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December 6, 2005

Jonathan G. Katz
Secretary
United States Securities and Exchange Commission
100 F Street. NE
Washington, D.C. 20549-9303

Re: Proposed Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934; *File No.:* S7-09-05

Dear Mr. Katz:

UBS Securities LLC ("UBS")[1] respectfully submits this letter in response to the U.S. Securities and Exchange Commission's ("SEC") request for comments on its proposed interpretive release entitled Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934 ("Interpretive Guidance").

UBS supports the efforts of the SEC in clarifying the requirements of Section 28(e), the safe harbor which permits a fiduciary to use a client's commissions to pay more than the lowest commission rate offered for "research and brokerage services." This furthers the dual ends of assuring best execution for client orders while supporting appropriate use of client commissions to acquire valuable services including independent research. We further endorse the SEC's attempt to conform the rules to those adopted by the FSA. For large international firms dealing in multiple international markets, consistency of regulation is an important goal. We believe that the Interpretive Guidance makes significant progress toward harmonization of regulation and that the regulators should continue the dialogue in the limited areas where views continue to diverge. We make a number of recommendations below on the specific aspects of the proposed interpretive release.

RECOMMENDATIONS:

As set forth in more detail below, UBS offers the following recommendations for consideration by the SEC. In its final release, the SEC should:

[1] UBS is one of the world's leading financial firms. UBS is the world's largest wealth manager, top tier investment banking and securities firm, and a key global asset manager. In Switzerland, UBS is the market leader in retail and commercial banking. UBS, headquartered in Zurich and Basel, is present in all major financial centers worldwide. It has offices in 50 countries and employs 69,000 people worldwide. UBS Securities LLC is the U.S. investment banking arm of UBS. It is one of the largest participants in the U.S. equities markets as a provider of execution, research and soft dollar services.

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- Reaffirm that best execution obligations are defined broadly to include non-cost factors;
- Ensure coordination of new disclosure requirements and clarification of "brokerage services" with the final Interpretive Guidance;
- Eliminate the temporal limitation with respect to the definition of "brokerage services;"
- Broaden the definition of eligible clearing arrangements and continue to allow firms to negotiate obligations and responsibilities of introducing and clearing firms;
- Avoid the creation of a preference for third-party, as opposed to, proprietary research;
- Prevent the imposition of additional supervisory responsibilities on broker dealer firms with respect to Money Manager use of the mixed-use allocation process;
- Ensure an appropriate balancing of flexibility and guidance so that firms can be comfortable in application of the safe harbor as the nature of research and brokerage services evolve; and
- Provide sufficient time for the industry to implement changes.

DISCUSSION:

1. **The SEC should reaffirm that best execution obligations are defined broadly to include non-cost factors.**

In defining best execution in relation to the fiduciary obligations of money managers, the SEC should reaffirm that the traditional definition of best execution includes various non-cost factors such as speed of execution, level of services provided, etc. For example, the NASD identifies the following factors that should be considered in determining whether the firm has used "reasonable diligence" to ascertain the best market for the securities: "(1) The character of the market for the security, e.g. price, volatility, relative liquidity, and pressure on available communications; (2) the size and type of the transaction; (3) the number of primary markets checked; (4) location and accessibility to … primary markets and quotation services."[2] Failure to include non-cost factors would unduly limit the discretion of money managers in choosing broker dealers that they believe provide the best package of services for clients.

2. **The timing of implementation should be coordinated with further guidance on disclosure requirements and clarification of "brokerage services."**

The Division of Investment Management is considering disclosure requirements for soft dollar relationships, including disclosure of the individual cost components of commissions. This will inevitably lead to discussion of "unbundling" of brokerage services. While clarifying the definition of eligible services is an important first step, the more difficult and complex issues will arise in connection with defining disclosure obligations and possible unbundling. Resolution of these issues will likely have a substantial impact on the brokerage business. Resolving the definitional issues apart from addressing the other could raise substantial problems for the industry. We urge the SEC to weigh all aspects of the soft dollar issue before issuing final Interpretive Guidance. If necessary, the SEC should delay release of the final Interpretive Guidance until these related issues are fully vetted. At the very least, the SEC should consider in its final Interpretive Guidance the potential impact on these related issues.

