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October 20, 2005

Mr. Jonathon G. Katz, Secretary
The Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Subject: Comment on Proposed Soft Dollar Interpretive Guidance (File # S7 09 05)

Dear Mr. Katz:

Thank you for giving the public this opportunity to express opinions about proposed regulations adding more definition to the appropriate use of soft dollar brokerage.

To put my comments in the context of my experience here is a brief summary of my background. I became a registered representative in 1971. I worked as a retail broker for Dean Witter until 1974 then for Merrill, Lynch - until late 1976. So, I was a retail broker during the period when the government forced negotiated commissions on the brokerage industry (May Day 1975) and at the time Congress passed Section 28(e), providing the safe harbor for investment managers to "pay-up" for research.

In 1976 I left the brokerage industry to sell computer "time sharing" and computer "service bureau" applications. Then, in the early 1980's I returned to the brokerage industry as an institutional services salesman when I was hired by SEI Financial Services. Including my tenure at SEI I have worked more than twenty two years as an institutional broker selling investment research services and soft dollar brokerage to bank trust departments, pension investment managers, mutual fund asset managers and hedge funds. After working for SEI, I worked for Wilshire Associates, CRA RogersCasey, Hoenig & Co., Fidelity Capital Markets, and Lynch, Jones & Ryan. - Please interpret my comments in this context.

<u>Comment Summary</u>:

1. Section 28(e) did not anticipate several very basic changes in the institutional brokerage industry.

2. The uneven interpretation and enforcement of Section 28(e) has fostered a non-competitive environment, has created disadvantages for consumers of institutional investment services and compromises the ability of fiduciaries to fulfill their responsibilities.

3. No further restrictions should be placed on third party institutional brokerage, or the use of commission premiums to buy invoiced research services, until full service brokerage firms institute reporting procedures which provide regulators, clients, and fiduciaries with better accounting of the uses of their commission premiums.

Comment:

Section 28(e) did not anticipate several very basic changes in the institutional brokerage industry.

When Section 28(e) was passed Congress obviously didn't anticipate the institutional brokerage industry bifurcating itself into two distinctly different operating models, with two very different approaches for offering (and pricing) execution and research.

Section 28(e) was passed by Congress at the last minute as an accommodation to the significant lobbying efforts of the brokerage industry. Section 28(e) was meant to accommodate the industry's historical practice of including the cost of research in institutional commissions.

In the months leading up to the deadline for negotiated commissions the brokerage industry made several significant structural changes. The industry began to un-bundle services to arrive at separate pricing for each service. They believed this would facilitate the negotiation process. At the same time many brokers decided their institutional clients would not pay a commission "premium" for research, so they disbanded their research departments or allowed the departments to buy themselves out of the larger firm. The newly independent research providers anticipated charging cash for their services, and many were eager for the opportunity to produce research without being hindered by the conflicts of interest of their previous employers. When Section 28(e) was passed these independent research providers saw the opportunity to use commission premiums as an alternative to cash payment for their research.

In the months after the passage of Section 28(e), in this changed environment, a new institutional brokerage business model began to evolve. The new model incorporated three party arrangements in which research providers supplied research to investment managers, the investment managers executed trades with <u>independent</u> brokerage firms and a specific ratio or percentage of the total commission was paid to the research provider (by the broker) for the research. Because the arrangement had three parties, each desiring to protect their own specific interests', soft dollar accounting became formalized quite rapidly. Soon soft dollar brokers documented their activities with research provision agreements, invoicing procedures and periodic account statements. The brokerage firms engaging in this new approach to institutional brokerage began to call themselves soft dollar "converters" or soft dollar brokers. (Some early examples of these firms are: Autranet*, Hoenig & Co, Capital Institutional Services, and Lynch Jones & Ryan.)

In addition to the formalization of procedures used by each party to protect their own interests the SEC soon contributed to the formalization process by issuing interpretive letters, "no action letters" and engaging in audits, enforcement actions and investigative sweeps, which added further definition and discipline to Section 28(e) and to soft dollar brokerage. <u>These influences caused (third party) soft dollar brokerage to evolve into a well documented, highly auditable business; soft dollar brokerage provides a very high level of commission transparency.</u>

* A division of Donaldson, Lufkin, Jenrette

The uneven interpretation and application of Section 28(e) has fostered a non-competitive environment, has created disadvantages for consumers of institutional investment services and compromises the ability of fiduciaries to fulfill their responsibilities.

