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William H. Donaldson, Chairman
Securities & Exchange Commission
450 Fifth Street
Washington, DC 20549

Re: Retention of Current Payments for Equity Research via Soft Dollar Programs

Dear Chairman Donaldson:

The Security Traders Association (STA)[1] has shared its perspective and expressed its views on a variety of issues that affect investors, the securities industry, and market structure. It is from this background that we are writing to urge the Commission to retain soft dollar programs. While we are aware that there is as yet no formal call for comments by the Commission, it is our hope that the task force currently considering soft dollar issues will review this letter as part of its deliberations.

Efficient Research and Investor Protection

Trading and investing are not zero-sum games. For that reason, information is essential to the development of effective trading and investment strategies.

1 The STA is a worldwide professional trade organization that works to improve the ethics, business standards and working environment for our members. There are approximately 6,000 members, all engaged in the buying, selling, and trading of securities. Members participate in STA through 28 national and international affiliate organizations and represent the interests of the trading community and institutional investors. The STA provides a forum for our traders, representing institutions, broker-dealers, ECNs, and floor brokers to share their unique perspectives on issues facing the securities markets. They work together to promote their shared interest in efficient, liquid markets as well as in investor protection.

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Equally important to investors is the research individual and institutional investors employ to achieve their investment goals. Absent this information, traders and investors are unable to develop coherent strategies, and consequently are at risk for violation of their fiduciary trust.

Simply put: good research is part of best execution.

Over the course of the last decade, research, like execution, has begun to be delivered electronically. Systems are now in place that take fundamental and technical analysis to levels that were inconceivable as little as 20 years ago. And this research is often tied to execution protocols.

Traditional research from brokerages has been augmented by independent analysis and analysts. Even in traditional firms, analysts are now separated from the investment banking functions to which they had been tied.

There are various mechanisms for the funding of research. One which has proven effective over time has been soft dollar or research-commission arrangements. Soft dollar, or research-commission practices are arrangements where commission dollars are used to pay for both research and trade execution services. The investment advisor or fiduciary selects the brokers and other service providers to provide execution and research services.

Currently the Commission has a task force reviewing questions related to soft dollar commissions. These inquiries are important, and similar reviews of soft dollar commission practices have been conducted by the Commission in the past. In the mid-1990s, the Commission reviewed what types of research were eligible for soft payments and refined these types.

The current review has been tied to the problems recently uncovered in the mutual fund industry. While it is critical that any abuses be uncovered and rectified, it equally is in investor interest that this important means of compensating for independent research not be eliminated.

In the Interest of Investors, Retain Soft Commissions

The mutual fund scandals involving late trade and market timing abuses have resulted in policymakers reexamining various other mutual fund practices. Attempts have been made to link the mutual fund scandals and soft dollar arrangements even though such abuses have not involved the use of soft dollars.

In the current environment, some argue for the modification or elimination of soft dollars. The fact is that this payment mechanism, properly understood, allows investors to secure independent research and efficient trading simultaneously, and at a reasonable cost.

The Commission has made great strides in assuring that research be independent. Taking away the efficient payment mechanism of soft commissions will have the effect of thwarting the Commission's explicit intent that investors have access to such research. Access to such research is contingent on providers being compensated.

The fact is that soft commissions benefit both investors and the overall efficiency of the market. It is for this reason that the STA recommends that this important mechanism be retained.

There are a number of net benefits of soft arrangements to investors, the markets and market participants.

The benefits include:

- Soft Dollar arrangements enhance competition, ultimately benefiting investors.

Soft dollar arrangements allow independent research providers to compete with in-house research, resulting in more research choices *for asset managers, coverage of more stocks, and more innovative research products.* Many independent research providers are small and often lack the resources to market their research product; therefore, they tend to rely on broker-dealers to market and provide their research to investment managers. Section 28(e) allows these arrangements, which permit broker-dealers to charge commissions that include both the execution and research costs. The recent global research analyst settlement demonstrates the value and need for truly independent investment research to lessen potential conflicts of interest. Restricting soft dollar arrangements would result in less independent research at a time when such research is otherwise being encouraged and promoted as an alternative.

