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Via Electronic Filing

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington DC 20549-9303

Re: Commission Guidance Regarding Clietn Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Rel. No. 34-52635

Dear Mr. Katz:

I appreciate the opportunity to comment on the SEC's proposed interpretive guidance on soft dollar practices. I am currently a law student writing on the issue as part of a research paper class. I have attached the introduction to my paper entitled *Exposing Invisible Costs: Accounting and Disclosure of Soft Dollar Commissions*. Thank you again for this opportunity to comment.

Sincerely,

Thomas F. Lamprecht, CPA
Villanova University School of Law
Class of 2006

EXPOSING INVISIBLE COSTS:
ACCOUNTING AND DISCLOSURE OF SOFT DOLLAR COMMISSIONS

Investors are currently paying billions of dollars as compensation for research and other services that may not benefit them.[1] In addition, investment advisers can improve their bottom line by transferring expenses that should be paid from their management fee to unknowing investors.[2] The system that enables these seemingly inequitable outcomes is known as soft dollar compensation. The Securities and Exchange Commission (SEC) defines soft dollars as "arrangements under which products or services other than the execution of securities transactions are obtained by an adviser from or through a broker-dealer in exchange for the direction by the adviser of client brokerage transactions to the broker-dealer."[3] The SEC has recognized that soft dollar compensation is an essential link between the brokerage industry's supply of research and the money management industry's demand for research.[4]

"Research is the foundation of the money management system."[5] A critical function of the brokerage industry is to provide research, and this research is essential for investment advisers to make informed investment decisions for their clients.[6] This supply-demand relationship between brokers and investment advisers spawned the soft dollar compensation system. In the pre-1975 era of fixed commission rates, brokers competed for investment

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[1] *See* Whitney Tilson, *The Disgrace of Soft Dollars* (Mar. 3, 2004), *at* http://www.fool.com/news/commentary/2004/commentary 040319wt.htm (estimating soft dollar commissions at ^.3 billion for mutual funds along).
[2] *See id.* (noting practice of investment advisers to transfer costs to investors).
[3] *See* SEC OFFICE OF COMPLIANCE, INSPECTIONS AND EXAMINATIONS, INSPECTION REPORT ON THE SOFT DOLLAR PRACTICES OF BROKER-DEALERS, INVESTMENT ADVISERS AND MUTUAL FUNDS 7 (Sept. 22, 1999) [hereinafter INSPECTION REPORT].
[4] *Id.*, *see also* Todd C. Ganos, Editorial, *Soft dollars: Advisers' Welfare Program*, INVESTMENT NEWS, Sept. 19, 2005 (explaining "soft dollars" are above-market trading commissions that an investment adviser agrees to pay to a brokerage firm that are then rebated to the adviser in the form of investment research, software, Bloomberg terminals, office space and, in egregious cases, travel expenses).
[5] INSPECTION REPORT, *supra* note 3, at 2.
[6] *Id.*

advisers' business by offering non-execution services like research.[7] On May 1, 1975, Congress unfixed commission rates as part of the Securities Acts Amendments of 1975 (the "1975 Amendments").[8] Investment advisers became concerned that with competitive commission rates they would have to allocate brokerage solely on the basis of lowest execution costs.[9] Furthermore, if an investment adviser paid more than the lowest commission rate, it would result in a breach of fiduciary duty.[10] The consensus was valuable research would be more difficult to obtain and commissions could not be used to obtain it. [11]

Congress responded to concerns by including a "safe harbor" in the 1975 Amendments.[12] Section 28(e) of the Securities Act of 1934 ("Section 28(e)") establishes a safe harbor that permits money managers to use client commissions to purchase "brokerage and research services" for their managed accounts under certain circumstances without breaching their fiduciary duties to clients.[13] The use of soft dollar compensation has flourished under the safe harbor, but often the products and services obtained by advisers with soft dollars do not meet the

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[7] *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*, Exchange Act Release No. 52,635 (Oct. 19, 2005), *available at* http://www.sec.gov/rules/interp/34-52635.pdf [hereinafter *Interpretive Release*].

[8] *See* Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97, 107-08 (unfixing commission rates).

[9] *See Interpretive Release*, *supra* note 7, at 8. This concern is a result of investment advisers' duty to obtain "best execution of clients' transactions under the circumstances of the particular transaction." Exchange Act Release No. 23,170 (Apr. 23, 1986), 51 Fed. Reg. 16,004, 16011 (Apr. 30, 1986) [hereinafter 1986 Release].

