NSCP

NATIONAL SOCIETY OF COMPLIANCE PROFESSIONALS INC.

November 22, 2005

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 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:

The National Society of Compliance Professionals ("NSCP")* appreciates the opportunity to comment on the proposed guidance regarding money managers' use of client commissions to pay for research and brokerage services under Section 28(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act").† The proposed guidance sets forth a new framework for evaluating whether a given use of client commissions is covered by the safe harbor of Section 28(e) (the "Proposed Guidance").

The Proposed Guidance is of considerable interest to the NSCP and its members. The NSCP is the largest organization of securities industry professionals devoted exclusively to compliance issues, effective supervision and oversight. The principal purpose of the NSCP is to enhance compliance in the securities industry, including firms' compliance efforts and programs and to further the education and professionalism of the individuals implementing those efforts. An important mission of NSCP is to instill in its members the importance of developing and implementing sound compliance programs across-the-board.

The NSCP supports the Commission's efforts to clarify and update the guidance concerning the use of client commissions for research and brokerage services, but nevertheless is concerned about some aspects of the Proposed Guidance. First, the NSCP is troubled that the Proposed Guidance implicitly characterizes Section 28(e) as a mandate rather than a safe harbor. Second, the NSCP is concerned that the Proposed Guidance does not accurately address the realities of the use of client commissions within the buy-side community. Third, the NSCP believes that the Proposed Guidance relating to commission sharing arrangements may have adverse consequences to the market for third party research. These concerns, as well as other NSCP comments and suggestions are discussed below.

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* Since its founding in 1987, NSCP has grown to over 1,500 members, and the constituency from which its membership is drawn is unique. NSCP's membership is drawn principally from investment advisers, traditional broker-dealer firms, accounting firms, and consultants that serve them. The vast majority of NSCP members are compliance and legal personnel spanning a wide spectrum of firms including employees from the largest brokerage and investment management firms to those operations with only a handful of employees. The diversity of our membership allows NSCP to represent a large variety of perspectives in the asset management industry.

† SEC Release No. 34-52635 (Oct. 19, 2005)

I. The Proposed Guidance Implicitly Characterizes Section 28(e) as a Mandate Rather than A Safe Harbor

Section 28(e) of the Exchange Act is a safe harbor protecting money managers from claims that they have breached their fiduciary duties by paying more than the lowest available commission for research and execution of client trades and sets forth a list of conditions under which "[n]o person. . . shall be deemed to have acted unlawfully." In previous interpretive releases and reports, the Commission has emphasized repeatedly that Section 28(e) is a safe harbor and that conduct outside the safe harbor "*may* constitute a breach of fiduciary duty" (emphasis added). Consistent with previous Commission releases, the Proposed Guidance also notes that Congress enacted Section 28(e) as a safe harbor and that if a money manager meets the requirements of Section 28(e), he does not breach his fiduciary duties.

In contrast to previous releases, the Proposed Guidance does not consistently emphasize that Section 28(e) is a safe harbor and, in fact, suggests that the conditions set forth in Section 28(e) are necessary in order for a money manager to fulfill his fiduciary duty. Portions of the Proposed Guidance set forth conditions for compliance that are not qualified as necessary for the protection of the safe harbor, but rather are stated in absolute terms. For example, in discussing "mixed use" items and the accompanying footnote 108, the Proposed Guidance states that money managers "*must* use their own funds to pay for the allocable portion . . . used for marketing purposes." While we are certain that the Commission does not intend the Proposed Guidance to characterize Section 28(e) as a mandate, we believe that the tone of the release does not sufficiently reinforce that Section 28(e) is a safe harbor. Therefore we urge the Commission, consistent with its previous releases, to revise the discussion in the final release of the interpretation to consistently and clearly emphasize that Section 28(e) remains a safe harbor that cannot itself be violated and imposes no absolute requirements on money managers.

II. The Availability and/or Receipt of Research and Other Services from a Broker-Dealer but not Requested by the Money Manager Does not Implicate the Conflicts of Interest Inherent in the Use of Client Commissions

From a fundamental perspective, we believe that the Proposed Guidance does not accurately reflect the manner in which research services are provided within the brokerage industry in exchange for client commissions. Initially, the framework presented in the Proposed Guidance presumes that "research services" are bought by money managers rather than made available to money managers by broker-dealers as part of their bundled offerings. Second, the pricing arrangements among the full-service broker-dealer firms for trade execution and for more complete services such as prime brokerage make the application of the Proposed Guidance difficult, if not altogether impossible. Further, the framework for determining whether a given product or service is "research" or "brokerage" should be expanded and clarified with respect to some services, specifically order management systems and custodial services provided by broker-dealers. Finally, the relationship between "research" and "brokerage" should be developed in more detail.

