

November 25, 2005

Mr. Jonathan G. Katz
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-9303

**RE: File No. S7-09-05
Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the
Securities Exchange Act of 1934**

Dear Mr. Katz:

The CFA Centre for Financial Market Integrity (CFA Centre)¹ appreciates the opportunity to comment on the SEC's release providing interpretive guidance on the soft dollar safe harbor established under Section 28(e) of the Securities and Exchange Act of 1934.

Summary of Comments

The CFA Centre believes that the potential conflicts of interest inherent in soft dollar² arrangements must be addressed through a combination of increased disclosure and a strict definition of what products and services constitute "research." The CFA Centre supports the Commission's approach of narrowly construing the language of Section 28(e) to impose a "content-based" screen on the types of products and services that managers can claim provide "lawful and appropriate assistance" under the soft dollar safe harbor. However, we believe the Commission should not adopt the narrow approach of the NASD and FSA in defining research as to only include "a formula, idea, analysis, or strategy," or only material which "represents original thought...intellectual rigor...or involves manipulation of data." Such a restricted interpretation would improperly exclude from the safe harbor raw data and other market information used by money managers as inputs to their own independent research.

¹ The CFA Centre for Financial Market Integrity is a part of CFA Institute. With headquarters in Charlottesville, VA and regional offices in Hong Kong, London, and New York CFA Institute, formerly, the Association for Investment Management and Research, is a global, non-profit professional association of nearly 80,000 financial analysts, portfolio managers, and other investment professionals in 124 countries and territories of which more than 67,000 are holders of the Chartered Financial Analyst (CFA) designation. The CFA Institute membership also includes 131 Member Societies and Chapters in 52 countries and territories.

² We note that when referring to "soft dollars" we also intend to include bundled brokerage, whereby a broker provides proprietary research in exchange for brokerage commissions.

Concerns with Soft Dollars

Client brokerage commissions are client assets and must be spent in the client's best interest. Soft dollars allow a manager to use client assets to purchase goods and services. This allows managers to lower their costs and creates a conflict of interest. The ultimate question is not what constitutes research, but rather what costs are appropriate for clients to bear, and which should be paid for directly by the manager.

Soft dollars can create a conflict with a manager's duty to seek best execution, whereby a broker is chosen as a result of the soft dollar arrangement in place, rather than by the ability of the broker to deliver best execution. Soft dollars can also create conflicts by enabling managers to purchase goods and services with client assets as opposed to paying for the products themselves. We believe this leads to managers buying more research than they need and that managers would be more conscientious in what they purchased if they were paying for it themselves. Many managers have noted to us that the quality of the sell-side research reports they receive is low and that what they truly value is the access to company management that the sell-side firms provide.

In addition, by tying the acquisition of research to commissions, soft dollars can also cause a conflict whereby a manager needlessly increases trading in client accounts in order to generate enough credits to purchase certain products or services. This type of activity is clearly not in investor's interests.

One of the biggest concerns regarding soft dollars is the lack of transparency and reporting to investors on how their assets are being spent. We believe many of the concerns with soft dollars will be addressed by meaningful disclosure. Managers will avoid questionable uses if they must disclose those uses to clients. We understand the Commission is developing a second proposal to address this issue and we look forward to that release.

If soft dollar arrangements did not exist, it is difficult to argue, at least from an investor's perspective, that such a structure should be created. But soft dollars do exist and there must be effective checks and balances in place to manage the resulting conflicts. We believe that an out-right ban on soft dollars, as some have suggested, would have a disproportionate negative impact on smaller investment managers.

Some argue that managers that rely so heavily on clients funding research through soft dollars may not have a truly viable business model, but we are concerned that investors may be worse off if soft dollars were eliminated. Soft dollar arrangements help make it possible for clients of smaller money management firms, who may not be able to profitably support an extensive in-house research effort or pay hard dollars for research, to benefit from research provided to their money managers. Without soft dollars, modestly-sized money managers and independent research firms may be forced out of the investment industry, likely leaving investors worse off.

We believe that investors are best served by making a wide variety of research available to the markets. Soft dollar arrangements encourage the publication of research that provides asset managers and investors with a broad range of information and analysis of securities. While there are inherent conflicts of interest in soft dollar arrangements, the CFA Centre believes that options for investors to obtain investment or research services should not be limited.