The brokerage industry operated a fixed price monopoly until 1975. All brokerage firms calculated commissions based on a fixed price commission schedule, no commissions were negotiated. In 1975 the U.S. Government forced fully negotiated commissions on the brokerage industry. As a last minute concession to the industry's powerful lobbying efforts, Congress passed Section 28(e) which gave institutional brokers the opportunity, under certain conditions, to charge commission premiums as payment for research.

With Section 28(e) and the advent of the new three party brokerage business model the institutional brokerage industry was no longer monolithic, it divided into two camps: (1) soft dollar brokers, and (2) full service brokers.

Before1975 little was known about the costs of brokerage execution. Brokerage firms naturally resisted any attempts by the public and by regulators to understand the costs and the profitability of their business. Since 1975 full service brokers have continued to resist cost accounting, commission disclosure and commission transparency. They claim it's too difficult for them to isolate and account for the costs of the services (including research) they provide to their institutional clients.

But commission accounting is essential to fiduciary responsibility. If an institutional brokerage arrangement involves a fiduciary, the brokerage arrangement must be defended based on its value to the beneficiary – not its value to the fiduciary. Without commission transparency or commission accounting it's difficult to identify who has benefited.

Until recently full service brokers have been successful in obscuring the costs and benefits of commissions. However, because soft dollar brokerage arrangements provide a very clear view of the costs of execution and research, distinct from all the other uses of commissions, the full service brokerage industry has gone to extremes to lobby legislators, influence regulators, and cast dispersions on third party soft dollar brokerage. (*e.g.* The Sweeps I & II, and lobbying for restrictive regulations).[(1)]

In addition to the transparency provided by three party soft dollar arrangements another concurrent and important influence is closing in on the opaque accounting of full service brokerage. Since the mid-1980's a new science has evolved to help fiduciaries better understand the costs of brokerage execution. This new science, transaction cost analysis, or trading cost analysis, has now reached a fairly high state of development. Studies of large numbers of institutional trades indicate an average execution cost between 1.25 to 1.75 cents per share. Institutional commission rates charged by full service brokerage firms average around 5 to 6 cents a share. By deduction the pieces of the full service commission puzzle begin to fall into place.[(2)]

It is important for account owners and fiduciaries to be able to identify and study the brokerage services these significant commission premiums are buying, and to test who ultimately benefits from the "services". The full service brokerage business model does not accommodate fiduciary accountability.

No further restrictions should be placed on third party institutional brokerage, or the use of commission premiums to buy invoiced research services, until full service brokerage firms institute reporting procedures which provide regulators, clients, and fiduciaries with better accounting of the uses of their commission premiums.

From the recent brokerage firm investigations and prosecutions, and from the testimony about brokerage commission abuses, conflicts of interest and other questionable brokerage practices that has been submitted in hearings sponsored by The House Financial Services Committee and The Senate Banking Committee - testimony given by industry professionals since late 2000 - it appears that the opaque commission accounting practices of full service brokers have, by design, fostered and induced conflicts of interest and illegal practices.[(3)]

Even while its largest and most powerful members are being investigated, being prosecuted, paying fines to avoid prosecution, and being called to answer about their illegal and unethical practices, The Securities Industry Association and The Investment Company Institute point their filthy fingers at fully disclosed soft dollar brokerage, claiming that soft dollars are a source of rampant wrong doing.[(4)]

Since at least the early 1990's the full service brokerage industry (once known as the wire-house brokerage industry and lately identified as the investment banking brokerage industry) has engaged in a campaign to impugn the integrity of fully-disclosed, third party soft dollar brokers. It seems their long campaign has distracted supervisory and regulatory attention away from the numerous abuses and quid-pro-quos facilitated by their un-accounted (bundled) commission premiums.

Undisclosed full service brokerage commission premiums are the currency that fuels most of the brokerage industry's scandalous behavior. Without undisclosed commission premiums would their have been an analyst conflict of interest scandal, an initial public offering scandal, a mutual fund late trading scandal, or a commission payment in exchange for mutual fund shelf space scandal? (Undisclosed commission premiums even played a significant role in the rise and fall of Enron, Worldcom, Global Crossing, Web Van and other investment banking darlings). After all the sweeps, audits and investigations of soft dollar brokers and their clients, the fraud and economic damage discovered by regulators pales in significance when compared to the damage inflicted by full service brokers receiving undisclosed commission premiums in exchange for services such as: IPO allocation, late trading favors, mutual fund shelf space, wrap account and hedge fund introductions and the damage caused by conflicted research. Undisclosed commission premiums were the grease that lubricated these frauds.