Research Services Made Available but not Bought

Many money managers use client commissions to obtain either proprietary or third party research from broker-dealers. Just as often, a broker-dealer will provide its own research in connection with the execution of client trades even where the money manager has not requested or solicited such research and will not use it in the making of investment decisions. In such cases, the research services are not bought by the money manager, but rather are simply included by the broker-dealer as part of its overall offering. In fact, much of the research provided by a full-service broker-dealer is neither requested nor used by money managers in the making of investment decisions. Where research and other products and services are merely made available and not bought, there is no inherent conflict of interest and a money manager should not be open to claims that it has violated its fiduciary duties, provided that all of the relevant factors evaluated as part of the money manager's best execution analysis are met.

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The Proposed Guidance appears to imply that all research obtained with client commissions is (i) requested by the money manager and (ii) used by the money manager in the making of investment decisions. However, this implication potentially overlooks significant historical context and industry practice. In a typical soft dollar relationship, money managers use client commissions to obtain research and other products and services from broker-dealers. A fundamental element of such arrangements is an "exchange" or "purchase" of products and services for commission dollars. We urge the Commission to recognize that the availability of bundled items, including eligible and ineligible products and services, may not be a factor in a money manager's decision to place trades with a specific broker-dealer where full service broker-dealers customarily provide research and other services bundled in with execution.

A money manager may select a specific broker-dealer to execute trades based upon its skill in placing a difficult trade, its position in the market, its historical relationship with the money manager, its commission charged for the execution of the trade, or any of the myriad of factors considered when evaluating best execution. Frequently, the receipt of research and other bundled materials is not a factor in the money manager's decision to use a specific broker-dealer, and the money manager may have received a lower commission rate had it traded through a broker-dealer that did not deliver these non-requested proprietary services. We believe that where a broker-dealer includes non-requested research or services as part of its bundled offering and the money manager does not use the unsolicited research or services, the safe harbor of Section 28(e) is not implicated because the money manager is not paying up for those items and does not face a conflict of interest. Where a money manager is not paying up for proprietary research or services, the research or services should not even be subject to the framework set forth in the Proposed Guidance. Therefore, we would urge the Commission to retract the language from footnote 108 of the Proposed Guidance.

We do acknowledge that the availability of bundled products and services may pose a conflict of interest for money managers. To the extent a money manager receives products and services from a broker-dealer on an unsolicited basis for a bundled commission rate, and **uses** any those products and services, full disclosure should be made and provided to their clients. Money managers should also consider their duty to disclose the availability of such products and services to their clients.

Broker-Dealer Pricing Structures and Prime Brokerage

Many broker-dealers offer prime brokerage services in which other services such as clearance and custody, financing, technology, securities lending and customized reporting are bundled with the execution of trades. The Proposed Guidance could be read to suggest that a money manager is permitted to use client commissions to pay for "research" and "brokerage" but may not use client commissions to pay for any other products or services, even if included in a bundled commission. However, bundled services are seldom priced separately by broker-dealers and the Proposed Guidance is unclear as to what methodology a money manager would use to value these services for the purpose of determining what portion of the commission is not covered by the safe harbor. We believe that requiring money managers to value (and potentially pay for) the cost of bundled products and services that are potentially ineligible under Section 28(e) – in order to satisfy the safe harbor – but part of a bundled offering, could radically change existing industry practices without a compelling policy justification. We would urge the Commission to clarify that it does not intend to force this result.

The NASD Task Force considered the issue of "bundling" and whether it would be possible for a money manager to provide a fund board with a good faith estimate of the total dollar amount of proprietary research obtained with mutual fund brokerage commissions, and was unable to reach a consensus on this point. Among the reasons that the NASD Task Force was unable to reach a consensus on this issue were the difficulties in determining the cost of such research and the potential for widely disparate estimated amounts. Ultimately, the NASD Task Force objected to an SEC requirement that a money manager perform analysis to estimate such costs.

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We believe that to the extent a money manager receives products and services for a bundled rate and uses such services, full disclosure should be made to clients. However, we would urge the Commission to refrain from requiring money managers to engage in a valuing exercise. We would expect that when the Division of Investment Management releases its recommendations on enhanced disclosure of soft dollar practices, that it will suggest uniform disclosure standards.

The Temporal Standard of "Brokerage" may not Reflect the Industry Needs and Practices

We are concerned that the new temporal standard for "brokerage" is incompatible with the statutory language of Section 28(e)(3)(C) and contrary to long-standing industry practice. The Proposed Guidance defines "brokerage" as services provided beginning with the transmission of an order to a broker-dealer and ending when securities are delivered or credited to the advised account. Paragraph (3)(C) of Section 28(e) includes "effect[ing] securities transactions and [the] perform[ance] [of] functions incidental thereto (such as clearance, settlement and custody)." Not all functions "incidental" to effecting securities transactions may necessarily fall within the temporal standard set forth in the Proposed Guidance. For example, long standing industry practice is to include custody as a part of "brokerage", and, in fact, custody is specifically included within the statutory language of Section 28(e). However, not all instances of custody may fall within the temporal standard. We are concerned that the Proposed Guidance has the effect of changing the terms of the statute by interpretation, and we urge the Commission to adopt an interpretation that more closely follows the terms of the statute as well as industry practice.

