

[Rule-comments@sec.gov](mailto:Rule-comments@sec.gov)

December 6, 2005

Jonathan G. Katz,  
Secretary, Securities and Exchange Commission

File Number S7-09-05

Reference to the Securities and Exchange Commission (SEC) release No. 34-52635: File S7-09-05 “Commission Guidance Regarding Client Commission Practices under Section 28(e) of the Securities Exchange Act of 1934”

---

Thank you for the opportunity to comment on the proposed changes outlined in your Release No. 34-52635: file S7-09-05 “Commission Guidance Regarding Client Commission Practices under Section 28(e) of the Securities Exchange Act of 1934 (the “Proposals”).

The Proposals indeed clarify the scope of “brokerage and research services” in the context of current industry practices. This clarification together with the proposal for the equal treatment of bundled and independent research should address the growing concern that client funds are being improperly used by the industry and that the industry should be restructured so that money managers, rather than their clients, pay for research and brokerage.

The Proposals recognize:

- the value of research in making investment decisions;
- the money manager’s responsibility to actively and continuously look for trades that will increase the value of the plan;
- the principle that all research expenditures should add value to the portfolios;
- the need to align the objectives of the money manager and their clients (plan holders) and that expecting money managers to cut margins to pay for research that benefits the client’s portfolio is not alignment

We applaud the SEC for eliminating the term “soft dollar” in the use of commissions. Focusing on the appropriate use of commission dollars should go a long way to eliminating the negative innuendo associated with that term. We recommended such a move in our submission to the Financial Services Authority (FSA) in response to CP 176 and have been advocating for such a move by the Ontario Securities Commission (OSC) since 1995. Hopefully, now that you and the FSA have adopted this recommendation, the OSC will follow your lead.

We note that your proposals are far more investor friendly than the FSA policy statement PS 05/9 in that they recognize:

- the many different disciplines of money management;
- that “research” to one style of management is meaningless to other styles;
- in order for research to have value it must be used in investment decisions.

Both regulators – i.e. the SEC and the FSA agree that:

- “best execution” must take precedence in all trades;
- the money manager must “determine in good faith that the amount of the commission was reasonable in relation to the value of the brokerage and research received”;
- there must be an audit trail of accountability from the money manager to the plan for the use of commissions.

There are, however, differences in the ease of compliance by money managers for best execution and accountability in your respective jurisdictions.

The “playing field” is not level for money managers seeking best execution. In the USA, the research must originate with the executing broker and no give-ups are allowed to pay another broker for research. This rule does not exist in Canada or in the UK where money managers can contract directly with research providers and use any broker to pay for the service through commission rebates. As a result:

- “best execution” is easier to achieve in Canada and in the UK;
- in order to get paid, many research services in the USA have set up brokerage operations; these smaller brokerage operations often do not have the traction to provide “best execution”;
- if commission generation slows down in Canada or in the UK, the money manager can pay cash for all or part of the contracted service rather than over-trading.

For these reasons, we recommend that the structure of the industry in the USA be re-examined.

If research must come from a broker, perhaps a new category of broker should be created that provides research and contracts out execution. As you will see in our attached letter to the OSC dated February 10, 2004, we have lobbied for creating a “research broker”

category in Canada to address the “value added tax” disadvantage suffered by independent research providers.

A “research broker” in the United States (if such a category were to be created) would provide research in compliance with Section 28e but could contract out trade execution to meet best execution needs. A precedent for this structure in the USA would be the current practice of major dealers using “two dollar brokers” to handle some of their client order flow.

The FSA has taken a leadership role in demanding accountability by mandating that money managers price the research and brokerage services that they consume and provide an audit trail to their clients. This will force dealers to price their research. Your proposals recognize the need for financial accountability. However, we urge you to consider a closer alignment with the transparency requirements imposed by the FSA.

In order for money managers to provide evidence that they obtained research and brokerage at reasonable prices:

- bundled research will have to be priced – investment dealers are creative and can meet the challenge of pricing research and brokerage;
- money managers must demonstrate that the research paid for was value added;
- at least an annual accounting of commission use must be provided to plan administrators disclosing the services acquired and the prices paid for each service including bundled services.

It is extremely important that regulation governing the use of commissions in all markets be well defined, consistent and not so loose that investor interests can be abused.

It therefore is imperative that the SEC and the FSA resolve their differences on the eligibility of services that qualify for commission payment and the accountability measurements of those using commissions to acquire research and brokerage services.

The FSA’s PS 05/9 must be broadened to recognize the needs of all money management styles.

The SEC must demand more transparency in the accountability for commission use.

