Written Testimony Summary of the Investorside Research Association

Before the U.S. House of Representatives, Subcommittee on Capital Markets,

Hearing on: **"Mutual Funds Integrity and Fee Transparency Act of 2003"** June 18, 2003

Investorside applauds the Subcommittee's interest and effort to increase the transparency of soft dollars for investors. Soft dollars strongly serve investor interests, but greater transparency of soft dollars is necessary in order to restore investor trust. **<u>Investorside strongly recommends continuation of the 28(e) safe harbor for commissions to be used for research</u>. Investorside would oppose a study of soft dollars, if its ultimate purpose was to seek repeal of the 28(e) research safe harbor (rather than improving it), because <u>repealing 28(e) would effectively legislate the independent research industry out of existence</u>.**

<u>Soft dollars are a perfectly legitimate use of investor resources</u>, *if and when* they are used to benefit the investor who is paying for them. <u>The real scandal here is not the abuses of the legitimate industry practice of soft dollars, but the fact that there is no way for investors or the government to determine that soft dollars in fact are being used to benefit investors</u>. The litany of conflict of interest scandals continues to prove that conflicts do pay, especially when lack of transparency means there is so little chance of detection or enforcement action. It doesn't have to be this way.

If the government preserved 28(e) and also ensured that soft dollars were fully transparent:

- Investors would be armed with the necessary information to take their financial assets where their interests are best served;
- Money managers would have a new market incentive to compete on how they avoid conflicts of interest and put investors' interests first;
- Regulators and law enforcement would be able to detect and deter a multitude of conflict of interest schemes that undermine investor trust for the first time;
- Investor-aligned research providers would be less competitively disadvantaged vis a vis the investment banking firms which still dominate 95% of the business; and
- Market forces would result in increased competition and better dissemination of research to investors.

Until investors believe their investment research is working *for them* and not for companies and investment bankers, we believe investors are unlikely to trust investment research. We believe this is an **exceptionally important public policy problem to solve** because restoring trust in investment research is central to restoring trust in U.S. capital markets, which is central to the ability of companies to raise capital and create jobs, which in turn is central to maintaining Americans' financial and retirement security.

Recommendations for Preserving and Improving Soft Dollars:

1. **Require funds to disclose what percent of their soft dollars is paid to firms aligned with investor interests versus investment banking interests.**
2. **Require separate and transparent accounting of research, trading and investment banking soft dollars.**
3. **Promote "best research execution" practices.**
4. **Authorize soft dollars for fixed income trading to provide investor-aligned research competition to company-dominated credit research.**

Section 28(e) and soft dollars strongly serve investors' interests. Soft dollars promote investor choice by funding the "independent" research industry, the only viable competitive alternative to dominant investment banking research. They enable money-managers to supplement their in-house research capability with specialty and large scale research, which would not be economically feasible to reproduce in-house. They also promote competition by lowering barriers to entry. Finally, soft dollar brokers improve market efficiency by unbundling trading from research, allowing for a marriage of best trading execution and best-of-breed conflict-free research.

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"Preserving the 28(e) Research Safe Harbor and Improving Soft Dollars Through Increased Transparency"

Before the U.S. House of Representatives
Financial Services Committee
Subcommittee on Capital Markets,
Insurance, and Government Sponsored Enterprises

Hearing on

"Mutual Funds Integrity and Fee Transparency Act of 2003"

Wednesday, June 18, 2003

I. Introduction

Mr. Chairman, thank you in advance for including the written testimony of the Investorside Research Association into the formal record of your very important hearing on "Mutual Funds Integrity and Fee Transparency Act of 2003" so that the subcommittee hears the important perspective of independent research providers that work for investors and do not have investment banking conflicts of interest.

Investorside applauds the Subcommittee's interest and effort to increase the transparency of soft dollars for investors. Soft dollars strongly serve investor interests, but greater transparency of soft dollars is necessary in order to restore investor trust. **Investorside strongly recommends continuation of the 28(e) safe harbor for commissions to be used for research. Investorside would oppose a study of soft dollars, if its ultimate purpose was to seek repeal of the 28(e) research safe harbor (rather than improving it), because repealing 28(e) would effectively legislate the independent research industry out of existence.**

Investorside's testimony includes:

- An explanation of why investors need soft dollar transparency and accountability;
- Recommendations for improving soft dollars; and
- How soft dollars serve investor interests.

