Investment Management Association

24 November 2005

Jonathan G Katz
Secretary
Securities and Exchange Commission
100 F Street
NE
Washington
USA
DC 20549-9303

Dear Mr Katz

Commission Guidance Regarding Client Commission Practices under Section 28(e) of the Securities Exchange Act of 1934

(Release No 34-52635; File No. S7-09-05)

The IMA represents the UK-based investment management industry. Our Members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of about £2 trillion of funds (based in the UK, Europe and elsewhere), including authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our Members represent 99% of funds under management in UK-authorised investment funds (i.e. unit trusts and open-ended investment companies).

The IMA is pleased to have the opportunity to comment on the above guidance with respect to the use by investment managers of client commissions. We welcome the acknowledgement by the SEC of the desirability of a consistent global approach by regulators. As you are aware the IMA, together with the National Association of Pension Funds (NAPF), the London Investment Banking Association, and the Financial Services Authority (FSA), have worked over the last two years to develop a market solution in the UK to the disclosure of softing and bundling arrangements between fund managers and brokers. This resulted in new FSA regulations which come into force at the end of this year. The FSA has pursued a principles based approach and has put the onus on the fund manager to justify to his clients the generation and his use of commission in paying for execution and research services.

While the IMA believes that the SEC guidance is a useful clarification of the application of Section 28(e) of the Securities Exchange Act 1934, as originally conceived and as revised through time in various releases, we believe also that the statement does not provide for a level playing field for proprietary and for independent research and does not take adequate account of the changes in market structure since the original Act. Nor does it provide for a globally consistent approach to commission sharing arrangements.

Our observations are as follows:

- The history provided in the statement demonstrates the gulf between the industry structure underlying 28e and today's reality. The guidance does not adequately address this in its interpretation.
- It continues to take a sell-side view of the role of the broker-dealer in trading and describes an increasingly out of date business model, in that it does not fully take account of the emergence of the trading desk inside buy-side firms, nor of the increased emphasis on trading costs rather than commission in placing trades, nor of the emergence of alternative trading platforms and direct market access.
- The temporal time line starts too late. It omits the fact that increasingly it is the trading desk in the portfolio management firm that is choosing how and where to place the trade and that these decisions are supported by additional services in the same way as the initial investment decisions are. (See answer to Q3.)
- We are also concerned about the rather restrictive approach to commission sharing arrangements set out in the guidance on page 46.
    - If followed to the letter, the first bullet rules out third party non-broker research as it precludes researchers without some elements of an execution capability from being remunerated;
    - And the second bullet potentially puts the power into the hands of the broker as to the choice of third party researcher (i.e. to buy a Porsche you have to order it via Ford or GM!).

- Both strike us as at odds with the post-Spitzer desire for a bigger third party research industry.
- Moreover, it does not accord with what actually happens in the US market, which is that as long as the invoice is made out to the broker and he has the liability to pay then he has no further involvement i.e. that is the extent of the practical meaning of “provide”.
- Of course, if the strictures on page 46 of the guidance are applied literally, then UK style commission sharing is ruled out, and therefore in an increasingly key area for global firms, SEC and UK regulation remain far apart. If this remained the case, we would regard this as a missed opportunity by the SEC.

I hope these comments are useful input to your deliberations. Our responses to the specific questions follow in the Appendix. Should you have any queries then please do not hesitate to contact me.

Yours sincerely

Gordon Midgley
Director of Research

Appendix

Q1 Does the Commission's interpretation offer sufficient guidance with respect to the types of "advice", "analyses" and "reports" that are eligible as "research services" under Section 28(e)?

The IMA believes that the Commission's interpretation does offer sufficient guidance as to the meaning of what constitutes research services in that it is clear that what is key is that research should contain substantive content.

Q2 How would investors, money managers, broker-dealers, and others be affected by the Commission's interpretive guidance that client commissions cannot be used to obtain computer equipment as "research" under Section 28(e)?

The IMA agrees with the position that computer hardware does not fall within the definition of research, as, of itself, it contains no 'substantive content'. We do however urge the Commission to make a clear distinction between the services provided and the means of delivery. A fund manager may buy a service which is delivered over a dedicated terminal. It is not the terminal (which could be described as computer hardware) which is being paid for out of commissions but the service delivered via it.

Q3 Does the Commission's interpretation offer appropriate guidance as to the eligibility of market data and trade analytical software sunder Section 28(e)?

