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September 7, 2006

Ms. Nancy M. Morris, Secretary
U.S. Securities and Exchange Commission
100 F. Street, N.E.
Washington, D.C. 20549-1090

Subject: Public Comment on Disclosure, Transparency and the Misreporting Soft Dollar Brokerage Commissions – file: S7-13-06

Dear Ms. Morris, SEC Colleagues, Institutional Fiduciaries and Plan Beneficiaries:

Thank you for this opportunity to make further public comment on the use brokerage commissions for "trusteed" institutional investment accounts.

During the webcast of the SEC Open Meeting on July 12, 2006 some Commissioners and SEC staff commented on the need for a "second wing" of interpretive guidance on transparency and disclosure in bundled services brokerage arrangements. Since then I haven't seen anything to indicate that the SEC is actively working on interpretive guidance on transparency and disclosure. But I have seen a couple of troubling articles in the press.

One article was titled, Advisors Misreport Soft Dollars, it was written by Sara Hansard and published in Crain's Investment News on July 24, 2006.(1) The article quoted Lorie Richards, Director of the SEC Office of Compliance, Inspections and Examinations and David Tittsworth, Executive Director of the Investment Adviser Association. In the article, both Ms. Richards and Mr. Tittsworth commented on the frequency that advisors misreport, or do not report, the use of clients' commissions to purchase brokerage services above the cost of execution and clearing.

Then, while reading a brief news item titled, NASD Lets American Funds Off Easy, written by Charles Paikert and published in Crain's Investment News on September 5, 2006 - page 4(2) I was stunned by the following quoted statement, apparently released by the NASD's hearing panel, 'Mutual fund distributors aren't supposed to direct trading business to brokers as a reward for selling their funds, but Washington-based NASD's hearing panel decided that what American Funds did was merely "negligent, not intentional or reckless, and didn't harm shareholders."' (Underline emphasis is mine.)

At the risk of argument I'll state, many investment advisors and most full service broker / dealers have attempted to ignore the regulations passed by The U.S. Congress in 1975 when fully negotiated brokerage commissions were mandated and the permissible uses of client brokerage commissions, under the safe harbor of section 28(e) of the Securities Exchange Act of 1934, were defined. But, at this point, it seems important to acknowledge that fiduciary law and statutory law (3) are explicit when defining fiduciaries' responsibilities for the use of institutional clients' brokerage commissions.

It seems odd the NASD hearing panel didn't recognize the implications of the improper use of client brokerage commissions in the American Funds "anti-reciprocal brokerage" case. Unless I'm unaware of some detail in the facts of this case, the client commissions used in this reciprocal arrangement, and in many other advisory / brokerage reciprocal arrangements, should be characterized as soft dollar arrangements, and they should be reviewed and tested under all of the regulations for advisors' appropriate use of client commissions.

Over the past thirty years, or so, the costs of executing and clearing brokerage trades have decreased significantly. This decrease in execution and clearing costs has come mainly from significant advances in trading technology (electronic trading, crossing networks, order concentration strategies, straight through processing, etc.) and from increases in "market liquidity". However, as past Chairman of the Securities and Exchange Commission, Arthur Levitt pointed out in several speeches in late1999, institutional brokerage commissions have not declined as the costs of institutional brokerage (execution and clearing) have declined.(3) Chairman Levitt's conclusion, investment advisor's are benefiting from the use of "other peoples' money".

At this point you may be curious, how can one confidently estimate the cost of executing and clearing institutional brokerage trades?

When the U.S. Congress passed the Employee Retirement Income Security Act (ERISA) in 1974, the legislation mandated that institutional investment advisors managing multi-employer benefit plans must seek "best execution" from their brokers. Investment advisors soon began to worry about their obligation for best execution, so they asked "what is best execution?" The Department of Labor (DOL), which has responsibility for interpreting and enforcing ERISA, soon commissioned a study to define "best execution".

Several months of trial, error, back-testing, and refining different statistical approaches for measuring execution quality ensued, finally a method was developed and the details involved were published. Since then, transaction cost analysis has been continually refined and tested and a coterie of transaction consultants (3) has used transaction cost analysis to help identify "best execution".

An ancillary attribute of all this transaction cost analysis is that, while it reveals the cost of execution and clearing, it also raises questions about brokerage commissions paid in excess of the cost of execution and clearing.

