



Securities Industry Association

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Via Electronic Mail to cp176@fsa.gov.uk

May 31, 2005

Mr. Paul Craig
Wholesale and Prudential Policy Division
Financial Services Authority
25 The North Colonnade
Canary Wharf
London, England E14 5HS

Re: Financial Services Authority ("FSA") Consultation Paper 05/5

Dear Mr. Craig:

The Securities Industry Association ("SIA")¹ is pleased to have this opportunity to comment on Consultation Paper 05/5 which sets out draft rules designed to implement policy decisions published in Policy Statements 04/13 and 04/23 on bundled brokerage and soft commission arrangements. The vast majority of SIA's broker-dealer members who provide a broad spectrum of services to both retail and institutional investors, are either dually registered as investment advisers and/or have investment adviser affiliates. Therefore, we are extremely interested in the matters set forth in Consultation Paper 05/5 from both brokerage execution and investment management perspectives.

SIA's involvement has included interaction with the U.S. Securities and Exchange Commission ("SEC") and the NASD Mutual Fund Task Force, as well as monitoring regulatory developments in the U.K. and Canada, and communicating with regulators and/or trade groups in those jurisdictions. One of the major goals of this effort, is to achieve a high degree of regulatory uniformity and certainty across international boundaries. Thus, while there is still some diversity of opinion on the subject of unbundling, we are pleased to see

¹ The Securities Industry Association brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. At its core: Commitment to Clarity, a commitment to openness and understanding as the guiding principles for all interactions between investors and the firms that serve them. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated an estimated \$227.5 billion in domestic revenue and \$305 billion in global revenues. (More information about SIA is available at: www.sia.com.)

substantial parallels in the recommendations contained, respectively, in FSA's Policy Statement 04/23 and the NASD Mutual Fund Task Force report with respect to narrowing the scope of permitted research and brokerage services that could be received in exchange for commission dollars.² The content of these documents also closely parallels the specific recommendations that SIA had presented to the SEC in September, 2004.³ Therefore, subject to certain adjustments, we urge the FSA to proceed with efforts to narrow the range of goods and services that may be received by investment managers in exchange for soft commissions.

SIA also welcomes the FSA's efforts to enhance transparency to investment managers, shareholders and other beneficiaries, and we appreciate your willingness to consider industry solutions rather than adopt a more prescriptive approach. We do, however, have some concern that the methodologies intended to achieve the goal of greater transparency might have unintended consequences, and that FSA may wish to consider supplemental or alternative approaches that might provide more flexibility and a greater likelihood that any new initiatives will achieve their regulatory objectives. We discuss these matters further below:

SCOPE OF PERMITTED SERVICES

SIA believes that from an investor protection and public trust perspective, narrowing the scope of permitted services is the most critical aspect of FSA's soft dollar regulatory initiative, as well as initiatives that might be undertaken in the U.S. or other jurisdictions. We are pleased that regulators and market participants on both sides of the Atlantic share the goal of narrowing the scope of permitted services, and there is much common ground in the various proposals and recommendations as to what form this should take. We do, however, wish to address the following aspects of your proposal which we believe should be reconsidered or clarified:

Computer Hardware – It is apparent from other portions of the text of Consultation Paper 05/5, that FSA recognizes that computer software may be an appropriate and permissible research product. In such circumstances, the computer hardware in which the software is stored may be far more than merely a repository for data or a facilitator of an investment manager's performance of routine office functions. Therefore, we respectfully suggest that FSA clarify its categorization of computer hardware to permit computer terminals to the extent they are dedicated to research uses or necessary to employ research software, in furtherance of the investment manager's performance of its investment decision making responsibilities.

Valuation and Performance Measurement Services – As we understand it, one of the main objectives of the FSA's initiative is to promote a more rigorous review and

² See SIA Press Release, November 17, 2004 which states "We are pleased that the (NASD) task force and the FSA have similar approaches to help ensure that the products and services provided through soft dollar arrangements serve the best interests of investors."