II. Why Investors Need Soft Dollar Transparency and Accountability

Investorside strongly recommends that transparency of soft dollars is key to any effort to restore investor trust. Limited transparency causes a stunning lack of accountability for billions of dollars in public investor resources. Aggrieved investors and pensioners that were misled by investment banking research would be *appalled to learn* that no one in the government has the ability to audit and oversee soft dollars at full service brokerage firms -- to ensure soft dollars benefit investors or to detect/prosecute wrongdoing or misappropriation.

Not surprisingly, soft dollar brokers, which do not have investment banking conflicts, already have transparency enabling them to effectively monitor and report the allocation of commissions to services provided. On the other hand, investment banking firms, which have conflicts of interest, do not have or want transparency.

The current system of limited transparency of soft dollars and self regulation has enabled investment banking and company interests to dominate an estimated 95% of the investment research market. It also has allowed the investment banking industry to increasingly ignore or subvert investor interests without fear of detection. Investors distrust investment research because they've learned the hard way that the current research system simply does not work for them.

Soft dollars are a perfectly legitimate use of investor resources, *if and when* they are used to benefit the investor who is paying for them. The real scandal here is not the abuses of the legitimate industry practice of soft dollars, but the fact that there is no way for investors or the government to determine that soft dollars in fact are being used to benefit investors. The litany of conflict of interest scandals continues to prove that conflicts do pay, especially when lack of transparency means there is so little chance of detection or enforcement action. It doesn't have to be this way.

If the government preserved 28(e) and also ensured that soft dollars were fully transparent:

- Investors would be armed with the necessary information to take their financial assets where their interests are best served;
- Money managers would have a new market incentive to compete on how they avoid conflicts of interest and put investors' interests first;
- Regulators and law enforcement would be able to detect and deter a multitude of conflict of interest schemes that undermine investor trust for the first time;
- Investor-aligned research providers would be less competitively disadvantaged vis a vis the investment banking firms which still dominate 95% of the business; and
- Market forces would result in increased competition and better dissemination of research to investors.

III. <u>Investorside's Recommendations for Preserving and Improving Soft Dollars:</u>

Investorside offers four practical recommendations to help soft dollars better serve investor interests.

1. **Require funds to disclose what percent of their soft dollars is paid to firms aligned with investor interests versus investment banking interests.**

Few investors (including pension, trust, or 401k trustees) are aware that the overwhelming amount (as much as 95%) of the research purchased with soft dollars on *their behalf* is produced by investment banking firms. While many investors are aware of this problem in vague terms, they have no *concrete* way to measure/track it. Currently, a trustee/investor cannot compare funds by their commitment to investor-aligned research. Moreover, a trustee cannot benchmark and track over time a fund's progress in using more investor-aligned research.

<u>Market forces cannot work without transparency of key information</u>. Consumers cannot watch out for their best interests without transparency. Trustees cannot do their jobs without transparency. Both the SEC and the Department of Labor Employee Benefits Security Administration should require that pensions, trusts, and plan sponsors regularly disclose what percent of their soft dollar research budget pays for research aligned with their interests.

2. **Require separate and transparent accounting of research, trading, and investment banking soft dollars.**

Despite the litany of research/investment banking conflict of interest scandals, SEC policy continues to allow the commingling or "bundling" of research, proprietary trading and investment banking commissions into one payment pool -- without separate and transparent accounting. In a "normal" market, bundling would not be a regulatory or anti-competitive problem. However, this is not a "normal," but an extraordinary circumstance.

If the bundling conflict was not so obvious and still rampant, if the damage to investor trust was not so great, and if the stakes were not so high to the market, the economy and Americans' financial security, one could continue to argue that the intrusive requirement of separate and transparent accounting of commissions may not be warranted. However, the facts in this instance are overwhelming. Bundling is the source and financial incentive behind the conflict of interest problems that led to a court-enforced consent decree with ten of the largest Wall Street investment banks. Dozens of investment banks outside the global settlement, who bundle commissions, are not subject to the SEC's settlement research-banking safeguards.

Moreover, bundling prevents research from becoming a competitive market. Research continues to be dumped on the research market as loss leader advertising for investment banking and proprietary trading services. Furthermore, <u>bundling fosters a dysfunctional market where price has no relation to cost, supply does not respond to demand, unprofitable research businesses do not go out of business, and quality does not matter.</u>

<u>New off-the-shelf, web-based broker software could create an industry accounting transparency standard pretty easily and quickly.</u> (UK software company Rontech has a product called 4TEUS). This software would enable:

- Investors to weigh what part of their commission is for trading execution and what part is for research;
- Investors and government to make apples to apples comparisons of fund groups and brokerage firms;
- Government to have the data to audit and provide deterrence; and
- Investment banks to transparently show what amount of their overall commissions are for research so they could either size their research department to make it a profit center or publicly disclose the extent of the investment banking subsidy of research.