Recently quoted and widely accepted statistics on the current cost of executing and clearing institutional equity brokerage transactions indicate a range of costs between 1.25 to 1.50 cents per share. Most large investment advisors pay their full service brokers 5 to

6 cents per share of client commissions for institutional trades. Laypeople sometimes miss the significance of the size of this excess in commission payments because it's quoted in cents per share. It's helpful to realize that institutional size transactions are typically tens of thousands or hundreds of thousands of shares. It's also significant to realize that executing brokers rarely bare any inventory risk (no carrying cost, no risk of price decline, no inventory spoilage) since they generally act as broker only. Under such circumstances a few excess cents per share become a monster "sugar plum".

Another factor that exposes issues and raises questions about the use of client's commissions is that, for at least the past twenty five years, portfolio management and portfolio accounting systems used by investment advisors have included the capability of detailed accounting of brokerage commissions. These accounting records can be shown on a trade-by-trade basis, a broker-by-broker basis, and also on a client account basis.

These brokerage commission accounting records are used by some investment advisors to reconcile commission payments to "third party" brokers for independent research in fully disclosed brokerage arrangements. These brokerage commission accounting records are also used by some investment advisors to track the value of the commission business given to their brokers. And they use the data as evidence of the value of the relationship when negotiating favors (mutual fund distribution, separate account and wrap account introductions, allocation of initial public offering "hot issues", market intelligence, "first call" arrangements, and etc.) with their full service brokers.

The ability to identify and account for the excess brokerage commissions paid (above the broker's costs of execution and clearing) can be very compelling information when an investment advisor needs a favor from a broker, or when an advisor feels she is not receiving the level of attention due a valuable client.

Is it possible for investment advisors to review execution cost analysis data, then review and compare brokerage commission accounting data, then use the same data to negotiate value propositions with their brokers, and all the while claim they don't use soft dollars? And how can fiduciary's claim, convincingly, that their clients are not harmed by such uses of their brokerage commissions?

I believe the brokerage commission accounting records described above are part of the "maintenance of books and records" requirements regulatory authorities' mandate brokerage firms and investment advisors maintain. These books and records must be made available for regulatory audit. Barring any call by supervisory personnel to "clean-up your files" such records could be used to substantiate that client brokerage commissions have been used properly by investment advisors. These records might also be used to substantiate that the economic benefits of the excess brokerage commissions were allocated properly and accrued to the "direct benefit" of the appropriate client accounts.

Tracking these uses of client commissions is not only the appropriate responsibility of the SEC, but all trustees and co-fiduciaries should also be concerned. And they should mandate access to detailed trade data for the account they supervise, because it's also their responsibility to assure that client commissions are used for the "direct benefit" of the accounts under their trusteeship.

Thank you again for providing a public forum for my comment. It seems obvious to me that Supreme Court Justice Brandeis was on to something when he said, "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." - *Other People's Money, and How the Bankers Use It* (1933).

Hope Springs Eternal,

Bill George
http://www.home.earthlink.net/~wtgeo/

Footnotes

(1) See Crain's Investment News article, Advisors Misreport Soft Dollars, by Sara Hansard - published July 24, 2006
Link: http://www.investmentnews.com/page.cms?pageId=112&q=hansard+misreport

(2) See Crain's Investment News article NASD Lets American Funds Off Easy, by Charles Paikert published September 5, 2006 - page 4
Link: http://www.investmentnews.com/page.cms?pageId=112&q=Paikert+American

(3) Section 28(e) of The Securities Exchange Act of 1934 and DOL statutes under the Employee Retirement Income Security Act (ERISA)
Links: http://www.dol.gov/ebsa/publications/softdolr.htm

(4) See, text of former SEC Chairman Arthur Levitt's speech to the Securities Industry Association Annual Meeting in Boca Raton, FL in November of 1999. Scroll down to the section: "'Sticky' brokerage commissions"
Link: http://www.sec.gov/news/speech/speech420.html

(5) See, Links:
(a) ITG Plexus Group http://www.itginc.com/offerings/plexus_brokeredge_monitor.php
(b) Elkins McSherry Trade Evaluation http://www.elkinsmcsherry.com/EM/EMWHome.aspx
(c) Abel Noser TCA http://www.abelnoser.com/
(d) Tethys Tech http://www.tethystech.com/?gclid=CLPZ6dCmmYcCFQobWAodtEtMbQ
(e) Additionally, most large investment consulting firms will provide Transaction Cost Analysis (TCA) and brocker ranking reports to their clients, for a fee (generally paid in "soft dollars").