[2] NASD Rule 2320 (a).

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3. <u>The SEC should eliminate the temporal limitation with respect to brokerage services by clarifying the definition of "brokerage services" to include related pre- and post-execution services reasonably related to the execution of the transaction.</u>

The Interpretive Guidance defines "brokerage services" within the safe harbor as those products and services that relate to the execution of the trade from the point at which the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution through the point at which funds or securities are delivered or credited to the advised account. We believe that the temporal limitation on the definition may be too narrow and exclude certain valuable services provided to investment advisory clients in connection with the execution transaction but which occur before order transmission or after the settlement of the transaction. As a result, we believe the SEC should not adopt such a temporal interpretation but instead allow brokerage services "reasonably related" to the execution to be included in the safe harbor.[3]

In particular, we believe that the following types of services should be included in the definition of "brokerage services":

- Pre-order communication with the broker dealer in anticipation of placement of the order. This would assure that pre-order communications, such as those regarding indications of interest, willingness to commit capital or provide weighted average price executions, and the nature of the market and best method of executing a transaction, fit comfortably within the safe harbor definition.

- The provision of continuing prime brokerage services such as stock loan, margin, and custody services should be included in the definition, even if these services occur after the execution and settlement of the transaction. For example, continuing provision of financing and stock loan to support short positions after settlement is integrally related to the transaction and provides a valuable service to the client. Many of these services are integrally related to the execution, clearance and settlement of the transaction.

- Order Management Systems ("OMS") that are related to or involved in the execution of transaction should be included in the definition. Many of these systems act as the order capture mechanism, create the order tickets for executions, track the orders through ultimate execution and settlement, and evaluate execution performance against best execution standards. Tracking of order execution through these systems may be a significant aspect of providing best execution to the client order under consideration. Many of these systems are integrally related to and therefore cannot be separated from the actual execution of the orders.

[3] We also note that the temporal standard as proposed appears inconsistent with the FSA's rules on use of client brokerage. Under the FSA's rules, "execution" begins "at the point at which the *investment manager* makes an investment or trading decision…" which is earlier in time than the proposed Commission standard for brokerage. This could result in the inconsistent treatment by U.S. and U.K. law of similar items, such as pre-trade analytics.

- Pre- and post- trade analytics that evaluate the execution quality of the order are also important for determining execution quality, including for example liquidity, volatility and potential and actual market impact. All of the foregoing are important to obtaining the best execution of the order and evaluating the performance of the particular broker that executed the transaction.

4. <u>The SEC definition of eligible clearing agreements should be broadened.</u>

We ask that the SEC be cautious not to impose conditions on correspondent arrangements that would unnecessarily limit the money manager's choices on where to send orders for best execution or from whom to obtain research. Under its proposal, the SEC would require the introducing broker to:

- Be financially responsible to the clearing broker for all customer trades until the clearing broker has received payment (or securities);
- Make or maintain records relating to its customer trades required by SEC and SRO rules, including blotters and memoranda of orders;
- Monitor and respond to customer comments concerning the trading process; and
- Generally monitor the trading process and settlements.

These four conditions, which are taken from a no-action letter the SEC cited in its 1986 Release, are intended to preclude give-ups, but may not take into account the variety of correspondent arrangements that have developed since that time to benefit money managers as well as their advisory clients. The obligations and responsibilities of the introducing and clearing firms are generally spelled out in written agreements adopted pursuant to NYSE Rule 382 and NASD Rule 3230. Such agreements often do not require the introducing broker perform each of the functions that the SEC has proposed to require. Instead, the allocation of those obligations often varies depending on the facts and circumstances of the particular relationship.

The SEC should continue to allow the firms to negotiate the services that will be provided by each of the involved firms. Thus, we request that the SEC consider broadening the scope of permissible correspondent arrangements consistent with Section 28(e) to include arrangements where the introducing firm provides "real and valuable services." This will reduce the confusion and potential conflict of regulatory and SRO requirements. This should adequately distinguish between firms that provide services in connection with the execution and settlement of trades and those third party firms merely process soft dollar transactions and provide no additional services. Brokers providing "research" and/or "brokerage services" are necessary and value added to our clients, while brokers that provide no real services in connection with the execution add no value while increasing costs to the ultimate client.

