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(christopher.preston@fsa.gov.uk)

December 5, 2006

Mr. Christopher Preston
Financial Services Authority
25 The North Colonnade
Canary Wharf
London, England E145HS

Re: Proposed Amended Guidance to COB 7.18 - Use of Dealing Commission

Dear Mr. Preston:

The Securities Industry and Financial Markets Association (“SIFMA”)¹ is pleased to reply to the portion of FSA Consultation Paper 06/18 relating to a proposed amendment to COB 7.18 on the use of dealing commissions.

The rules pertaining to COB 7.18 were adopted in July, 2005 pursuant to FSA Policy Statement 05/9, and went into effect at the beginning of 2006. The proposed amendment would categorize connectivity services and associated software (including order management systems) as non-permitted services, i.e. – those that may not be obtained by investment managers through use of dealing commissions.

SIFMA members consist of banks, institutional asset managers, and broker-dealers, who provide a broad array of services to both retail and institutional investors. Most member broker-dealers are either dually registered as investment advisers and/or

¹The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA’s mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public’s trust and confidence in the markets and the industry. SIFMA works to represent its members’ interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

SIFMA was created, effective November 1, 2006, through the merger of the Securities Industry Association and The Bond Market Association.

have advisory affiliates. Therefore, SIFMA is well positioned to address the matters set forth in the proposed amendment to COB 7.18. In that regard, we strongly disagree with the content of the proposed amendment, as well as with the stated conclusions that connectivity services and associated software fail the temporal test or are inconsistent with duties owed to clients. Our disagreement is based on a number of factors, including the following:

- the proposal is inconsistent with the underlying approach taken by FSA in adopting its use of dealing commission rules.
- the proposal is also inconsistent with conclusions reached by other regulators regarding connectivity services and order management systems.
- The underlying assumption that such services fail the temporal test or are inconsistent with client duties when obtained through client commissions is inaccurate and not supported by any discussion or analysis.
- There are strong public policy reasons for not excluding these services.
- FSA has provided no indication that investment managers, who have the primary responsibility for assuring that dealing commissions are used for services that benefit the client and are properly disclosed to them, have expressed any concern with, or need for clarification with respect to these services.
- FSA has cited no evidence of abuse with respect to such services that would warrant adoption of the proposed amendment.

We discuss these matters in more detail below.

Lack of Regulatory Consistency

We believe that the current proposal lacks both internal and external regulatory consistency. We note that the rules previously adopted by FSA on use of dealing commission provide hi-level criteria to managers to assess whether services received fall into research or execution categories. In commenting on this approach in Consultation Paper 06/18, the FSA states that the rules are drafted in this way, rather than in a more detailed and prescriptive manner, because it believes it is appropriate for managers to take responsibility for making judgments about the goods and services they should purchase with client commissions.² We agree that this is a well reasoned and practical approach, and therefore do not understand why the FSA would abandon it, and seek to prescribe connectivity services and software, such as order management systems, which can, among other things, enhance both the efficiency and quality of executions and the manager's investment decision making process for the benefit of clients.

² See Consultation Paper 06/18, paragraph 5.5, p.18.

It is particularly noteworthy, that in the client commission practices interpretive guidance it issued in July, 2006³ the U.S. Securities and Exchange Commission (“SEC”) reached an entirely different conclusion, and explicitly determined that:

“...Under the temporal standard, communications services related to the execution, clearing, and settlement of securities transactions and other functions incidental to effecting securities transactions, i.e., connectivity service between the money manager and the broker-dealer and other relevant parties such as custodians (including dedicated lines between the broker-dealer and the money manager’s order management system; lines between the broker-dealer and order management systems operated by a third-party vendor; dedicated lines providing direct dial-up service between the money manager and the trading desk at the broker-dealer; and message services used to transmit orders to broker-dealers for execution) are eligible under Section 28(e)(3)c. In addition, trading software used to route orders to market centers, software that provides algorithmic trading strategies, and software used to transmit orders to direct market access (“DMA”) systems are within the temporal standard and thus are eligible “brokerage” under the safe harbor...”⁴.

We believe that in large measure the SEC reached its conclusions based on the view expressed in numerous comment letters, that connectivity services and order management systems are so integrated and interrelated with order execution and a variety of research services as to fall within the range of permitted services.