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August 14, 2006

Commissioner, Raul Campos
Securities and Exchange Commission
100 F. Street, NE
Washington D.C. 20549

Subject: Soft Dollars

Dear Commissioner Campos:

Early last week I read the transcript of your speech before the attendees of the Teachers Retirement System of the State of Illinois "Opportunity Forum" July 21, 2006.(1) I was very pleased to see that, in your speech, you emphasized that, when applying the Interpretive Guidance On The Use Of Client Commissions,(2) fiduciaries should use caution. Your statement, "Remember, the context in which we are analyzing services is a safe harbor from a fiduciary duty – not an entitlement." I hope that more statements such as this will increase fiduciaries' focus on their responsibility to protect client commissions from soft dollar abuse.

In the same regard, I think it's important to motivate awareness among fiduciaries that all brokerage commission costs in excess of the qualifying costs of execution and ancillary clearing must be closely analyzed for their compliance under Section 28(e) and the Interpretive Guidance. The importance of motivating this awareness seems to be emerging within the SEC, and also among some sophisticated investment professionals.(3)

In my personal experience I have heard many senior executives of large investment advisory complexes claim proudly "We do not use soft dollars." But, when one studies the commission practices at these executives' investment advisory firms one discovers they typically pay five or six cents per share brokerage commissions even though they could easily negotiate a two cents per share commission rate, or less.(3) One has to ask, "What does the excess in brokerage commissions buy?" (4)

There is one section of your speech that I find confusing and unsettling. It's the section where you state, "Some managers, such as Fidelity, have taken matters into their own hands, encouraging brokers to unbundle the commissions they charge, exposing the cost of the actual execution and the cost of the ancillary research services. Others, including the 2004 Mutual Fund Task Force and the SIA, support a more moderate approach of instilling transparency and disclosure to the soft dollar regime, thereby preserving the safe harbor but arming shareholders and fund directors with information on how their money is spent, without demanding unbundling. I too have urged this position for the near term but continue to believe we must look at all alternatives." I find this part of your speech confusing and unsettling because I cannot see how true disclosure and transparency can be accomplished without un-bundling. It seems that, at a minimum, execution related services and the research services provided by brokerage firms must be fully disclosed, accounted for, and separated from other brokerage services to facilitate the tests for compliance with section 28(e) and the Interpretive Guidance. At a minimum, this accounting would amount to at least a partial un-bundling of services.

I believe that, when Section 28(e) was passed it was The U.S. Congress' intention to force the un-bundling of research services and provide a fully disclosed approach for fiduciaries and brokers to negotiate the value of the proprietary research "provided by" brokerage firms. The full service brokerage industry has resisted this intent by claiming it's too difficult to un-bundle their services. Such un-bundling and disclosure is not really a technological problem for full service brokerage firms, it's a financial problem. A significant amount of the profit at full service brokerage firms comes from excess institutional brokerage commissions "paid-up" by investment advisors who are seeking favoritism, and competing for undisclosed services.

As you undoubtedly know, after the passage of Section 28(e) a new brokerage operating model began to evolve. The new operating model became known as "third party brokerage". Third party brokerage evolved in direct response to the requirements of Section 28(e) and to the successive versions of interpretive guidance, SEC Comment Letters, and No Action Letters. Additionally, as compared to full service brokerage, third party brokerage has suffered disproportionate attention by regulators in the form of audits and examination "sweeps".[(6)] This regulatory pressure has brought third party brokerage to a very high level of Section 28(e) compliance, however, it definitely has not benefited third party brokerage or independent research in their ability to compete with the (less scrutinized) bundled undisclosed brokerage commission arrangements used by full service brokerage firms.

In your speech I also found another of your comments very interesting. The comment, "These reports were disturbing not only for the third-party research provider, who might be a small, up and coming company trying to compete against the conflicted, in-house research provider, but also for small firms." brought a smile to my face because you didn't bother to use any of the more politically correct qualifiers like, "sometimes conflicted" or "often conflicted" or "potentially conflicted".

I believe that, when appropriately used, third party brokerage and independent research mitigate some of the conflicts of interest inherent in bundled full service brokerage commission arrangements. And, I believe that independent research contributes significantly to market efficiency. Furthermore, I believe that third party brokerage is the most efficient approach for sponsoring independent research and its benefits.[(7)]

Your speech seems to indicate that you are seeking some middle ground between un-bundling full service brokerage firms' services and a total ban on soft dollars. I hope that this letter and the references in its footnotes are helpful in your quest.