The current system already has a procedure in place that could help separate and track these research commissions for investors and government. Each and every trade can have a unique DTC (Depository Trust Company) five digit tracking number to tag a trade specifically for a research provider.

- Unfortunately few are aware of this existing procedural potential to unbundle for more transparency and accountability because unbundling is not in the financial interests of the investment banking industry.

3. **Promote "best research execution" practices.**

<u>The SEC also needs to better balance the goal of minimizing costs through best trading execution with the need for "best research execution</u>." Regulators currently have a bias for focusing on best trading execution because excessive trading costs can hurt performance *and because* these costs are the *easiest to measure* objectively. However, the critical importance of best research execution should not be ignored just because the impact of research is more subjective and harder to measure. Over-emphasizing trading execution at the expense of research execution is *missing the forest for the trees*.

<u>Overall, research matters much more to fund performance than trading execution</u>. Research is what spurs a transaction out of a deteriorating company that may drop in value or go bankrupt, or spurs a transaction into a company that is growing, or has an improving outlook. Research is at the core of all good stock picking and sector picking. Good research fuels funds performance, while poor research drags down funds performance. A vibrant, investor-aligned research industry is also essential to making capital markets as efficient as possible.

Investorside believes regulators can help investors much more by improving best research execution than by further fine tuning best trading execution. Best trading execution has been a focus for years and has been successful in lowering transaction costs for investors. Meanwhile, investment banking research scandals have greatly damaged investor trust in research, in large part because <u>a lack of transparency has allowed industry research payment practices to become so anti-investor</u>. Investor trust in research can't be restored without a strong effort by regulators to dramatically improve research payment practices in the industry.

As for the United Kingdom's proposed approach to soft dollars, <u>Investorside believes the UK's assault on soft dollars is misguided and runs counter to Congress's intent</u> under section 28(e), which makes investment research a legitimate safe harbor use of soft dollars. We believe the real problem is that a lack of transparency allows problems with soft dollars. The answer is not to scale back soft dollars, but to ensure *they are used to benefit investors*. The UK approach is somewhat analogous to saying that because automobiles are used to speed and can hurt or kill people, it therefore is necessary or good public policy to ban or prevent the use of automobiles. <u>The UK solution could prove worse than the problem</u>.

Investorside also disagrees with the UK's Financial Services Authority Consultation Paper 176 which proposes to exclude market pricing and information services, such as dealing screens, market information and portfolio management support services from services that can be bought with commission or order flow. Investorside believes that is too narrow a definition of research and unnecessarily defines research too narrowly as to discourage research innovation going forward.

- The definition of research should be broad, but clearly exclude investment banking services -- including preferential access to company management for soft dollars which is the newest variant of undisclosed investment banking research conflicts of interest and also a potential Regulation FD problem.
    - (Providing preferential access to management for soft dollars can undermine a research firm's or analyst's independence because unfavorable research could lessen a company's willingness to personally visit with the research firm's preferred institutional investor clients.)

Moreover, Congress does not need to repeal or modify 28(e), the <u>SEC simply needs to better oversee what "research" can be paid for by soft dollars under section 28(e) and then implement oversight/audit procedures</u> to ensure that research commissions in fact are:

- Paid for the benefit of investors;
- Competitive; and
- Based on value, performance, and merit.

Furthermore, the SEC also should scrutinize the following practices that are antithetical to investor interests:

- Distribution or marketing of funds that do not benefit investors (revenue sharing);
- Preferential access to IPOs which violates fair trade rules; and
- Preferential access to public company management for soft dollars, which could run afoul with Regulation FD (Fair Disclosure) and is another serious form of undisclosed investment banking conflict with research.

Authorize soft dollars for fixed income trading to provide investor-aligned research competition to company dominated credit research.

The bankruptcies of Enron, Global Crossing, WorldCom, and Adelphia exposed systemic weaknesses in fixed income research, which focuses primarily on evaluating balance sheet risk. Traditional equity research focuses primarily on the health of companies' income statements and generally delegates evaluation of balance sheet risk to the credit agencies.