From what I have read, the intention of The Glass-Steagall Act was to legislate/regulate away the monopolistic advantages of integrated investment banking and asset management. The Act's intention was to give the consumer a fighting chance.

From what I have seen, the investment banking and asset management industries seem to have nullified the intent of Glass-Steagall by a setting-up economic arrangements between investment bankers and asset managers. These arrangements are facilitated by quid-pro-quos (investment banking favors and asset management distribution favors in exchange for fat undisclosed commission premiums), quite predictably, they shared the benefits of their economic franchises between themselves; the benefits never got to the consumer. Then - years after they had essentially castrated the law - they merely exercised their economic and political influence by having Glass-Steagall repealed.*

In conclusion, I will again emphasize that what has become known as soft dollar brokerage is a well documented, highly regulated activity. In soft dollar arrangements the third party agreements, account statements, invoicing procedures, third party payment data, and trade data provide a clear audit trail which can be made available to regulators, fiduciaries and clients. The transparency of these soft dollar arrangements provides a startling contrast to the opaqueness of full service brokerage commissions and services. The full service brokerage industry would prefer not to have the soft dollar business model as a standard of comparison. <u>I believe that, for the sake of competition and for fiduciary oversight, the current operating model for third party soft dollar brokerage should not be changed until full service brokers provide an equally transparent brokerage model.</u>

It's also obvious to me that third party independent research is a vital force that can help to restrain the abuses flowing from the conflicts of interest inherent in full service brokerage (*i.e.* investment banking) "analyst's" recommendations. At present, third party soft dollar brokerage is the only economic and dependable payment method that allows independent research to compete with full service brokerage "research" offerings. <u>I believe increased restrictions and regulations on institutional third party soft dollar brokerage would be counterproductive and would not contribute to healthy competition in the brokerage industry.</u>

Thank you again for the opportunity to comment on the most recently proposed Interpretive Guidance for the use of client commissions.

* See PBS FRONTLINE article, <u>Mr. Weill Goes To Washington</u> - published May 8, 2003
http://www.pbs.org/wgbh/pages/frontline/shows/wallstreet/weill/

Sincerely,

William T. George

Footnotes:

(1) See SEC's Inspection Report on the Soft Dollar Practices of Broker Dealers Investment Advisors and Mutual Funds which was released September 22, 1998.
Link: http://www.sec.gov/news/studies/softdolr.htm

(2) 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

(3) Sample Testimony:
Congressional Hearing: Analyzing the Analysts I – June 14, 2001
See testimony of David Tice and Scott Cleland
Link: http://financialservices.house.gov/hearings.asp?formmode=detail&hearing=54
Congressional Hearing: Mutual Fund Practices and Their Effect on Individual Investors
March 12, 2003 See testimony of John C. Bogle and Wayne Wagner
Link: http://financialservices.house.gov/hearings.asp?formmode=detail&hearing=187
Congressional Hearing: Who's Looking Out For Investors? - November 4, 2003
See testimony of Eliot Spitzer, Arthur Levitt, and Mercer Bullard
Link: http://financialservices.house.gov/hearings.asp?formmode=detail&hearing=268
Senate Hearing: Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Fund Operations and Governance. February 26, 2004
See Testimony of John C. Bogle
Link: http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=85
Senate Hearing: Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Fund Operations and Governance. March 23, 2004
See Testimony of Mercer Bullard and Barbara Roper
Link: http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=99
Senate Hearing: Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Examining Soft-Dollar Practices – March 31, 2004
See Testimony of Howard Schilit and Grady Thomas

(4) In spite of their problems the full service brokerage industry continues to lobby for more restrictions on third party soft dollar brokerage. Could this be an attempt at distraction? The SIA's Response to the FSA Consultation Paper of 5/5/05. The SIA suggests limiting the scope of allowable soft dollar services while maintaining the bundled commission practices of full service brokers. Take notice of the CC's on the last page.
Link: http://www.sia.com/2005_comment_letters/6618.pdf
Statement of ICI on position on soft dollar brokerage and third party research
Link: http://www.ici.org/statements/nr/03_news_soft.html