Sincerely,

William T, George
http://www.home.earthlink.net/~wtgeo/

Cc.
Ms. Lori Richards, Director of the SEC' Office of Compliance, Inspections and Examinations.
Mr. David Tittsworth, Executive Director of the Investment Advisor Association

Footnotes:

(1) Speech By SEC Commissioner: Remarks at The Teachers' Retirement System State of Illinois Opportunity Forum, by Commissioner Raul C. Campos – Chicago, Illinois - July 31, 2006 See, http://www.sec.gov/news/speech/2006/spch073106rcc.htm
(2) Interpretive Guidance regarding Client Commission Practices Under Section (28)e of the Securities Exchange Act of 1934 see, http://www.sec.gov/rules/interp/2006/34-54165.pdf
(3) Comments by Lori Richards, Director of SEC's Office Of Compliance, Inspections and Examinations and comments by David Tittsworth, Executive Director of The Investment Advisor Association in a Craine's "Investment News" article titled "Advisors misreport use of soft dollars" written by Sara Hansard, published July 24, 2006 See, http://www.investmentnews.com/login.cms
(4) Without sacrificing execution quality.
(5) Speech by SEC Chairman: Remarks Before The Annual Meeting of the Securities Industry Association by Chairman Arthur Levitt - Boca Raton Florida, November 9, 2000. See section heading, "**Sticky Brokerage Commissions**" http://www.sec.gov/news/speech/spch420.htm
Also, see the book "Blood on The Street" by Charles Gasparino
http://www.amazon.com/gp/product/0743250230/sr=11/qid=1155479855/ref=sr1_1/102-7493135-0314519?ie=UTF8&s=books
(6) Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisors and Mutual Funds, released September 28, 1998. See, http://www.sec.gov/news/studies/softdolr.htm
(7) The Unintended and Undesirable Consequences of Banning Soft Dollars Testimony Before The U.S. Senate Committee on Banking, Housing and Urban Affairs - by Prof. Howard Schilit, March 31, 2004. see, http://banking.senate.gov/_files/schilit.pdf and the Statement of Grady G. Thomas Before the Committee on Banking, Housing and Urban Affairs of The United States Senate - March 31, 2004 see, http://banking.senate.gov/_files/thomas.pdf

Unintended Consequences

"Soft Dollars" Background and History:
The Securities Exchange Act of 1934 was amended in 1975. The amendment, known as Section 28(e), allows institutional fiduciaries to "pay-up" from a fully negotiated commission rate and, for the excess commission, receive qualifying research "provided by" broker dealers.

Recently, several well intentioned people have suggested ending the Section 28(e) safe harbor. They have suggested that institutional investment managers (who are fiduciaries) should use their own "hard dollars" rather than using client commissions to pay for research. It's obvious most people who make this suggestion believe it would shift the cost of research from being a client paid expense to being an investment manager's overhead expense. This assumption is not correct.

Unless there are significant changes in the way institutional asset managers and full service brokerage firms work together such a change would not shift most research costs from a client commission expense to a manager overhead expense.

As a practical matter most institutional investment firms do not negotiate brokerage commissions on a trade-by-trade basis. Most institutional asset managers, and the brokerage firms they trade with, negotiate a flat cents-per-share rate for their trades. The rate is periodically reviewed and renegotiated based on (average) trade parameters and the value of the relationship. For some specific trades some asset managers may from time-to-time agree to add to the flat rate to reward the broker for added special services (e.g. difficult trades, or capital commitment). And in some cases asset managers may have different cents-per-share flat rates for different brokerage relationships - based on different brokerage firm's specialties or service offerings. But, for most institutional investment managers the same flat rate is generally used across all trades and across all brokerage firms. At present the industry accepted flat rate commission used by most institutions is 5 cents per share.(1)

Statistically validated transaction cost studies performed on large numbers of institutional trades confirm that the cost of executing and clearing most institutional trades is 1.25 to 1.75 cents-per-share.(2) So, by comparison, the average institutional brokerage commission is approximately three and a half times the cost of execution and clearing.