[10] *Id.* As fiduciaries, investment advisers cannot use client assets to benefit themselves. INSPECTION REPORT, *supra* note 3, at 3. By buying research with client commissions, the investment adviser is receiving a benefit because the adviser does not have to produce or purchase the research. Therefore, a conflict of interests develops where the adviser has a need to obtain research and obtain the best execution for the client. *Id.*

[11] *Id.* at 9.

[12] *See* Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97, 161-62 (enacting Section 28(e)).

[13] *See* Securities Exchange Act of 1934 § 28(e). The section provides:

> No person . . . shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law . . . solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion.

Id.

requirements of the safe harbor.[14] While the SEC recognizes the value of the soft dollar system, it is looking to reign in some of the abusive practices by clarifying the safe harbor and updating its guidance for technological advances.[15]

On October 19, 2005, the SEC published its proposed interpretive guidance (the "Interpretive Release") on soft dollar practices.[16] The Commission's goal is to clarify advisers' use of client commission dollars to pay for research and brokerage services under Section 28(e).[17] The Interpretive Release provides a three-prong analysis for determining the eligibility of brokerage and research services for safe harbor protection: (1) the adviser must determine that the brokerage services fall within the limits of Section 28(e)(3); (2) the adviser must determine whether the product or service actually provides lawful and appropriate assistance in the performance of its decision-making responsibilities; and (3) the adviser must make a good faith determination that the amount of client commissions paid is reasonable in light of the value of products or services provided by the broker deal.[18]

The Interpretive Release does provide much needed clarity on what brokerage and research services qualify for safe harbor treatment, but the Commission missed an opportunity to

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[14] *See* INSPECTION REPORT, *supra* note 3, at 4 (noting inspection "found that a significant number of broker dealers (35%) and advisers (28%) provided and received *non*-research products and services in soft dollar arrangements").

> Examples of products acquired included: advisers using soft dollars to pay for office rent and equipment, cellular phone services and personal expenses; advisers using soft dollars to pay an employee's salary; an adviser using soft dollars to pay for advisory client referrals and marketing expenses; an adviser using soft dollars to pay legal expenses, hotel and rental car costs and to install a phone system . . . .

Id.

[15] *See* SEC Chairman Christopher, Statement at the Commission Open Meeting Regarding the Proposed Soft Dollar Interpretive Release (Sept. 21 2005) ("It is proposed that the Commission publish an interpretive release to provide guidance to money managers who pay 'soft dollar' commissions."); Morgan Lewis LLP, *SEC Proposes Revised Interpretation of Soft Dollars Safe Harbor Under Section 28(e)*, INVESTMENT MGMT. FYI, Sept. 22, 2005, at 1 (indicating that SEC is going to narrow definition of research to "intellectual content" of research).

[16] *Interpretive Release*, *supra* note 7. The most recent Interpretive Release represents the fourth time the SEC has addressed the soft dollar issue.

[17] *See id.* (stating goal of Interpretive Release).

[18] *See* Nancy Persechino et al., *Securities Exchange Commission Publishes Proposed Interpretive Guidance Regarding Soft Dollars* (Oct. 26, 2005), *at* http://www.mondaq.com/i_article.asp_Q_articleid_E_35706 (describing three-prong analysis).

make the soft dollar system more transparent for investors. Current disclosure practices do not provides investors with sufficient information to understand an investment adviser's soft dollar practices.[19] In order to improve disclosure for investors, the Commission must first improve accounting methods for soft dollar activities. If investment advisers were required to properly account for soft dollar arrangements, investors could be given meaningful financial data to use in assessing the adviser's soft dollar practices in relation to those in the industry at large.[20] Therefore, while the Interpretive Release may prevent some soft dollar abuses, disclosure is the best remedy for ensuring the benefits of soft dollar compensation are enjoyed with the least misuse. This theory is in conformity with the philosophy championed by Justice Brandies: "Sunlight is said to be the best of disinfectants: electric light the most efficient policeman."[21]

[19] *See* William T. George, *Comment on Proposed Soft Dollar Interpretive Guidance* (October 20, 2005), at http://www.sec.gov/rules/interp/s70905.shtml (arguing for better accounting of soft dollar compensation).
[20] *See* Jason Karceski et al., *Mutual Fund Brokerage Commissions* (Jan. 2004), *available at* http://www.zeroalphagroup.com/news/ZAG_mutual_fund_true_cost)study.pdf (noting difficulty for investors to evaluate mutual fund soft dollar practices because of lack of disclosure).
[21] L.D. BRANDIES, OTHER PEOPLE'S MONEY 62 (1914). Disclosure was the remedy chosen by James M. Landis, a former clerk of Justice Brandeis, in the design and administration of securities regulation in the United States. *See* THOMAS K. MCCRAW, PROPHETS OF REGULATION 153-209 (discussing Landis and the statecraft of the SEC).