³ In the U.S. such recommendations would be implemented through modifications to existing interpretations of the scope of goods and services that could be provided under Section 28(e) of the Securities and Exchange Act of 1934. Section 28(e) provides a safe harbor to allow investment managers to pay more than the lowest commission in recognition of receipt of research and brokerage services.

accountability to ensure that investment managers receive commensurate research and execution services in exchange for commissions. Valuation and performance measurement services significantly contribute to making such determination. Performance measurement services also help investment managers to understand the attributes of their performance and better assess the quality of their investment ideas, which may result in changes to investment strategy. Therefore, while cogent arguments might be made either way as to whether such services are, per se, research or execution, they are clearly related to those services, and from a policy standpoint their use should be further encouraged by excluding them from the “non-permitted” category. Also we think that FSA should not include in its final rules the principle that permitted services need to be provided prior to execution of relevant investment. The fact that a service is provided after execution does not necessarily mean that the service is not very closely related to the execution (e.g., post-trade analytics used to evaluate execution quality)

Seminar Fees and Related Expenses - We believe that seminars and conferences focused on matters that have a direct bearing on, and contribute to, an investment manager’s decision-making process should be classified as permitted services. This would include those with content related, among other things, to industry trends and investment strategies. It is not desirable to create regulatory disincentives to participate in such activities, and the fees and other costs associated with such participation should also be within the realm of permitted services. Other travel and accommodation, as well as entertainment expenses, should be treated as “non-permitted.”

Subscriptions For Publications - While we would agree that subscriptions to mass-market publications should not be permitted products, there are many limited purpose publications that are focused on subjects largely of interest only to professional investment managers, rather than the general public. These industry specific periodicals, trade journals, technical publications and the like, are critical to an investment manager’s decision-making process, often providing in-depth analysis of technical, economic and scientific information that directly affects the value of investments. Therefore, we respectfully suggest that FSA clarify its position to reflect that it only intends to exclude mass market publications from the permitted category.

UNBUNDLING OF COMMISSIONS

As previously noted, SIA applauds the fact that FSA has actively sought input from industry trade groups, and allowed them to play a role in shaping commission transparency enhancements. Further, we believe that investment managers should be able to obtain all reasonable information necessary for them to determine that the permitted services they receive are commensurate with the commissions generating those services. Underlying investors, in turn, should be provided with sufficient information to satisfy themselves that investment managers are properly making such determinations. However, while we appreciate the efforts of counterpart trade associations that have developed methodologies for unbundling the research and execution components of a commission, we have significant concerns that undue focus on unbundling may have unintended consequences.

Some of our concern emanates from the general U.S. view that proprietary research is so integrated and interwoven with overall broker-dealer services that it cannot be effectively separated with a high degree of accuracy. However, we have a more fundamental concern that the emphasis on unbundling may deflect investment manager and investor attention away from much more significant factors relating to the broker selection process. In that regard, we note that by the end of 2003 the average U.S. institutional trading commission had fallen to just over 4 cents per share,⁴ which reflected a continuing downward trend. We understand that the U.K. and Canada have experienced a similar trend and that their average institutional commission rates are even lower. This commission cost is generally referred to as an explicit cost and is readily quantifiable. Aside from the fact that explicit costs are declining in general, they are also usually the smallest component of portfolio transaction costs. In a 2003 Concept Release on portfolio transaction costs,⁵ the SEC observed that:

“...commissions are explicit, readily identifiable and quantifiable. Spread, impact, and opportunity costs are implicit costs. Because the implicit costs, which are difficult to identify and quantify, can greatly exceed the explicit costs, there is no generally agreed upon method to calculate securities transaction costs...”