\*\*\*

The following sets out our responses to some of the specific questions you asked in your Proposals:

Question 1 – This release of 28e clarifies the services that qualify as research for commission payments.

Question 2 – Computers are a cost of doing business in today’s world – When we first started doing business in 1992, money managers were purchasing their first computers so that they could use quantitative research provided on discs from research providers. Today, anyone considering opening a money management company would recognize that they need computers to analyze and organize data. The SEC is correct in recognizing that it is time that policies and rules reflect this change.

Question 3 – Market data and trade analytical software are adequately discussed in this release of 28e with appropriate guidance provided.

Question 4 – The Commission might consider moving to a more principles-based policy that would require less definition on the qualification of each service

Question 5 – We believe that the industry could be restructured so that “Research Dealers” could contract out trade execution as discussed in our submission. This would lead to a form of commission sharing or give-up that would make best execution easier. The current guidance does not recognize that product or service specialization can lead to trading and research firms that will be far more competitive by concentrating on their discipline.

Question 6 – The SEC has chosen to be rules based instead of principles based. It is our belief that a principles-based policy offers more flexibility in meeting the needs of a changing industry. It is more difficult to harmonize the policies of different regulators if they adhere to different policies.

Question 7 –

Question 8 – The SEC should provide a sample of an auditor’s check-list so that Money Managers can provide proper documentation on mixed use products or services

Question 9 – Money managers that provide a list of services paid for with commissions will be very reluctant to identify ubiquitous newspapers or journals as additional plan expenses.

Question 10 – This can be accomplished by setting an implementation date for the new release of 28e.

We would be pleased to discuss any aspect of our submission with you.

Yours very truly,  
Commission Direct Inc.

Wayne B. McAlpine  
President

Attachment Referred to in the Submission dated December 6, 2005 of Commission Direct Inc. to the SEC on Release No. 34-52635 – File No>S7-09-5

February 10, 2004

Ontario Securities Commission

20 Queen Street West  
19<sup>th</sup> Floor, Box 55  
Toronto, ON M5H 3S8

Attention: Paul M. Moore, Q.C, Vice Chair  
Cindy Petlock, Manager Market Regulation

Dear Mr. Moore and Ms. Petlock:

Re: Fostering Independent Research

You will recall meeting last December with myself, Michael Palmer and Anthony Scilipoti of Veritas Investment Research to discuss the structural disadvantages faced by independent research providers in Canada and the potential solutions to this structural disadvantage. We also discussed the appropriate use of client commission dollars to pay for independent third party research.

At that time you advised that the Ontario Securities Commission was reviewing its dealer registration categories with a view to simplifying their structure, registration and compliance needs.

You encouraged us to make a submission for consideration by your Capital Markets Committee on how you could foster independent research by making changes to the registration structure while at the same time dealing with issues surrounding the use of client commission dollars to pay for this research.

The following outlines our recommendations and our reasons for making them.

### ***Establishment of a New Restricted Registration Category***

We recommend that the OSC establish a new dealer registration category (which we refer to as a "Research Services Dealer") that is restricted to providing research to registered investors or money managers such as investment counsel, portfolio managers, mutual fund managers

and pension fund managers. It would also be able provide its research to registered dealers for redistribution to the public.

The Research Services Dealer:

- would not be permitted to trade securities. Accordingly, it would not have the capital requirements of a dealer nor would it need to file joint questionnaires.
- would be eligible to receive commissions through commission splitting arrangements with commission-conversion brokers (who are also referred to as soft dollar brokers). It is the ability to receive these commissions that removes the structural inequity that currently impedes the development of independent research providers. This is discussed in more detail under the headings “Structural Disadvantage” and “Impact of the GST”.
- would be restricted from engaging in any corporate finance activity including receiving any commissions or payments from or in respect of new issues or secondary offerings.
- would be able to distribute its research to the public through partnering with a full service broker with the infrastructure to deal with the suitability and know your client requirements.
- would pay an annual registration that would be established for this category and that would cover the OSC’s set-up and supervision costs.

### ***Observations***

Structural Disadvantage. It is important that the new registration category be a dealer registration category in order to remove the structural disadvantages directly faced by independent research providers. The structural disadvantages are also faced indirectly by institutional investors as well as by members of the public whether their money is managed on their behalf by institutional investors or is directly managed by money managers.

Impact of the GST. The structural disadvantage was inadvertently created at the time of the introduction of the Goods and Services Tax (GST) when only registered brokers and investment dealers were exempted from paying GST on commission fees. In doing so, the legislators did not take into account, and probably were not aware of, the growing trend to unbundle the services traditionally provided by full-service dealers.