Regarding the Commission's proposition that market data is eligible as "research services", the IMA agrees that such services can be paid for out of commission, but suggests that they more properly fall within the definition of "brokerage" or "execution". Real time price information and real time trading information are among the necessary inputs to the choices of venues, brokers and trading mechanisms that the dealing desk in a fund management company make in delivering the best outcome for clients. The data are also necessary elements in establishing whether best execution has been achieved.

With respect to trade analytics, the IMA regards these as important elements in the trading decision. There are four steps in the investment process:

- an investment decision (to buy, sell or hold a particular security);
- a trading decision covering trading mechanism, trading counterparty, and timing;
- the trade (the exchange of securities and cash), and;
- assurance of trading quality.

To the extent that trade analytics informs the manager of trading quality to be expected in addition to measuring that achieved, it is an essential input into pre-trade analysis of where, how and when to place an individual trade or trades in a particular security and of a particular size. The IMA supports the inclusion of such services within the definition of "execution" or "brokerage".

Q4 Does the Commission's interpretation offer sufficient guidance as to the eligibility of "brokerage" services, functions, and products under Section 28(e)? How would this guidance affect existing arrangements or practices? Is the Commission's temporal standard sufficiently clear? Are there types of services that should be excluded from the safe harbour, even though they might appear to satisfy the temporal standard? If so, explain why those services should be excluded – for example, is the service unrelated to execution of transactions?

No. See Q3 regarding trade analytics. A temporal standard based on a particular division of activity between two parties risks being of only short term value. Market structures are not static and services eg execution may migrate either in whole or in part between counterparties making a temporal based standard either quickly redundant or a disincentive to innovation. The advent of OMS systems which contain order execution functionality are one example of innovations that are not well catered for in a temporal standard. It would appear that under Section 28(e) that they should at a minimum be eligible under a mixed-use item.

Q5 Does the Commission's interpretation offer sufficient guidance about third-party research and commission –sharing arrangements?

No. As outlined in our letter the IMA believes that the SEC interpretation does not give sufficient guidance or clarity about the ability of investment managers to purchase the independent research of their choice and that its guidance is too restrictive.

Q6 Does the Commission's interpretive guidance differ from the approaches that other regulators, SROs, market participants, trade organisations, and investor advocacy groups have adopted or recommended with respect to client commission practices?

Yes. Although the Commission's guidance appears similar in some respects to the regime in the UK, albeit broader in scope in a few areas, it is different in relation to commission sharing and the use of commission to pay for third party research. There is little convergence with respect to commission sharing arrangements – see comments in the covering letter.

Q7 Are there types of products or services that are commonly paid for with client commissions for which additional guidance would be useful? If so, please provide facts about these products and services and their components, and how they are used. For example, are client commissions commonly used to pay for proxy voting services?

We are not aware of any other products or services which should be paid for out of client commissions. We do not believe that proxy voting services are paid for out of client commissions, at least in the UK.

Q8 Should the Commission provide additional guidance on the allocation and documentation of mixed-use items?

The IMA believes that the principles guiding the eligibility of mixed-use items is clear and that fund managers have a definite obligation under the interpretive guidance to allocate that part of the cost of the product or service which is eligible with “required good faith determination”. It is also clear that this allocation poses a conflict of interest and that it should be well documented and disclosed to clients.

However, in this regard footnote 108 Page 37 could usefully be either further clarified or omitted. It seems to imply that where there is a bundle of services sold at a single composite price, the money manager is obliged to split the price across the services even in circumstances where the money manager receives (he can’t avoid receiving) but does not use some of the services. The economic reality is of course that the price that the money manager is prepared to pay for that part of the bundle that he uses is the same with or without the rest of the bundle. We believe that this would be a better basis for allocation that than proposed in footnote 108.

Q9 Concerns have been expressed by some industry participants and others that mass-marketed publications (publications that are widely circulated to the general public and intended for a broad, public audience) are part of a firm’s overhead and should not be paid for with client commissions. To what extent are these types of publications currently being paid for with client commissions? Are the purposes and uses of these types of publications distinguishable from those of traditional research products? Should the Commission provide further guidance in this area?

The IMA is unable to answer the question as to what extent these publications are paid for out of client commissions in the US.

Q10 Should the Commission afford firms time to implement the interpretation? In commenting, please provide specific examples of any potential implementation issues.

A transition period of twelve months would appear reasonable.