

March 28, 2006

Via Electronic Mail (rule-comments@sec.gov)

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

Re: Proposed Interpretation by the Securities and Exchange Commission Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934

Dear Mr. Katz:

J.P. Morgan Securities Inc. (“JPMSI”) welcomes the opportunity to provide the following supplemental comments in response to the proposed interpretation by the Securities and Exchange Commission (the “Commission” or “SEC”) regarding client commission practices under Section 28(e) of the Securities Exchange Act of 1934 (“Exchange Act”).¹

In November 2005, JPMSI submitted a letter requesting that the Commission revise the proposed guidance on commission-sharing arrangements (“CSAs”) in favor of a more flexible standard.² In that letter, JPMSI questioned the efficacy of the “normal and legitimate correspondent relationship” overlay to CSAs, and, in particular, the Commission’s proposed requirement that specific brokerage functions be performed by the research producer /introducing broker as part of the CSA.³ In our view, these rigid requirements unnecessarily curb legitimate and economically beneficial activity by excluding CSAs not predicated on the traditional introducing-clearing relationship from the scope of the Section 28(e) safe harbor.

¹ Securities Exchange Act Rel. No. 52635 (Oct. 19, 2005), 70 Fed. Reg. 61700 (Oct. 25, 2005) (“Proposed Interpretation”).

² See JPMSI letter dated November 28, 2005 to Mr. Jonathan Katz, SEC, available at <http://www.sec.gov/rules/interp/s70905/jpmorgan112805.pdf>.

³ These functions would include accepting the financial responsibility in the event of a customer fail, maintaining certain books and records, responding to questions about the trading process, and monitoring trades and settlements. See Proposed Interpretation, 70 Fed. Reg. at 61711-12.

As discussed in the November comment letter, JPMSI believes that this outcome does not further the policy objectives of Section 28(e). Instead, the Commission should expressly allow broker-dealers to enter into a CSA where one broker-dealer functions *solely* as a producer of research products and services as the “Research Service Producer,” while the other assumes full responsibility for trade execution and settlement as the “Execution Service Provider.” Under this approach, money managers would receive research directly from one or more Research Service Producers, which in turn would receive periodic (monthly or quarterly) payments from the Execution Service Provider. Such payments would be made out of a “soft dollar” or “holding” account maintained by the Execution Service Provider for the benefit of each money manager and its advised accounts. This approach would obviate the need for the money manager to identify, on a trade-by-trade basis, exactly how commissions should be allocated among different broker-dealers from whom it has received research products and services. Exhibit A of this letter outlines in greater detail the material elements of the proposed arrangement (referred to herein as the “Soft Dollar Accrual Arrangement”).

JPMSI believes that this Soft Dollar Accrual Arrangement should be deemed to satisfy Section 28(e). Currently, under Section 28(e), the Commission deems acceptable the payment by executing broker-dealers to third-party research vendors if the vendor invoices the executing broker-dealer for research received directly by money managers, based on the view that the vendor’s research is “provided by” the executing broker-dealer. As further detailed in Exhibit A, the Research Service Producer’s products and services similarly would be “provided by” the Execution Service Provider. As in the case of a third-party research vendor, the Research Service Producer should not be required to play a specific role in the trade execution process.

JPMSI respectfully submits that the Soft Dollar Accrual Arrangement would substantially benefit public investors and market participants for the following reasons:

- Transparency and Accountability. While the Execution Service Provider is contractually obligated to pay for research services, in order for the Research Service Producer to be compensated, money managers must determine the economic value they attach to the specific research products and services received. This process will promote transparency and accountability on the part of money managers because the valuation information they supply is kept in a centralized format facilitating the review and audit of the money manager’s brokerage practices by its advised accounts.
- Execution Efficiency and Liquidity. Money managers will more likely consolidate their order flow with one or more Execution Service Providers, while maintaining flexibility in selecting specific research services they wish to receive. This process promotes competition among well qualified broker-dealers of execution services, resulting in greater liquidity in the marketplace, more opportunities for order interaction, and improved execution quality.
- Independent and Specialized Research. The Research Service Producer may focus its activities on delivering bona fide research services to money managers, unfettered by

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the need to provide execution services and potential conflicts of interest. This process will promote competition and production of independent and specialized research services that are beneficial to money managers' advised accounts.