5. <u>The Final Interpretive Guidance should not favor third party research providers over proprietary research</u>.

The SEC acknowledges that the safe harbor applies equally to research provided as part of the bundled execution cost and third party research where the provider is not involved in the

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execution of the transaction. We believe that both alternatives are important to money managers in deciding how to best execute orders. Bundled execution costs charged by full service brokerage firms as well as unbundled costs for independent third party research provide many benefits and are equally important to money managers. The SEC should be careful to coordinate its final releases on covered services, clarification of "brokerage services," and soft dollar disclosure requirements in order to maintain consistency across these areas.

6. The mixed-use allocation process should not impose additional supervisory responsibility on broker dealer firms.

Under the Interpretive Guidance, mixed–use items must be reasonably allocated between eligible and ineligible uses and the allocation must be documented to enable the money manager to make the required good faith determination of the reasonableness of commissions in relation to the value of services provided. Footnote 108 of the Interpretive Guidance states that "the manager must use his own funds to pay for the allocable portion of the costs of the products and services that are not within the safe harbor." While the mixed-use allocation process reasonably places additional responsibility on money managers to meet their fiduciary obligations, broker dealers should not be required to police the performance of those responsibilities. In this regard, broker dealers should not be responsible for the good faith determination or the actual payment of the portion allocated to the money manager. Failure by money managers to document their good faith determination or make appropriate payments should not create regulatory liability for the broker dealer firms. The SEC should assure that firms are not burdened with additional compliance responsibilities for enforcing the safe harbor, particularly with respect to money managers that they do not control. Clarification of these responsibilities in the final release would be helpful in instructing the SEC Divisions of Market Regulation, Investment Management, Enforcement, and OCIE how to implement and enforce the rule going forward.

7. The final Interpretive Guidance should provide an appropriate balancing of flexibility and guidance so that the industry can be comfortable in application of the safe harbor.

The Interpretive Guidance should provide sufficient flexibility for evolution of the market including the provision of new types of "research" materials and brokerage services. Thus, the SEC should confirm that the interpretive guidance is general and provides sufficient flexibility by allowing judgment by the firms whether the services fall within the definition of research or brokerage. On the other hand, the definition should provide sufficient clarity so as not to undercut the nature of the safe harbor. Money managers and broker dealers must be able to comfortably rely on the safe harbor without the risk that their judgments will be called into question by hindsight review. As noted earlier, this makes coordination of disclosure requirements and clarification of "research services" along with the Interpretive Guidance significant for implementation and enforcement purposes.

8. The SEC should allow sufficient time frame for implementation to allow firms to review and revise existing practices and existing relationships.

The SEC's proposed Interpretive Guidance would limit the definition of "research services" and propose minimum standards for correspondent arrangements. Implementation of any of these proposals could require significant changes in operations, relationships between broker-dealers and customers, as well as with another broker-dealer, and often new legal documentation. For example, the proposed change to requirements surrounding clearing

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arrangements could warrant a complete review of those relationships and restructuring of those relationships where necessary. Implementation would also require investment advisers to review each of their soft dollar arrangements and document the review to assure they meet the new standards and requirements. Given the magnitude of the changes proposed by the SEC, we request that the SEC provide a significant time period, not less than one year, for the industry to implement the amendments.

CONCLUSION:

UBS appreciates this opportunity to address the issues the SEC has raised in proposing interpretive guidance with respect to Section 28(e). We look forward to working with the members of the SEC and its staff on these issues. If you have any questions concerning these comments, or would like to discuss our comments further, please feel free to contact us.

Sincerely,

Christopher Buck
Executive Director
Soft Dollars and Directed Brokerage

cc: Honorable Christopher Cox, Chairman
Honorable Paul S. Atkins, Commissioner
Honorable Roel C. Campos, Commissioner
Honorable Cynthia A. Glassman, Commissioner
Honorable Annette L. Nazareth, Commissioner
Mr. Robert L.D. Colby, Acting Director, Division of Market Regulation
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