



September 3, 2004

Chairman William H. Donaldson  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

Dear Chairman Donaldson:

We were pleased to hear your position that there should not be a distinction between third-party investment research and proprietary research when you testified on April 8, 2004 before the Senate Banking Committee. We were excited to hear your answer to Senator Sununu that you thought *“it would be a real mistake to eliminate the ability to pay for research from third-party people.”* And that you believe *“that the disclosure by the broker of how much of that commission is for execution and how much is for research is a very important thing that needs to be done and needs to be displayed by the mutual fund...”*

The Investorside Research Association (Investorside) strongly supports your views and is confident from our many interactions with the Securities and Exchange Commission staff that you and the Commission genuinely want to do the right thing for investors and for the marketplace. We believe the SEC will do what is best for investor protection by issuing new rules implementing section 28(e) of the Exchange Act consistent with your views. We believe this will foster a more robust and competitive research market and, importantly, one which will be aligned with investors' interests.

At issue is growing evidence that some institutional investors are shifting their research commissions (known as “soft dollars”) from a mix that is roughly 15% independent to 0% independent; thus, relying on proprietary (Wall Street) research for up to 100% of their needs. This is problematic for a number of reasons. As they do this, they will receive no disclosure of their research costs, since proprietary research providers do not need to disclose them. It has also been well proven by many academic studies that independent research outperforms proprietary research. We worry this burgeoning trend may lead fund firms to place their bottom line ahead of their fiduciary obligations to their investors.

This problem, which has been referred to as the “chill in the market,” has arisen because this group of institutional investors is avoiding valuable independent research largely because it is transparent and auditable. We have enclosed results of a new survey of independent research providers as evidence of the impact of this growing problem. We have also provided several recommended actions the SEC can take to easily and quickly mitigate much of this problem.

## **I. The Problem:**

### **A. Discriminating Against Independent Research**

A key problem is that some institutional investors have concluded, we believe erroneously, that it is acceptable for them to game the system and to discriminate against independent research. They act as if it is safer for them to scale back or even eliminate independent research because its costs are fully disclosed and thus, auditable. These same institutional investors continue to use commissions to pay for proprietary research, knowing those costs are fully hidden. It should alarm all of us that the reason they prefer proprietary research is its lack of transparency, which in turn makes their research costs free from examination by their own boards of directors and by regulators. The public is completely shut out. The loser is the investor because independent research consistently outperforms proprietary research in study after study. This is also entirely inconsistent with the Global Research Settlement and with the SEC's recent actions against Deutsche Bank and others.

During the period the SEC's task force has been studying this issue, the silence from the Commission has invited those who oppose independent research to accelerate their campaign against the use of commissions as a payment method. In December of 2003, the Investment Company Institute (ICI) proposed banning the use of commissions to pay for research, but only for research from independent firms while preserving its use for research from proprietary firms. This was widely, and, we believe, correctly, condemned. This proposal, however, did not die; it simply changed form. The ICI now is encouraging its members to implement their proposal and many actually are. The Mutual Fund Directors Forum (MFDF), with reported links to the ICI, recently recommended a purported "best practice" to ban all soft dollars. We are concerned this will be implemented out of ignorance or expediency by many new independent directors without clear SEC guidance to the contrary. The Commission's silence is being taken advantage of by those who oppose independent research and by those who oppose transparency. We support your view that "research" be more clearly defined, that all commissions used to pay for any research should be fully disclosed and that there be no discrimination between independent and proprietary research. Unfortunately, some in the market are moving in exactly the wrong direction.

### **B. Survey Results Show Harm Due to Discrimination Against Independent Research**

To quantify the impact of this discrimination, Investorside conducted a survey of its 75 members. The results strongly suggest that independent research is being harmed by misunderstandings about forthcoming SEC guidance on soft dollars. **Attachment I** compiles the answers from the 37 respondent member firms. We have highlighted the key findings:

- 95 percent of surveyed firms report being negatively affected by the soft dollar "chill;"
- 81 percent reported fund clients moving to hard dollars;
- 65 percent have either postponed hiring or have reduced personnel; and
- A stunning 70 percent of surveyed independent research providers would consider exiting the business altogether if the industry moves to hard dollars only.

A key purpose of this letter is to alert the Commission to a real and emerging threat to "the market's best watchdogs" – independent research. Under the new SEC doctrine of "no surprises," a proactive "ounce of SEC prevention" now (see Investorside's recommendations) would be worth more than a reactive "pound of cure" months from now, after the Task Force has completed its study.