Under securities laws, because independent research providers are not registered brokers or investment dealers, they are not entitled to charge a commission fee directly.

Because they are not registered dealers, the discounted commissions they receive in payment for their research are subject to GST thus creating a 7% financial disadvantage to the independents vis-a vis full service dealers offering bundled research.

This financial disadvantage is a significant impediment to the growth of independents in competing with the bundled research provided by the full service dealers. It can easily translate into the cost for the services of one or more analysts.

One has to ask whether this 7% disadvantage is in the interests of the investor or the regulator whose mandate is to protect investors and foster fair and efficient capital markets.

OSC Statement of Priorities. Countries that do not have a Value Added Tax such as the GST do not impose this disadvantage on investors. At a time when the OSC's priorities (expressed in its Statement of Priorities for Fiscal 2003/2004) is focused on:

- insisting that investors get the inputs they need to make informed investment decisions,
- developing a model to permit flexibility in business models registrants can use; and
- ensuring that investors have access to markets and education and information at levels equal to or superior to the best of its peer group;

the establishment of a Research Services Dealer category as outlined above is an efficient and effective way of permitting and fostering flexibility in business models that registrants can use to accomplish these objectives.

Fair Dealing Model. The contemplated introduction of the Fair Dealing Model outlined in the OSC's recent Concept Paper is reflective of the OSC's change in philosophy regarding registrant relationships with the retail investor. We believe that expanding the Fair Dealing Model relationship to the institutional market by establishing a Research Services Dealer category would be a natural extension of this philosophy and would pave the way for growth in unencumbered independent research competing with bundled "Street Research".

This extension is yet another step in the unbundling process for the creation and distribution of arm's length investor services as well as a

mechanism allowing the flow-through of client commission dollars to pay for these services including unbundled, independent research.

Commission Dollars. An important benefit to the marketplace would also be the opportunity to clarify the permitted use of client commissions to pay for the equivalent, legitimate unbundled services that once were only encompassed in the bundled services provided by full service dealers.

The starting point – as pointed out in the enclosed Commission Direct Inc.-led submission to the OSC dated October 17, 1995, *Framework Respecting the Use of Commission Dollars to Acquire Goods and Services* – is to recognize that the commission dollars belong to the client and can be used to pay for services to the client in addition to bare execution services.

The Framework approach we recommended in 1995 (and still recommend) would go a long way to increasing public understanding of this matter and reducing the current “soft dollar” controversy.

Eliminating the use of the term “soft dollars” and implementing a policy that would govern the appropriate use of client commission dollars would have the added benefit of solving the regulatory dilemma of how to handle a fundamental reality of the marketplace with appropriate checks and balances including transparency.

Transparency. The services provided by Research Services Dealers and the compensation flows would be totally transparent and available for audit by regulators and plan administrators whose commission dollars the money managers are spending. This is a very key element of the *Framework Proposal Governing the Use of Commission Dollars*. The Research Services Dealers, as dealer registrants, would have direct access to commissions and their relationship with commission converters (soft dollar firms) would be similar to a jitney<sup>1</sup> relationship.

Alignment with SEC Policies. In creating a “broker class”, the OSC would align its policies closer to the SEC in requiring that all independent research that is eligible for commission payment come from a registered broker.

Global Lead. The recommendations that we have made enable the OSC to take a global lead in addressing the need for independent unbiased

---

<sup>1</sup> The term “jitney” was originally used to describe the commission splitting relationship between brokers where one broker uses the execution services of another broker to trade on markets where the originating broker was not registered or did not have registered traders. This is not to be confused with the current jitney practice where brokers conceal their identity on a trade by having other brokers trade securities for them on an exchange where they have trading capabilities.

research. By outlining its intentions and calling for submissions from interested parties regarding the framework for this new registration category, the OSC would harness the intellectual resources of "Bay Street" and the global investment community through the internet.

We note that this registration class would be attractive to all independent research providers as well as to many industry consultants whose advice is sought by institutional investors. As mentioned above, registration fees should easily cover the OSC's expenses in establishing and monitoring these service providers.

\* \* \*

We urge the OSC to take the relatively simple and straightforward step of establishing a new dealer registration category as outlined above. The current registration system unfairly penalizes investors trying to get the most value from their commission dollars and third party independent research providers in trying to stay independent.

I would be pleased to meet with you or your Capital Markets Committee to discuss this submission and the implementation of its recommendations.

Yours very truly,  
Commission Direct Inc.

Wayne B. McAlpine  
President