Moreover, the vast majority of factors that investment managers should consider in broker selection are qualitative in nature. In that regard, a CFA Institute Trade Management Task Force issued guidelines which cite more than twenty qualitative factors that investment managers should consider in selecting executing brokers⁶. These factors include, but are not limited to:

- maintaining and committing adequate capital to complete trades
- minimizing number of incomplete trades
- searching for and obtaining liquidity
- accommodating unusual market conditions
- execution of unique trading strategies
- prompt execution
- executing and settling difficult trades
- maintaining client anonymity
- maximizing opportunities for price improvement
- accounting for and correcting trading errors in a satisfactory manner, and
- ability to efficiently execute after-hours and cross-border trading

Viewed in the overall context of the broker selection and best execution processes, commission costs are only one, and often the smallest, component. Therefore, in considering the value of unbundling, is it not reasonable to ask what an investment manager would or should do with the information? For example, if an unbundling formula reflected that where a 4 cent average commission is charged 2 cents were allocable respectively to research and

⁴ Source: Greenwich Associates.

⁵ Release No. 33-8349, December 18, 2003.

⁶ CFA Institute Trade Management Guidelines, November 8, 2002, p. 7-8. Mr. Paul Richards of FSA was an observer to the task force. The CFA Institute was previously known as the Association of Investment Management and Research.

execution, and the manager only valued research at one cent, should the manager feel compelled to direct commission trades elsewhere if the current broker-dealer refused to reduce average commission charges to 3 cents a share? Would that be a desirable result? Will investment managers tend to view application of unbundling formulae developed by industry associations as a form of “safe harbor” since the FSA proposal would consider use of such formulae in assessing the adequacy of an investment manager’s disclosure regimen? Will this cause investment managers to place more weight on the unbundled components of explicit costs, than on the less easily quantifiable, but typically greater implicit costs, or on all of the qualitative factors that are an integral part of the broker selection process?⁷

In sum, we believe that introducing measurement criteria into a process that is so overwhelmingly qualitative, or largely not measurable, has the potential to distort the overall investment process in a way that will not prove beneficial to investors.

CONCLUSION

Our comments regarding the relative value of unbundling the research and execution components of a commission charge should not be construed as implying that the fine work done by U.K. trade groups should be disregarded. Rather, we believe it needs to be put in the overall context of the broker selection process. In that regard, we respectfully suggest that FSA’s policy more clearly reflect that unbundling is only one methodology which may be part of the overall broker selection process, and that other methodologies may also be appropriate in lieu of, or in addition to, unbundling. Such a clarification will not only help avoid the potential distortions that concern us, but will also help to achieve cross-border regulatory uniformity by accommodating a wider range of approaches that an investment manager may employ in fulfilling its obligations to its clients with respect to the broker selection process.

With regard to regulations narrowing the scope of permitted services, subject to the modifications and clarifications discussed above, we urge the FSA to move expeditiously to adopt them. We believe FSA should move forward on this portion of its proposal, even if it determines that more time is needed to consider the more controversial aspects of the proposal relating to transparency issues. We would note that one of the primary objectives of enhanced transparency is to ensure that the products and services that an investment manager receives in exchange for soft commissions inure solely to the benefit of the investment manager’s clients. That objective may be largely achievable simply by removing from the scope of permitted services those that are the most problematic. The current proposal would seem to do that in an effective manner.

We appreciate the opportunity to comment on Consultation Paper 05/5. Should you have any questions, please contact the undersigned at 202-216-2000 or Michael Udoff of SIA staff at 212-618-0509.

⁷ While we have provided an example at the individual transaction level, this analysis and commentary would be equally applicable to the allocation of aggregate commissions paid during a specified period.

Very truly yours,

Ira D. Hammerman
Senior Vice President
General Counsel

cc: The Honorable William H. Donaldson – Chairman, SEC
The Honorable Paul S. Atkins – Commissioner, SEC
The Honorable Roel C. Campos – Commissioner, SEC
The Honorable Cynthia A. Glassman – Commissioner, SEC
The Honorable Harvey J. Goldschmid – Commissioner, SEC
Annette Nazareth – Director, Division of Market Regulation, SEC
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