In sum, we respectfully request that the Commission revise its proposed guidance on CSAs or otherwise clarify that the so-called "normal and legitimate correspondent relationship" requirement does not apply to CSAs that operate as the Soft Dollar Accrual Arrangement. Once again, JPMSI commends the Commission's efforts to provide additional clarity regarding the scope of Section 28(e) and appreciates the opportunity to share its views on the Proposed Interpretation. If you have any questions concerning these comments, please feel free to contact me at 212-622-5346.

Very Truly Yours,

/s/

David W. Miller
Vice-President and Assistant General Counsel
J.P. Morgan Securities Inc.

cc: The Honorable Christopher Cox
The Honorable Cynthia A. Glassman
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Annette L. Nazareth

Jo Anne Swindler, Assistant Director

Exhibit A
Soft Dollar Accrual Arrangement - A Proposed Outline

I. Structure of the Soft Dollar Accrual Arrangement

A. Overview

1. The Execution Service Provider provides execution services and performs related clearance and settlement functions for money managers and their advised accounts. The Research Service Producer delivers, directly to money managers, products and services that qualify as bona fide “research” within the meaning of Section 28(e). The Research Service Producer’s products and services are limited to its “proprietary” research, which does *not* include “products and services which are readily and customarily available and offered to the general public on a commercial basis.”¹
2. For each trade, the Execution Service Provider “bills” the money manager’s underlying client accounts for commissions in accordance with an agreed-upon “all-in” fee schedule. Such commissions, once received by the Execution Service Provider, result in “soft dollar credits” that accrue to the benefit of the money manager and its advised accounts. Soft dollar credits represent client commissions beyond what the Execution Service Provider will retain for its execution services. All soft dollar credits are held in the designated “Soft Dollar Account” of the Execution Service Provider for the benefit of the relevant money manager.
3. Periodically (e.g., monthly or quarterly), the Execution Service Provider makes payments to one or more Research Service Producers out of the Soft Dollar Account. These payments are made on the basis of the money manager’s value determinations. That is, the money manager determines the exact monetary worth of research services that it has received, and the Execution Service Provider makes the corresponding payment. The Research Service Producer never bills the money manager, and the money manager never incurs any direct financial obligation to pay the Research Service Producer.

B. Formalization of the Arrangement through Appropriate Documentation

1. Because the Execution Service Provider’s payments are made out of the Soft Dollar Account, which holds client commissions, the Research Service Producer must be a registered broker-dealer in accordance with the staff’s interpretation of Section 15(a) of the Exchange Act. The

¹ See Exchange Act Release No. 12251 (Mar. 24, 1976), 41 Fed. Reg. 13768 (Mar. 31, 1976).

relationship between the Execution Service Provider and each such Research Service Producer will be formalized in a written agreement that sets forth the two broker-dealers' respective roles and functions (the "Research Services Agreement"), subject to appropriate oversight by a self-regulatory organization ("SRO").

2. The Research Services Agreement will document the fact that the Research Service Producer performs no trade execution, clearance or settlement functions but is responsible for its proprietary research products and services, which are received directly by money managers. In return, the Research Service Producer receives compensation from the Execution Service Provider through the Soft Dollar Account.²

II. Point of Comparison: Third-Party Research Vendor Arrangement

A. Overall Similarities

Like a third-party research vendor, the Research Service Producer plays no role in the trade execution process, and is compensated by the Execution Service Provider for research services that benefit money managers and their advised accounts. Like a third-party research vendor arrangement, the Soft Dollar Accrual Arrangement involves using client commissions to obtain bona fide research services. Congress recognized the importance of research by specifically including research as a service that money managers may purchase with client commissions within the protection of Section 28(e), provided that the applicable statutory conditions are met.

B. Advantages of the Soft Dollar Accrual Arrangement

1. The relationship between the Research Service Producer and the Execution Service Provider, including the respective responsibilities of the parties, is clearly documented *via* the Research Services Agreement. The Research Service Producer has an obligation as a registered broker-dealer to ensure that its research services comply with applicable federal securities laws and regulations, including the SRO research rules.³

² The SEC has expressly recognized, in the context of fixed price offerings, that providing research is a valuable service, uniquely in a class by itself, for which one broker-dealer may receive transaction-based compensation from another without participating in a specific securities transaction. *See, e.g.*, Exch. Act Rel. No. 17371 (Dec. 19, 1980) ("Papilsky Release") (approving changes to the NASD's rules governing the receipt of compensation in a fixed price offering). In the Papilsky Release, the SEC described the provision of research as a *sui generis* part of the distribution process.