### **C. Repeating Regulatory Mistakes of the Market Bubble**

We believe there is a real risk of repeating one of the worst regulatory mistakes in recent history. When, years ago, the SEC did not proactively guard the independence and integrity of investment research from conflicted investment banking interests, it contributed to the investment banking research abuses and corporate fraud of the market bubble. Just as the investment banks were allowed to dominate the investment research industry and to undermine the investment protection of independent research in the past through benign regulatory neglect, investment banks and large fund groups are now overtly undermining the investor protection benefits of independent research by *proactively discriminating* against transparent third-party research in favor of opaque proprietary investment banking research – under the pretense of investor protection.

Investment banking research became so conflicted before and during the bubble because regulatory action was not taken at an early stage, when it could have been effective in maintaining the independence and integrity of investment banking research. The SEC has the opportunity and duty now to put a stop to this new and growing anti-investor protection and anti-competitive trend before it does lasting damage to the integrity of free-market mechanisms that protect American investors' financial and retirement security.

### **D. Hard Dollar Trend Creates New and Potentially More Corrosive Conflict of Interest**

Part of the problem is the odd and inaccurate term, “soft dollars.” We believe it is far more accurate to make the distinction between “transparent commission payments” versus “hidden commission payments.” Many in the media are further confused because the most widely known use of the phrase “soft dollars” is used to describe hidden political contributions, whereas “hard dollars” most often describes fully disclosed and regulated political contributions.

Because there are so many misunderstandings about “soft dollars,” certain mutual fund companies are divesting themselves of this legitimate payment practice as a good public relations move. However, it often just shifts whom they buy research from – when mutual funds are acquiring research from the nation's largest integrated investment bank, they are indeed acquiring them with soft dollars. Unlike independent soft dollars, proprietary soft dollars are completely undisclosed.

*Commissions are not only a legitimate method for research, they provide the best method and are the most investor-aligned as long as they are fully disclosed.*

The trend towards hard dollar research may lead to a new and highly corrosive conflict of interest: some institutional investors seem to be putting the bottom line of their own fund company ahead of their fiduciary obligations to their investor.

A fund company's primary financial interest is to market and sell its funds to collect more assets because this is a more effective way to consistently increase fund company profits than by spending hard or soft dollars on research to increase fund performance. The reality is that soft dollars, *when appropriately accounted for and transparent*, can be completely aligned with investors' interests to protect them from fraud and maximize their returns. The safe harbor of 28(e) allows research to be paid for in commissions only when the investment adviser can make a good faith finding that the expense is in the investor's best interest. Alternatively, hard dollars are not investor resources. Rather, they are an operating expense for fund companies that can be cut to enhance fund company profits. Contrary to the seemingly common misconception, hard dollars are not investor's money that the fund company has a fiduciary obligation to use to protect investors - hard dollars are simply

corporate operating expenses that the company can do with however they see fit. Widespread ignorance of this simple fact has led many to be misled about what best serves investor protection.

Another aspect which has been ignored in the soft dollar debate is the fact that soft dollars are the only true investor-aligned pool of resources. Lost in the discussion of soft dollars is that investors seek not only protection of their assets but also *growth of their assets*. Market-beating returns are not easily attained; they require skilled money management, supported by high quality research. In an effort to throw out the bad in soft dollars, there is no policy restraint and perspective on preserving the good. We believe soft dollars, properly disclosed, are the market's investor-aligned currency that fund, incentivize, and reward market-beating research. Moreover, soft dollars are the free-market mechanism of the exchange and debate of investment ideas, insights and information.

## **II. The Solution:**

### **A. Real Conflict Deterrence Comes from Transparency, Accountability, and Audit-ability**

In our view, scaling back or eliminating the use of commissions to pay for independent research will create the possibility that investors may be victims of another systematic multi-billion dollar fraud, such as the one addressed by the Global Research Settlement. The remedy for potential conflicts is full transparency and consistent enforcement. It is simply too easy for a proprietary firm to get its research paid for in commissions since they do not un-bundle the services provided to their institutional customers. It's simply too easy to attack independent research because its costs are fully transparent. If the SEC does not require the unbundling of commissions, such as proposed by Fidelity, then it must require the disclosure of all commissions used to pay for research. All sources of research are either in the safe harbor of 28(e) or they are not. The very same rules should apply to all.

The regulatory and enforcement agenda of the Commission is sweeping and impressive. As we observe it, we are struck that most of the current market ailments that the SEC has been trying to eradicate in policy and enforcement proceedings - such as directed brokerage, revenue sharing, investment banking research conflicts, IPO spinning and IPO laddering - all have one obvious common source of infection: the laundering of conflicts of interest through the opaque and un-auditable bundling of trading, research, banking and other commissions. Follow the money. As long as a conflicts of interest "contagion" is allowed to live on and remain hidden from oversight from investors, fiduciaries, the market and regulators, new sicknesses will continue to emerge.