It is also clear that while the SEC recognized certain differences in U.K. and U.S. governing law and rules, it strove to maximize the compatibility of the respective regulations pertaining to use of dealing commissions. In particular, the SEC noted that “...To the extent that the Commission’s approach to client commissions is compatible with that taken in the United Kingdom, market participants’ costs of compliance with multiple regulatory regimes are reduced...”⁵. We observe that there is nothing in the FSA final rules as set forth in Policy Statement 05/9, that would have led the SEC to conclude that its interpretive guidance regarding connectivity services and order management systems would be a potential source of regulatory incompatibility – nor in our view should it be. In fact, in commenting on the position taken by FSA in Policy Statement 05/9 regarding order management systems, the Canadian Securities Administrators stated that ...”The FSA’s position is that these systems may be paid for with client brokerage commissions to the extent that they are used for purposes that are directly related to order execution, and that provide benefit to the clients...”⁶.

³ SEC Release No. 34-54165

⁴ Id at p.41.

⁵ Id at p.20.

⁶ Canadian Securities Administrators Notice of Proposed National Instrument 23-102, “Use of Client Brokerage Commissions as Payment for Order Execution Services or Research (“Soft Dollar Arrangements”) (July 21, 2006)

Rationale for Proposal

It has been a consistent practice of FSA in its consultation papers and policy statements to provide detailed analyses and discussion in support of its regulatory initiatives. Therefore, we find it surprising that such analyses and discussion is almost totally absent with respect to the current proposed amendment to COB 7.18. Instead the proposal offers only conclusionary statements, which we believe to be largely inaccurate.

While it is somewhat difficult to respond in detail to conclusionary statements unsupported by any discussion setting forth the rationale behind them, we can at least make certain important observations. With regard to the temporal test, and as described earlier in this letter, the SEC has concluded that the subject services largely fall within the temporal standard, and otherwise fall within the scope of permitted brokerage or research services. While we understand that structural differences and local practices may sometimes dictate different regulatory approaches, the FSA has failed to cite what they might be in this instance, or to otherwise offer any explanation as to why they would have found the SEC's analysis faulty, or otherwise inapplicable to the U.K. marketplace. To our knowledge these types of services are available in a similar fashion to investment managers in the U.S., Canada and the U.K., and in many instances from the same brokers.

Most fundamentally, we strongly disagree with the statement that such services are inconsistent with duties owed to clients. On the contrary, these services can significantly enhance the quality and efficiency of the order execution process, to the substantial benefit of investment manager clients. In particular, the characteristics of these services can significantly reduce the implicit costs of execution, which are generally considered to greatly exceed explicit commission costs.⁷ Thus, as both a matter of public policy and good business practice it is important to encourage managers to consider utilizing dealing commissions to obtain these services to enhance execution quality for the benefit of clients.⁸

As a final matter, we note that none of our investment manager members have expressed any concern about possible difficulties in making judgments regarding the appropriateness of utilizing dealing commissions to obtain such services. Furthermore, we are unaware of any abuses concerning such services, nor have any been cited by FSA which would warrant such a draconian prescriptive solution.

Conclusion

For all of the foregoing reasons we believe the FSA should not proceed with the adoption of the proposed amendment to COB 7.18. Even if the FSA determines that the matter should be given further consideration, it should not do so without first publishing a

⁷ See SIA letter to Paul Craig regarding FSA Consultation Paper 05/5, p.4 (May 31, 2005) and SEC Concept Release 33-8349 (December 18, 2003).

⁸ As noted in the SEC interpretive guidance certain of these services may also qualify as research.

supplemental consultation paper fully analyzing and discussing the rationale for the proposed amendment, and inviting further public comment thereon.

SIFMA appreciates the opportunity to comment on the proposed amendment to COB 7.18. If you have any questions regarding this letter or related matters please contact me at 212-618-0509 or mudoff@sifma.org.

Sincerely,

Michael D. Udoff
Vice-President and
Associate General Counsel

cc: Joanne Swindler – Associate Director, Division of Market Regulation, SEC
Andrew Donohue – Director, Division of Investment Management, SEC
Robert E. Plaze – Associate Director, Division of Investment Management, SEC