JPMorgan

November 28, 2005

**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 – File No. S7-09-05**

Dear Mr. Katz:

J.P. Morgan Securities Inc. ("JPMSI") respectfully submits the following 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]

JPMSI commends the Commission's efforts to clarify the scope of what qualifies as "brokerage and research services" in the context of Exchange Act Section 28(e), which permits a money manager to use client commissions to pay for such services, provided that the money manager makes a good faith determination that the amount of the commission is reasonable in light of the brokerage and research services received. In particular, JPMSI applauds the Commission's goal of providing guidance that responds to "evolving technologies and industry practices."[2] As a leading institutional brokerage firm offering comprehensive and innovative execution services and solutions to investors, JPMSI supports the Commission's effort to instill a greater degree of transparency and accountability for money managers' expenditure of client commissions.

To this end, we believe that the Proposed Interpretation represents an important opportunity to examine the overall effect of commission-sharing arrangements ("CSA"s) as they relate to the use of client commissions by money managers. As previously noted by the SEC and

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

[2] Proposed Interpretation, 70 Fed. Reg. at 61700.

its staff, a number of money managers use a CSA to execute trades with one broker-dealer and obtain research or other services from a different broker-dealer.[3] One commonly found CSA is that between an "introducing broker" and a "clearing broker," both of whom have client relationships with money managers. As noted by the Commission, in some of these CSAs, the introducing broker is "unaware of the daily trading activity of its customers because the orders are sent by the money manager directly (and only) to the clearing broker-dealer."[4]

For the reasons discussed below, JPMSI is concerned that the Proposed Interpretation calls into question the regulatory status of certain such CSAs under Section 28(e). In particular, the Commission's proposal for imposing minimum activity requirements on the introducing broker -- as applied in the context of the new "temporal standard" for brokerage services -- could substantially limit the type of CSA eligible for the safe harbor. JPMSI respectfully submits that this result would neither reduce money managers' conflicts of interest nor improve broker-dealers' execution services. Instead, the Commission should consider taking an alternative approach based on appropriate disclosure of CSAs. A similar approach has been taken recently by the United Kingdom Financial Services Authority ("FSA").[5] JPMSI believes, as was noted by the FSA, that CSAs may be used as "part of the market-led solution to deliver greater transparency and accountability,"[6] and as such, their use under Section 28(e) should not be unduly restricted.

**Background**

Pursuant to NYSE Rule 382 and NASD Rule 3230, a CSA between an introducing broker and a clearing broker is documented by the parties using the so-called "carrying agreement" or "clearing agreement." These rules of self-regulatory organizations ("SRO"s) do not specify which functions must be performed by which broker.[7] Indeed, consistent with the requirements of the SROs' rules, the parties may agree to assign their respective functions in such a way as to leave the introducing broker with no clear regulatory responsibility for effecting any particular customer trade. To date, those CSAs in which the introducing broker "has little, if any, role in

[3] *See* Proposed Interpretation, 70 Fed. Reg. at 61711; SEC Office of Compliance, Inspections and Examinations, Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds (Sept. 22, 1998).

[4] Proposed Interpretation, 70 Fed. Reg. at 61711. It should be noted that this type of arrangement would not involve a "step-out," as the introducing broker does not execute, clear, or settle any portion of the trade. *See id*., at 61711 fn. 125 (distinguishing step-out arrangements from CSAs).

[5] *See* FSA, Policy Statement 04/23, Bundled Brokerage and Soft Commission Arrangements: Update on Issues Arising from PS 04/13 (November 2004), at ¶¶ 2.36 - 2.41, available at http://www.fsa.gov.uk/pubs/policy/ps04_23.pdf ("FSA Statement").

[6] *Id.* at ¶ 2.37.

[7] Proposed Interpretation, 70 Fed. Reg. at 61711 & fn. 128.

accepting customer orders or in executing, clearing or settling any portion of the trade"[8] have not been subject to a uniform set of rules.

When operating under this type of CSA, the introducing broker is able to focus on providing research services to money managers, independent of execution services and free from potential conflicts of interest. The money manager, in turn, is able to allocate client commissions, as it sees fit, taking into account the relative value of the services provided by each broker-dealer. In the United Kingdom and elsewhere in Europe, we understand that money managers frequently use such CSAs to accrue commissions into a "soft" or "holding" account at an executing/clearing broker-dealer and then instruct that broker-dealer to allocate commissions to one or more introducing brokers on a periodic basis (*e.g.*, monthly or quarterly), rather than on a trade-by-trade basis at the time of execution or settlement. In these jurisdictions, the practice further appears to not link particular trades with particular soft allocations. In the United States, it appears that some broker-dealers offer a comparable service to money managers. JPMSI would like to enter into similar arrangements whereby money managers may accrue commission dollars on trades executed with JPMSI and allocate client commissions to various introducing brokers on a periodic basis; we are concerned, however, that the Proposed Interpretation, could call into question the eligibility of such CSAs under Section 28(e).

**Discussion**

As noted above, while CSAs are common enough, their status under Section 28(e) has not received comprehensive guidance from the Commission. Prior to the Proposed Interpretation, the SEC staff reviewed certain CSAs on a case-by-case basis through the no-action letter process. In these letters, the staff took the position that the safe harbor protection would not be lost merely because the money manager by-passed the order desk of the introducing broker and placed its trades directly with the clearing broker, but also noted that the introducing broker's role should be more extensive than the mere receipt of commissions for providing research services.[9] In 1983, in a letter issued to SEI Financial Services Company,[10] the SEC staff reviewed a "specific broker correspondent relationship focusing on the services provided and concluded the nature of the relationship did not preclude reliance on section 28(e)."[11] We understand that the Commission now seeks to codify this no-action letter.