### **B. Proactively Promote Investor Protection, Not Just Reactive Enforcement**

The SEC needs to provide clear guidance to the market on the following key investor protection questions. Does the SEC protect investors by:

- Allowing the market to have unfettered access to investment research that is aligned with investors' interests?
- Discouraging discrimination against transparent third-party research in favor of opaque proprietary research?
- Having an efficient and transparent market mechanism where research is provided by thousands of third-party research and information providers or through only the few hundred broker dealers that can afford a trading desk and all the associated compliance costs?
- Having full transparency of what soft dollars are paying for, so that investors, fiduciaries, the market and regulators can oversee them?

- Having full transparency about what percent of an investor's asset management fee goes to protecting and maximizing returns and what percent goes to corporate overhead?

These are the questions for which the market players are trying to guess the SEC's answers. Unfortunately many in the market are fumbling in the dark and needlessly coming up with wrong answers.

**C. Recommendations:**

**1. Task Force:**

Complete the study of soft dollars as quickly as possible to lift the regulatory uncertainty, which is stifling the investment research business and independent research in particular.

We would suggest September 30, 2004 as the deadline.

**2. Communication:**

- a. Immediately communicate to all SEC personnel, especially in compliance and enforcement:
  - i. Not to discriminate against third-party research in favor of proprietary research.  
  
The word from clients in the field is that SEC audits are heavily skewed to rigorously examining third-party research because it is transparent and easily auditable, but do not attempt to audit proprietary research as intensively, because the auditing is harder since the records are opaque, bundled and there is no audit trail. Thus, the strong impression left with fund companies is that the SEC is negatively biased toward third-party research and favors proprietary research.
  - ii. That fund company policies banning soft dollars for independent, third-party research and moving to hard dollars will not result in more favorable regulatory or enforcement treatment from the SEC.
- b. Communicate forcefully to the marketplace that while the Task Force study is not complete, the SEC still supports 28(e), will soon redefine "research;" and will soon mandate the disclosure of all commissions to pay without discrimination between independent and proprietary sources.
- c. Communicate explicitly to new independent fund directors that banning soft dollars is not a "best practice" to fulfill their fiduciary responsibility to protect investors. Since the SEC established the requirements that an independent director chair the board of a mutual fund and that such boards have a 75 percent majority of independent directors, we believe it is imperative that the SEC give clear guidance to these directors. We agree with the Investment Council Association of America (ICAA) that MFDF recommendations are fundamentally flawed. We believe the MFDF's recommendations should be completely rejected by independent directors wherever they conflict with SEC policy.

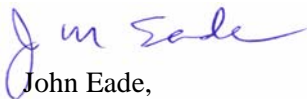
**3. Disclosure Policy:**

- a. Require transparency, accountability and an audit trail for soft dollars. Mandate separate and transparent accounting of trading, research, banking and other commissions, so investors, fiduciaries, independent directors, and regulators can oversee and ensure that soft dollars are actually being used to benefit investors.
- b. Establish full disclosure as a best practice to investors:
  - i. What percent of a fund company's resources go to maximizing shareholder returns through active money management and research and what percent goes to overhead; and
  - ii. What percent of a fund's external research expenses go to research financially aligned with investor interests?

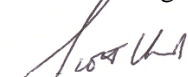
**Conclusion:**

We are confident that the Commission wants to guard the integrity and independence of the investment research process to protect investors from the perverse return of corporate conflicts of interest dominating investment research. The Investorside survey provides evidence that independent research is being adversely affected by unintended consequences from SEC policies and enforcement actions. The problem is real, getting worse and could get out of hand if the Commission does not address it promptly. Time is of the essence so that the damage to the integrity of the investment research does not become irreparable. We have made detailed recommendations of what SEC actions could better protect investors. We thank you in advance for your prompt consideration and we look forward to being of assistance to the SEC as needed.

Sincerely,



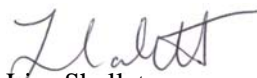
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Lisa Shallet  
Director, Investorside Research Association  
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Attachment I: Investorside Research Association survey of members

CC:

**Securities and Exchange Commission**

Hon. Paul S. Atkins, Commissioner  
Hon. Roel C. Campos, Commissioner  
Hon. Harvey J. Goldschmid, Commissioner  
Hon. Cynthia A. Glassman, Commissioner  
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