Rather than attempt to address these conflicts by eliminating soft dollar practices, thereby possibly threatening the amount of information, analysis, and research available to investors, the CFA Centre believes that conflicts

of interest can be effectively addressed by 1) strictly limiting the services available through soft dollar arrangements to “research services” that primarily benefit investors, and 2) increased disclosure regarding soft dollar practices to investors.

CFA Institute Soft Dollar Standards

In 1999, CFA Institute (then the Association for Investment Management and Research) issued its *Soft Dollar Standards – Guidance for Ethical Practices Involving Client Brokerage*. The Soft Dollar Standards provide guidance to investment professionals world-wide through the articulation of high ethical standards that are consistent with and complement the CFA Institute *Code of Ethics* and *Standards of Professional Conduct* that all CFA Institute members and candidates for the CFA designation are required to follow.

The CFA Institute Soft Dollar Standards are founded upon the core principle that brokerage commissions belong to the client. As a result, client commissions must be spent in the client’s best interest. The Standards create a framework that restricts the use of client commissions in soft or bundled arrangements to the acquisition of research and/or brokerage services. A critical component of these standards is a narrow “use-based” definition of research that reflects a more restrictive view of research than current SEC interpretation. This “use-based” definition requires firms to determine if a product or service is used as research. Thus, the same product or service could be considered research by one firm and not by another. The Standards define research as services and/or products that directly assist the investment manager in the investment decision-making process and not in the management of the firm.³ Furthermore, the Standards require transparency via regular client reporting on how the client’s commissions have been spent.

The Commission’s proposed interpretive guidance of Section 28(e) is consistent with the objective of the CFA Institute Soft Dollar Standards to ensure that only products and services that legitimately benefit clients be paid for with soft dollars. We hope that this release and further guidance from the Commission on disclosure of soft dollar practices will move the industry closer to the ethical practices embodied by the CFA Institute Soft Dollar Standards.

“Content-Based” Definition of Research

The Commission’s proposed interpretive release reiterates that, to be eligible for the safe harbor protection, research services must meet the statutory requirements of Section 28(e) and, therefore, are restricted to “advice,” “analyses,” and “reports” concerning subject matters set forth in Section 28(e). The SEC’s proposed guidance imposes a “content” based standard for determining what constitutes eligible products and services. Products and services that meet the “content” definition must then be analyzed as to how they are used (mixed use analysis).

The CFA Centre supports the Commission’s efforts to narrowly construe the language and intent of Section 28(e) to circumscribe the definition of research so that only products and services that benefit the managers’

³ The Commission noted in its interpretive release that some investment professionals have improperly attempted to pay for “certified (sic) financial analyst (CFA) exam review courses.” We note that such a service is clearly not research and use of soft dollars to pay for a Chartered Financial Analyst exam review course would certainly violate the CFA Institute Soft Dollar Standards.

clients are protected by the safe harbor. We believe that this narrower definition of research will help ensure that managers meet their fiduciary duty by using client commissions for the benefit of their clients.

The proposed interpretive guidance reiterates that, to be eligible for safe harbor protection, “research services” must meet the statutory requirements of Section 28(e). An eligible product or service constitutes “advice,” “analyses,” and “reports” concerning subject matters set forth in Section 28(e). The Commission notes that “an important common element among “advice,” “analyses,” and “reports” is that each reflects substantive content – that is, the expression of reasoning and knowledge.”

By returning to the language of the statute, the Commission is adding a “content-based” filter for analyzing products and services eligible for the safe harbor. Adopting a relatively broad “content” filter based on the statutory language of Section 28(e) with a “use-based” definition of research is a more appropriate and effective definition of research than is currently in place. The proposed interpretive guidance meets in substance and spirit, the original objectives of Congress in enacting the safe harbor provision, while addressing the major areas of abuse. The guidance will strengthen the protection afforded to investors by reducing conflicts of interest while preserving investment advisers’ ability to obtain a variety of research services that can ultimately benefit their clients.

We support the Commission’s rejection of the more narrowly drawn definitions of research supported by the North American Securities Dealers and the UK’s Financial Services Authority. The proposed NASD definition focuses on the “intellectual content” of the research so that it protects:

any investment formula, idea, analysis or strategy that is communicated in writing, orally or electronically and that has been developed, authored, provided or applied by the broker-dealer or third-party research provider (other than magazines, periodicals or other publications in general circulation).