Two Operating Models:[3]

1) **Full service brokerage** firms generally provide a “bundle” of services to their institutional asset manager clients. In spite of the requirements outlined in Section 28(e) there has been a surprising lack of identification and accounting (disclosure and transparency) for the brokerage commission amount “paid-up” for proprietary research (and other “services”) provided in full service brokerage bundled commission arrangements.[4] This lack of transparency and disclosure has created opportunities for quid pro quos and conflicts of interest in full service brokerage and in investment management.[5]

2) **Third party brokerage**.[6] After Section 28(e) was passed in 1975 a variation of the old full service brokerage business model was created. The new business model evolved in response to the requirements of Section 28(e). In this new brokerage operating model institutional brokerage commission “premiums” are used to buy third party research. Third party research is research produced by parties who are independent from the broker and the asset manager. In third party brokerage the details of the arrangements are documented and disclosed. Payments to research providers are reported to each party in the transaction. Because this business model developed in direct response to Section 28(e) and because the brokers who use this business model are so specialized they became known as soft dollar brokers. Since 1975 most of the regulatory effort for compliance with Section 28(e), has been focused on third party brokers and what has become known as soft dollar brokerage.[7]

The Unintended Consequences:

Because regulators have not enforced Section 28(e) evenly across both institutional brokerage operating models the most significant unintended consequence of banning soft dollars would be to cripple independent research and third party brokerage.[8] And if soft dollars were banned without specific attention to the practice of paying-up for unspecified services in bundled brokerage arrangements, it’s doubtful there would be a significant reduction in client commission expenses. In fact, if “soft dollars” were banned without significant changes in regulatory focus, I believe the commission dollars presently used to purchase third party research would undoubtedly be reallocated to full service brokers (by investment managers) to compete, and qualify, for more undisclosed bundled services.

The Immediate Solution:

Another important point that must be considered, client brokerage commissions are an asset of the client. These brokerage commissions are appropriately within the oversight responsibilities of the client’s fiduciaries, co-fiduciaries, plan sponsors / plan trustees, mutual fund directors and the asset owners themselves. Fiduciary law and statutory law provide enough definition for fiduciaries to pursue issues relating to the appropriate use of client commissions. Co-fiduciaries must ask detailed questions about the appropriate use of client brokerage commissions and all fiduciaries must be prepared to defend the quality of their oversight to owners of these assets.

Footnotes:

[1] See, Remarks of Chairman Arthur Levitt at the 2000 Annual Meeting, Securities Industry Association, Boca Raton, Fla. November 9, 2000 topic headings: " 'Sticky' Brokerage Commissions", and "Order Flow and IPO's". http://www.sec.gov/news/speech/spch420.htm

[2] For a description and overview of Transaction Cost Analysis, see:
http://www.investmentfunds.org.uk/news/research/2004/topic/soft_commissions/TRANSACTIONCOSTANALYSIS.pdf
For more on transaction cost analysis, see: http://www.itginc.com/offerings/plexus_alpha_capture.php
And for more on transaction cost analysis, see:
http://www.elkinsmcsherry.com/EM/EMWHome.aspx
And for more on transaction cost analysis, see
http://www.tethystech.com/index.html

[3] For more about the two operating models used by institutional brokerage firms, see:
http://www.sec.gov/rules/interp/s70905/wtgeorge9607.pdf

[4] Investment Council Association of America letter See page 2, last paragraph (through top of page 3): http://www.icaa.org/public/letters/comment030304.pdf

[5] For an overview of some of the abuses financed by un-accounted client commissions, see:
http://www.pbs.org/wgbh/pages/frontline/shows/wallstreet/

[6] For a brief definition of third party brokerage, see:
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=615281
Also see, Statement of Grady Thomas Before The Committee On Banking, Housing and Urban Affairs of The U.S. Senate - March 31, 2004. http://banking.senate.gov/_files/thomas.pdf

[7] To understand the regulatory focus and to review a sample of the SEC's regulatory inspection and enforcement approach it might be helpful to read the "Inspection Report" that was released by the SEC after a major regulatory review of Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds, which, in the industry, became known in the industry as "The Sweeps", see:
http://www.sec.gov/news/studies/softdolr.htm

[8] The Unintended and Undesirable Consequences of Banning Soft Dollars Testimony Before The U.S. Senate Committee on Banking , Housing, and Urban Affairs - by Prof. Howard Schilit, CPA on March 31, 2004. http://banking.senate.gov/_files/schilit.pdf and The Welfare Effects of Soft Dollar Brokerage: Law and Economics by Steven M. Horan, CFA and Bruce Johnsen (Published in 2000 by The Research Foundation of the Association for Investment Management and Research (AIMR) Now known as the Society of Chartered Financial Analysts (CFA)
http://mason.gmu.edu/~djohnsen/Welfare_Effects.pdf and Concept Paper 23-402: Best Execution and Soft Dollar Arrangements by Wayne B. McAlpine - May 13, 2005
http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part2/Comments/23-402/com_20050513_23-402_mcalpinew.pdf