provide research going forward, the money manager then would have the choice to either pay more if they truly desired the research, or to seek better research elsewhere from a competitor of the research provider. Another option is, of course, for the research provider to provide a better product, *i.e.,* better research. In any event, under such a commission sharing arrangement, the cost of the research more closely matches its value to the money manager and its clients.[23]

d. Interpositioning

One of the concerns that commission sharing arrangements can raise is interpositioning. Commission sharing arrangements like BrokerShare, however, do not raise such concerns. Interpositioning abuses commonly occur when the presence of an additional broker-dealer results in an account bearing unnecessary expenses (or receiving reduced proceeds) from a transaction executed on its behalf. However, where the addition of another party in the transaction results in the customer achieving a better result than he would have absent the inclusion of that party, interpositioning is not a concern. In the case of BrokerShare, there is no extra charge to participate in the program. Moreover, as noted, the division of labor between the broker-dealer executing the transaction and the broker-dealer providing the research significantly reduces the cost of trading for the money managers and helps them lower commission costs, obtain better execution, and minimize the commissions they need to commit to obtain research.

3. Reduced Competition

Commission sharing arrangements like BrokerShare allow low cost executing broker-dealers to team up with a number of introducing broker-dealers that provide high quality independent research and offer money managers an alternative to full service brokers. However, as noted, many of these research providers may not be able to satisfy the minimum obligations discussed in the Proposed Guidance. Moreover, even if they could comply, it is likely that the costs of such compliance will render these arrangements more expensive. This will of course lead to fewer research choices and less competition in the market.

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[23] We also note that the unbundling, combined with the fact that the money manager determines the value of the research, allows the money manager to more easily comply with its duty under Section 28(e) to make a good faith determination that the commissions paid are reasonable in relation to the research provided.

Moreover, by placing these restrictions on introducing broker-dealers, the Proposed Guidance unfairly favors full service brokers which maintain in-house research departments. Obviously, the in-house research departments at full service brokers will not be expected to participate in the "*effecting*" of the transaction. Nor will the research departments of full service firms be expected to meet any of the four new "minimum" requirements set forth in the Proposed Guidance. Unfortunately, rather than creating a level playing field, it seems likely that the Proposed Guidance will have the effect of favoring full service brokers.

4. Transparency

The unbundled nature of BrokerShare, and other similar commission sharing arrangements, allows for much greater transparency. Indeed, it allows the money manager or regulator to review each part of the transaction separately. Regulators can easily review and evaluate the process, while the money managers can more easily break out the costs of execution and research and therefore be in a position to determine in good faith, as required by Section 28(e) "that such amount of commission was reasonable."[24] In contrast, there is little or no transparency for commissions paid to traditional full-service brokerage firms.

5. Protects Inefficient and More Costly Arrangements

Finally, we note that the obligations discussed in the Proposed Guidance concerning commissions sharing arrangements could lead to the anomalous and unwanted consequence where inefficient and more costly arrangements will be protected under Section 28(e), while other arrangements, which may be significantly less costly and more advantageous to money managers and their customers, would be outside the safe harbor.

For example, suppose Money Manager A trades with Broker-Dealer B because of certain specialized research that Broker-Dealer B is able to provide. However, Broker-Dealer B's commission rate (six cents per share) is above industry averages and is significantly higher than Instinet's commission rate (e.g. two cents per share). Therefore, Money Manager A is "paying up" in exchange for the research. Additionally, while Broker-Dealer B's execution services are adequate, they may not be as good as Instinet's. However, Money Manager A has determined in good faith that the commissions paid to Broker-Dealer B are reasonable in light of the research provided.

In this example, Money Manager A could trade through a program like Instinet's BrokerShare program, and still obtain Broker-Dealer B's research, all at a lower total cost to Money Manager A's clients. However, if the Proposed Guidance discourages arrangements such as the BrokerShare program, the Section 28(e) safe harbor may permit Money Manager A to cause its clients to pay higher total costs by trading directly through Broker B.

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[24] 15 U.S.C. 78bb(e)(1).

Conclusion

It is our opinion that the position taken by the Commission in the Proposed Guidance with regard to third-party research and commission-sharing arrangements is not supported by the Commission's prior interpretations of the soft dollar safe harbor, nor by the statute or its legislative history. Furthermore, we believe that the Proposed Guidance could actually serve to undermine the goal of the safe harbor, namely provision of securities research to investors and their advisors. For these reasons, we request that the Commission reconsider the requirements placed on third-party research and commission sharing in the Proposed Guidance.

Very truly yours,

Jeffrey T. Letzler