A similarly restrictive definition of research was also adopted by the Financial Services Authority. The FSA defines research as:

capable of adding value by providing new insights that inform fund managers when making investment or trading decisions about their client’s portfolios. That is, the output (in whatever form):

- *represents original thought – that is, the critical and careful consideration and assessment of new and existing facts – and does not merely repeat or repackage what has been presented before;*
- *it has intellectual rigor and does not merely state what is commonplace or self-evident; and*
- *it involves analysis or manipulation of data to reach meaningful conclusions.*

We believe the NASD/FSA approach is too narrow and, as the Commission points out, would eliminate many products and services that investment advisers legitimately use as research to benefit their clients. Such definitions may exclude the building blocks for an analyst to conduct their own, independent research. Products and services that one adviser may use primarily for non-research purposes may be a critical research tool for another adviser. For example, access to Bloomberg software may not be used for “research” purposes by large firms that have extensive in-house research departments. But small firms may rely on the information gleaned from Bloomberg to help them formulate an effective investment strategy for their clients. Products and services that are legitimate research should not be eliminated from safe harbor protection simply because they may also be used for a broader or non-research purpose. The CFA Centre believes that use of a narrow standard would threaten the types of research that the section 28(e) safe harbor is designed to protect.

Mass-marketed Publications as Research

The CFA Centre believes that an important aspect of the capital markets is the ability of money managers to bring new information to the markets by conducting research on their own. To facilitate this, the Section 28(e) safe harbor should be interpreted to protect the type of raw market data that can be used by money managers to independently conduct research. As stated above, protected research should not be limited to finished research reports. Importantly, in order to promote truly independent research, the proposed interpretation should not preclude managers from obtaining various inputs to conduct their own research. If it is permissible to purchase a completed research report, it should also be permissible to acquire the inputs for a manager to complete a report on their own.

Whether that raw data used by analysts comes from mass-marketed publications should make no difference as to whether such information is protected under the statute. In adopting its interpretive guidance, the Commission effectively addresses abuse of soft dollar practices by creating a two-step analysis looking at both *content* and *use* of the products and services. Examining how the products and services are received by the manager would effectively add a third test based on the *form of delivery* of those products and services. We do not think this additional screen is necessary. It would further complicate money managers' efforts to determine what products and services are eligible for the safe harbor without adding any significant safeguards of investor protection.

In addition, use of soft dollars to pay for the relatively inexpensive cost of the publications does not represent a significant threat of abuse of client commissions. Managers must still 1) make a good faith determination that commissions paid are reasonable in relation to the value of the products and services provided by the broker-dealers, and 2) make a good faith determination regarding their allocation of mixed-use items between eligible and ineligible uses and document their allocation. The manager will have to make a determination if paying up for the publication subscription is reasonable and, unless the publication is being used solely for research, determine what portion of the subscription cost can be attributable to research. We believe most managers will likely forgo this complicated analysis and associated record-keeping for such a minimal expense and pay for their subscriptions to mass-marketed publications with hard dollars.

Applicability to Principal Trades

Principal or spread trades imbed the commission with the price of the security. This makes it very difficult to determine the amount of the commission paid by the client. We recognize the difficulty, therefore, in applying this interpretation to these trades, but we strongly encourage the Commission to continue to examine this area to determine how to best protect investors and mitigate conflicts of interests.

Conclusion

The CFA Centre supports the Commission's efforts to narrow the scope of products and services covered by the safe harbor of Section 28(e) to research, reports, and analyses that lawfully and appropriately assist the money manager in the performance of their investment decision-making responsibilities. However, we note that adopting a narrow definition of research is only one part of protecting client interests in their managers' use of soft dollars.

The CFA Centre believes that full and fair disclosure by managers regarding their soft dollar practices is the other critical step managers must take to meet their fiduciary duty. If managers provide a description of the products and services and the costs, investors can determine whether they want to buy those services. Disclosure allows investors to make informed decisions about whether they are receiving a benefit from the soft or bundled research obtained by their investment manager, how much they are paying for the service, and whether to use investment managers who enter into soft commission arrangements. For some time, CFA Institute, through the Soft Dollars Standards, has called on industry participants to make such disclosure. We look forward to additional guidance from the Commission on disclosure in the future supporting this position.

Respectfully,

/s/

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/s/

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