These arrangements provide managers with more choices, allowing a wealth of research to be provided and assist managers in the investment decision-making process. In addition, independent research providers tend to create innovative products, unencumbered by other potentially conflicting relationships, to serve the needs of asset managers. The increased competition among research providers helps to spur coverage of more stocks, particularly the less actively traded stocks, often those of smaller companies. The benefits of increased competition ultimately accrue to all investors.

Soft dollar arrangements result in more investor choices as such arrangements benefit smaller asset managers by lowering the barriers to entry and allowing more competition with large, well-established managers. To assist in the investment decision-making process, asset managers must rely on in-house research, in-house research enhanced by outside research, or outside research only. Soft dollar arrangements allow fund managers to acquire research necessary for the creation of innovative investments strategies and products, thus better enabling mutual funds to compete not only on the basis of price, but also on product differentiation. Small managers, since they lack economies of scale, often prefer to pay for their research services through soft dollar arrangements to reduce their costs, enabling them to compete with larger managers. The increased competition allows investors more choice between mutual funds and among products.

Abolishing soft dollar arrangements would have negative implications on the competitive landscape of mutual funds. Competitive forces benefit investors by providing more choices and lowering costs. Soft dollar arrangements lower barriers to entry into the fund management business as fund managers are allowed to use commission dollars to pay for both execution and research services. Elimination of soft dollar arrangements would increase barriers to entry, benefiting large, more established funds at the expense of small and new asset managers.

Rulemaking should not protect established players, nor should it select winning or losing business strategies. As discussed above, small funds often use soft dollar arrangements to gain entry into the market. Rules eliminating soft dollar arrangements would create artificial barriers to competition, thereby protecting established funds and placing new entrants at a disadvantage. If such arrangements are abolished by law, the government would in effect be picking winners and losers, limiting competition, limiting investor choices, and thwarting the due diligence of performing research, all of which appear to be in conflict with our quest for a national market. A national market encourages fairness and an equal playing field for all investors. This fairness does not stop with individual markets, but rather encompasses all market participants and investors.

- Soft Dollar arrangements lessen conflicts of interest.

Critics of soft dollar arrangements claim that since such arrangements are paid for by the investors through commission dollars the manager is encouraged to engage in more trading and pay more for commissions. However, a recent *Barron's* editorial points out that if soft dollar arrangements are paid for by the management fee rather than by investor commissions, active fund managers would likely attempt to cut costs by purchasing less research.[2] The resulting impact would be the perverse incentive for such managers to use a "closet indexing" investment approach, while continuing to charge the same, or higher, management fee.

Such conflicts of interest are lessened when commission dollars are used to pay for research since the manager has the incentive to identify investments with a higher rate of return, thus acting in the best interests of investors. Soft dollar arrangements allow management to turn a liability, the cost of research, into an asset resulting in a higher rate of return. Academic research provides evidence that those money managers that pay more for commissions to receive research perform better on a risk-adjusted basis.[3]

2 D. Bruce Johnsen, "Hard Facts on Soft Dollars," *Barron's*, March 15, 2004.
3 Ibid.

Although gross commissions are higher, it is a result of increased trading volume, not higher per-share commissions. Per-share commissions have steadily reduced throughout the years due to competitive pressures. More specifically, commissions related to soft dollar arrangements have declined to an average rate of 4.9 cents per share, down from 5.6 cents per share in 2002.[4]

Soft dollars are an important mechanism to foster a greater range of research alternatives to investors at a reasonable cost.

The STA hopes that a full analysis of the benefits of soft dollars will result in the retention of this practice.

Very truly yours,

Mary McDermott-Holland
Chairman

John Giesea
President and CEO

cc: The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid

Annette L. Nazareth, Director
Robert L.D. Colby, Deputy Director
Division of Market Regulation
Jonathan Katz, SEC secretary

4 Lawrence C. Strauss, "The Turning of the Tide," *Barron's*, June 7, 2004.