³ *See* NASD Rule 2711 and NYSE Rules 351 and 472. These rules apply to "research reports" as defined therein.

2. Today, a broker-dealer “providing” research through various third-party vendors processes multiple invoices from such vendors that each show, in differing amount of detail and frequency, the nature and value of products and services a particular money manager has obtained.⁴ The Soft Dollar Accrual Arrangement simplifies the administrative burden associated with such procedures by enabling the Execution Service Provider to receive a centralized description from the money manager instead, listing all the relevant categories of products and services received from various Research Service Producers. The money manager’s description must include a good-faith determination about the value of the products and services it has obtained from each Research Service Producer, in a manner consistent with the existing fiduciary duty imposed under Section 28(e).
3. This process allows the Execution Service Provider to maintain accurate books and records pertaining to the Soft Dollar Account. Such information provides, in essence, an “audit trail” of how client commissions are spent by a particular manager to obtain research services, as distinguished from execution services, facilitating the review and audit of the money manager’s brokerage practices by its advised accounts.

III. Regulatory Clarification Regarding the Soft Dollar Accrual Arrangement

A. Differences from Other CSAs

1. While many CSAs may involve a “normal and legitimate correspondent relationship” between two broker-dealers, the Soft Dollar Accrual Arrangement is not predicated on having any such relationship. To the contrary, the Research Services Agreement will clarify that the Research Service Producer is compensated for its research products and services only and will not act as an “introducing broker.”
2. The Soft Dollar Accrual Arrangement involves sharing of client commissions because the Execution Service Provider makes payments to the Research Service Producer out of the Soft Dollar Account. The Research Service Producer itself is *not* actually charging or receiving commissions from money managers and their advised accounts. Nor is the Research Service Producer “sharing” client commissions in the sense of being automatically entitled to a certain portion on each trade executed. The Research Service Producer receives payments only after the money

⁴ These invoices are required to be generated under the terms of most third-party soft dollar agreements. For example, a typical contractual provision may include the following language: “Broker-Dealer hereby accepts and assumes the sole obligation to pay the charges owed from time to time to Vendor for the Services. The parties agree that the value of the Services received from Vendor will be determined by Money Manager periodically in good faith. Invoices for Services rendered under this Agreement shall be sent directly by Vendor to Broker-Dealer promptly following any such determination.”

manager determines the economic value of the research products and services it has received.

B. Relevant Precedent

1. Third-party research arrangements involving a research vendor have been long permitted under Section 28(e). In the case of the Soft Dollar Accrual Arrangement, the Research Service Producer plays the functionally equivalent role of a vendor. The staff has previously recognized that third-party research services covered by Section 28(e) may include research produced by a broker-dealer that does not perform any specific brokerage functions.⁵
2. The Research Service Producer need not separately prepare invoices and send them to the Execution Service Provider. The latter is contractually obligated to make payments when money managers supply the relevant information about the nature and value of research products and services they have received. The Research Services Agreement will expressly document the fact that the Research Service Producer has no legal recourse against any money manager for separate or additional compensation, in lieu of or in addition to the payments made by the Execution Service Provider.
3. The Execution Service Provider's payments to the Research Service Producer do not constitute an improper "give-up" that Congress intended to exclude from the protection of Section 28(e). To the contrary, these payments are required to be made under Section 28(e), because the Research Service Producer's services are deemed to be "provided by" the Execution Service Provider. *Unlike* the give-up recipient, the Research Service Producer is entitled to receive compensation directly from the Execution Service Provider, and *unlike* the give-up payer, the Execution Services Producer is directly obligated to make such payments to the Research Service Producer.
4. Outside the United States, foreign securities regulators have concluded that CSAs with attributes similar to the Soft Dollar Accrual Arrangement are generally beneficial to the public by promoting greater transparency and market efficiency.

⁵ Gilder, Gagnon and Co., SEC No-Action Letter (pub. avail. July 4, 1987) (the "Gilder Gagnon Letter"). Note that the Soft Dollar Accrual Arrangement differs in several aspects from the arrangement discussed in the Gilder Gagnon Letter, where the executing broker-dealer would first "subscribe" to research services generated by other broker-dealers, which in return would receive "flat fees." As discussed above, the Research Service Producer's services are received directly by money managers, and the Execution Service Provider's payments are made out of the Soft Dollar Account, which represent transaction-based compensation received by the Research Service Producer.