Should the Commission determine that its proposed temporal standard for "brokerage" best reflects the intention of Section 28(e), we recommend that the Commission expand the scope of the temporal standard to include the money manager's entry of a trade order into an order management system ("OMS"). The modern OMS has become an integral part of a money manager's operation and has an important role in providing portfolio management, including assistance in achieving best execution, determining trade allocation and reducing trading costs. Many OMSs include connectivity directly with broker-dealers and are an essential starting point for initializing a trade. The OMS is specifically removed from the definition of "brokerage" in the Proposed Guidance as not sufficiently related to order execution. We believe that such systems do perform "functions incidental to the effecting of securities transactions" within the statutory language of Section 28(e). We therefore respectfully request that the Commission expand the temporal interpretation of "brokerage" to include a money manager's entry of an order into an OMS.

The temporal standard as presented in the Proposed Guidance makes no mention of broker-dealer custody, which, as previously noted, has historically been a part of brokerage services, as either included or excluded from the definition of "brokerage." The "brokerage" standard should therefore be clarified with respect to the effect of the Proposed Guidance on custodial services provided by the broker-dealer. Custody is an important feature supplied by broker-dealers as part of their trade and execution services. The Proposed Guidance does not discuss the effect of the new framework on broker-dealer custodial services. Custody is specifically included in the language of Section 28(e) and therefore should be included in the Proposed Guidance as part of "brokerage." However, if the Commission decides to interpret "brokerage" to exclude even limited custodial services provided by broker-dealers incident to the execution of trades, we respectfully request that the final guidance include the methodology by which money managers may price the custodial services in order to allocate the appropriate payments.

Relationship between "Research" and "Brokerage"

The Proposed Guidance sets forth new interpretations of "research" and "brokerage" services. Some products or services may fall outside of the safe harbor with respect to one definition, but meet the conditions set forth with respect to the other definition. For example, an OMS or a trade analytical system may be interpreted under the Proposed Guidance as not sufficiently related to a "brokerage" service because the use of such system occurs either before the money manager communicates with the broker-dealer or after the securities are delivered, but such a tool

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provides valuable "intellectual content" in the form of reports or analysis concerning the performance of accounts, i.e. "research." The Proposed Guidance is unclear as to whether or not a product or service specifically excluded from either "research" or "brokerage" may fall within the safe harbor with respect to the other definition. We believe that an OMS or trade analytical system, even if not considered "brokerage," may still qualify for the safe harbor as permitted research, and we request that the Commission specifically adopt that position in the final release.

III. The Proposed Guidance Relating to Third Party Research and Commission Sharing may have Adverse Consequences to the Market for Third Party Research

The Commission Should Request Rulemaking on the Part of the SROs

As a threshold matter, we are concerned that both the National Association of Securities Dealers, Inc. ("NASD") and the New York Stock Exchange ("NYSE") have effectively addressed commission sharing arrangement and "give ups" through NASD Rule 3230 and NYSE Rule 382. If the Commission believes that "give ups" or inappropriate commission sharing arrangements are occurring within the marketplace, we urge the Commission to request rulemaking on the part of the SROs rather than adopting the interpretation set forth in the Proposed Guidance.

The Potential Adverse Effect of the Proposed Guidance on Third Party Research Providers

Under current guidance, a broker-dealer may provide third party research directly to a money manager where the broker-dealer incurs the legal obligation to pay for such research. In addition, a commission sharing arrangement falls within the safe harbor where an introducing broker receives commissions paid in good faith from an executing broker who is the introducing broker's normal and legitimate correspondent. The Proposed Guidance reiterates previous guidance with respect to third party research, but imposes additional requirements on commission sharing arrangements. Specifically, the Proposed Guidance would require an introducing broker to be financially responsible for customer trades, to make and maintain records relating to customer trades, to monitor customer comments and trades and settlements.

We are concerned that the new commission sharing requirements in the Proposed Guidance may impose a burden on introducing brokers that will lead to adverse consequences to the market for third party research. The increased expense associated with the commission sharing requirements may lead to consolidation within the market for third party research as introducing brokers seek to attain economies of scale necessary to offset the increased expense of doing business. This consolidation would limit the number of independent third party brokers and therefore the amount of independent research available to money managers. Many money managers feel that the independent research is superior to the proprietary research generated by a full-service broker-dealer. Further, we do not see the perceived harm associated with an introducing broker who is not financially responsible for its customers' trades. Limiting the availability of such research by increasing the expense of providing it will harm money managers' ability to obtain high quality independent research and will ultimately harm investors.