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[8] *Id.* at 61711.

[9] *See* Data Exchange Securities, SEC No-Action Letter, [1981-82 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,016 (pub. Avail. May 20, 1981).

[10] SEI Financial Services Co., SEC No-Action Letter, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,631 (pub. avail. Dec. 14, 1983).

[11] Securities Exchange Act Rel. No. 23170 (Apr. 23, 1986), 51 Fed. Reg. 16004, at 16007 fn. 19 (Apr. 30, 1986).

Specifically, the Proposed Interpretation sets forth the following four functions that must be performed by an introducing broker in order for the CSA to qualify as a "normal and legitimate correspondent relationship" within the meaning of the safe harbor:

- The introducing broker must be financially responsible to the clearing broker in the event that a customer fails to pay;
- The introducing broker must "make and/or maintain records" for the customer trades, including order records, in accordance with applicable regulations;
- The introducing broker must "monitor and respond to customer comments concerning the trading process;" and
- The introducing broker must "generally monitor trades and settlements."[12]

On their face, these requirements do not specify exactly *when or how* these activities should be conducted. For example, it may be possible for the introducing broker to meet the requirement relating to recordkeeping by having the clearing broker contractually agree that order records created and kept by the clearing broker are deemed to be made on behalf of the introducing broker. Nevertheless, given the fact that the Proposed Interpretation would define brokerage services to begin "when the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution" and to end "when funds or securities are delivered or credited,"[13] one could infer that the introducing broker should perform at least one, if not all, of the required functions at some point during the temporal process.[14]

This means that, in effect, the Proposed Interpretation would require the introducing broker to obtain knowledge of a particular customer trade at some point during the period brokerage services are being rendered -- if not at the point of execution, at some point in time before clearance and settlement is completed. Indeed, if a money manager were to use a CSA to allocate client commissions some time after the trade settles (e.g., on a monthly or quarterly basis), it is not clear how the introducing broker, upon receipt of such commissions, would ensure that it has performed all of the above required functions. For example, if the introducing broker is not notified of a particular customer trade executed today until a month later when it is allocated a portion of the commissions, it is not clear what steps, if any, can be taken at that point

[12] Proposed Interpretation, 70 Fed. Reg. at 61711-12. These four functions were the responsibility of the introducing broker in a correspondent relationship that received no-action relief in 1983. *See* SEI Financial Services Co., *supra* n. 10.

[13] Proposed Interpretation, 70 Fed. Reg. at 61708.

[14] This is particularly true in light of the Commission's statement that "[e]ach broker-dealer *must play a role in effecting securities transactions* that goes beyond the mere provision of research services to money managers." Proposed Interpretation, 70 Fed. Reg. at 61711 (emphasis added).

in time by the introducing broker to monitor trades or otherwise to take financial responsibility for them.

As a result, JPMSI is concerned that a money manager using CSAs to provide periodic allocations of client commissions would not be able to rely on the Section 28(e) safe harbor. In our view, this would not be a desirable policy outcome, because these CSAs, when used judiciously by money managers with appropriate disclosure to their advised accounts, benefit the investing public by promoting greater transparency and market efficiency. The periodic allocation feature, as distinguished from trade-by-trade allocations (either on an execution or settlement basis), affords administrative convenience and flexibility by streamlining the money manager's decision making process as to how much of its client commissions should be credited to which introducing brokers. This feature thus facilitates clear specification of the value money managers attach to the particular research services being provided.

In addition, these CSAs enable money managers to consolidate their order flow to a select group of qualified execution service providers, while continuing to access a broad array of research providers. The FSA expressly has noted the beneficial effect stemming from "concentration of execution in the hands of the more efficient brokers," as such developments are likely to result in greater liquidity in the marketplace, more opportunities for order interaction, and improved execution quality.[15] Ultimately, by enhancing the ability of money managers to purchase execution and research services from separate broker-dealers, these CSAs promote the use of independent and specialized research, the benefits of which the Commission has expressly acknowledged in the Proposed Interpretation.[16]

In sum, JPMSI respectfully requests that the Commission revise the propose guidance on CSAs in favor of a more flexible standard that focuses on appropriate disclosure, rather than focusing on when or how introducing brokers must perform specified brokerage functions. In our view, there is no added level of investor protection or greater accountability by money managers resulting from mandating that an introducing broker play a role in effecting a securities transaction when the clearing broker has agreed to accept full responsibility for all aspects of trade execution. Indeed, JPMSI believes that the economic benefits associated with CSAs that allow for periodic allocations of client commissions materially outweigh any intangible cost associated with introducing brokers not participating in the brokerage process. Accordingly, we respectfully request that the Commission revise its proposed guidance or otherwise adopt an alternative approach that would expressly permit the use of such CSAs under Section 28(e), subject to appropriate disclosure and existing legal guidance on fiduciary duty and best execution.

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[15] *See* FSA Statement at ¶ 2.39.

[16] Proposed Interpretation, 70 Fed. Reg. at 61710.

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

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