Fixed income markets are much less efficient than equity markets. The spreads between the high-yield fixed income "bid" and "ask" prices can be huge compared to equity market spreads. Moreover, there is no "tape" or public market price in fixed income markets. This glaring lack of market transparency perpetuates market inefficiency and unnecessary concentration of the market. It also enables the largest investment banking houses to dominate fixed income trading even more than they dominate equity trading.

Investorside believes a large reason why fixed income research failed investors so badly is that there are no soft dollar commissions on bond trades (effected on a principal basis) to pay for investor-aligned fixed income research. The lack of such a market mechanism limits investors almost exclusively to company side research that is not working for investors. (Currently some large fund groups allow their fixed income managers to pay for research through the equity soft dollar process, but that is the exception not the rule. Moreover, equity research tends to focus on income statement analysis and not fixed income/balance sheet analysis.)

The lack of funding for fixed income research is exacerbated by SEC policies that have the unintended but practical effect of being anti-competitive. The SEC's licensing process for credit agencies has created a de facto credit rating oligopoly that protects credit rating research from investor-aligned research competition. Moreover, these credit rating agencies are paid by companies -- aligning their financial interests more with companies than investors. <u>In business, you are who you work for</u>. Furthermore, the SEC has granted these credit rating agencies an exemption from Regulation FD. This effectively sanctions an "inside information" advantage on credit rating agencies conferring a powerful anti-competitive advantage over investor-aligned investment research.

IV. <u>How Soft Dollars Serve Investor Interests</u>

How do soft dollars <u>benefit investors and pensioners</u>?

1. **Soft dollars <u>promote investor choice</u> by**:
    - Funding the "independent" investment research industry;
    - Supplementing money-managers' in-house research resources with specialized research and portfolio support services, which are not economically feasible for a fund to do in-house; and
    - Providing a market mechanism to seed and reward research innovation.

2. **Soft dollars <u>promote competition</u> by**:
    - Lowering barriers to entry by affording new entrants the same scale advantages as the dominant investment banking broker-dealers; and
    - Enabling funds to pay for research performance rewarding value-added research and not supporting poor research.

3. **Soft dollars <u>save investors money</u> by**:
    - Providing money managers a <u>*variable* cost mechanism</u> that can be increased/decreased to respond to market changing conditions;
    - Enabling investors to sample research for longer periods of time to gauge its value before buying it than in the hard dollar market;
    - Providing access to specialty, large scale, or market-wide research that would not be economically feasible to reproduce in-house or to pay for exclusively; and

- Sharing the cost with other investors for the cost of specialty research that a fund may not need full time or need only in some market conditions.

4. **Soft dollar brokers improve market efficiency by**:
    - Unbundling execution from research allowing for a marriage of best trading execution with best-of-breed conflict free research;
    - Creating an efficient and convenient market mechanism for funds to access a wider diversity of small specialized providers that otherwise would not have sufficient scale to trade with;
    - Lowering barriers to entry for a new research entrant or for the one person research shop;
    - Providing best trading execution for small research providers that could never meet best execution requirements on their own; and
    - Serving as a convenient aggregator of a broad variety of research and portfolio support services, much like a store is convenient distribution for shoppers that don't have time or interest to buy direct from every factory.

Note: **It is important to clarify that the definition of soft dollars applies to Wall Street sell-side commissions as well as third party research commissions**. As the SEC's Office of Compliance, Inspections and Examinations states in its 1998 Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds: *"Broker-dealers typically provide a bundle of services including research and execution of transactions. The research provided can be either proprietary (created and provided by the broker-dealer, including tangible research products as well as access to analysts and traders) or third party (created by a third party but provided by the broker-dealer). Because commission dollars pay for the entire bundle of services, the practice of allocating certain of these dollars to pay for the research component has come to be called "softing" or "soft dollars."*

V. Conclusion

Investorside strongly recommends increasing transparency of soft dollars to begin restoring investor trust in investment research. Increased transparency and accountability of soft dollars would enable investors to be better consumers, government to be better overseers and market forces to better protect investor interests.

Investorside strongly recommends continuation of the 28(e) safe harbor for commissions to be used for research and opposes any study of soft dollars that may have the purpose of ultimately seeking the repeal of the 28(e) research safe harbor. Investorside believes soft dollars do and can strongly serve investor interests, but that greater transparency of soft dollars is necessary in order to restore investor trust.

Investorside looks forward to working constructively with the government to help restore trust in investment research and U.S. capital markets. Investorside appreciates the opportunity for our views to be included in the official record of the hearing before the Subcommittee.