The Proposed Guidance is also unclear as to where the responsibility ultimately rests for ensuring a broker-dealer meets the requirements set forth in the Proposed Guidance with respect to commission sharing, i.e. financial responsibility, maintaining records and monitoring customers and trades. We believe that the cost incurred by a money manager to independently verify the broker-dealer's satisfaction of the commission sharing requirements will exceed the benefit accruing to the money manager. We therefore request that the Commission set forth in the final release that a broker-dealer shall be under a continuing obligation to inform the money manager of its compliance with commission sharing requirements of the Proposed Guidance and any change in such compliance. The final release should also make clear that a money manager may rely on the broker-dealer's representations and that if such representations are not accurate or should change without the money manager's knowledge, the money manager should not lose the protection of the safe harbor.

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Finally, the Proposed Guidance does not sufficiently explain how it applies to "step outs." Specifically, we are unclear from the Proposed Guidance what minimum standards should be applied to step outs in order that they may fall within the safe harbor. We respectfully request that the Commission set forth the minimum requirements for step outs to fall within the protection of the safe harbor.

IV. Effective Date of the New Interpretation

The Final Interpretation should be Released Concurrently with the Division of Investment Management's Disclosure Release

As noted above, the Division of Investment Management has indicated that it will soon release its recommendations on enhanced disclosure of soft dollar practices by money managers and mutual funds. The Proposed Guidance implicates some disclosure issues that will likely be addressed in that recommendation. The Commission may create an undue burden on broker-dealers, money managers and investment companies by issuing its final interpretation prior to the final release of the Division of Investment Management's recommendation on disclosure. We therefore strongly urge the Commission to issue its final release in conjunction with the Division of Investment Management's final release of its recommendation.

Allowance for Existing Long-Term Arrangements

Many of the arrangements concerning the delivery of products and services or commission sharing are long-term contracts of a period of one year or longer and were drafted in reliance on the current interpretation of Section 28(e). The Proposed Guidance makes significant changes to the products and services available under the Section 28(e) safe harbor as well as the permissible types of commission sharing arrangements. Money managers, broker-dealers and third party research providers who have entered into long-term arrangements will need sufficient time from the date of the publication of the final interpretation to fulfill their obligations and make the necessary changes in their businesses to comply with the new interpretation.

Money managers, introducing broker-dealers and third-party research providers who have entered into long-term arrangements will be adversely affected by the changes set forth in the Proposed Guidance if they are not permitted sufficient time to effect compliance with the new interpretation. A money manager who currently receives products and services (under a long-term contract) that will be excluded from the safe harbor upon the effectiveness of the final interpretation will need time to develop alternative financing strategies to ensure the uninterrupted receipt of such products and services. An effective date falling too close to the final publication date could give incentives to money managers to increase trading with particular broker-dealers, subject to best execution, in order to generate credits for research that may no longer be within the 28(e) safe harbor but committed to be supplied by the broker-dealer over time.

Introducing broker-dealers and third party research providers who have entered into long-term contracts may likewise be adversely affected by the changes set forth in the Proposed Guidance. Introducing broker-dealers who are not legally responsible for the execution of trades may be subject to obligations to pay for services no longer protected by the Section 28(e) safe harbor. In such situations, broker-dealers may not receive adequate commissions to meet their obligations under the contract, and may be unable to finance their obligations under the contract by other means. Third party research providers will be unable to collect fees due under existing contracts where the introducing broker-dealers are unable to pay them. Introducing broker-dealers will need a significant period from the final release of the interpretation to its ultimate effective date in order to make the necessary arrangements to accept legal responsibility for trade execution and to make amendments to their existing contracts with third party research providers. Third party research providers will need a similar period to develop new pricing structures, amend their existing agreements, and develop arrangements with other broker-dealers to purchase their research services and products.

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A delay in effectiveness of at least one year will allow for most of the existing contracts to expire, and enable money managers, broker-dealers and third party research providers to develop alternative financing arrangements to ensure the continued flow of research and limit potential harm to investors. The United Kingdom recognized this need in adopting its policy on the use of client commissions and adopted a delayed effective date. Therefore, we request that the Commission delay the effectiveness of the new interpretation for a period of at least one year from the date it is published in the Federal Register.

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We thank the Commission for the opportunity to comment on the Proposed Guidance, and we hope that you find these comments useful in preparing the finalized guidance. We would be pleased to discuss our views further with the Commission or the staff. Please feel free to contact Joan Hinchman at the NSCP at (860) 672-0843 with any questions or comments.

Very Truly Yours,

Joan Hinchman
Executive Director, President and CEO

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