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Investorside[SM] RESEARCH ASSOCIATION

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March 8, 2004

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

Subject: Investorside Recommendations to SEC and Congress on how to Prevent Soft Dollar Problems While Preserving Soft Dollar Benefits to Investors.

Dear Chairman Donaldson:

This letter makes the policy case of <u>why it would harm investors to ban soft dollars and shift to a hard dollar payment system for research</u>. This letter also recommends how the government can make soft dollars more transparent, accountable and investor-aligned in order to better protect investors.

The core premise underlying Investorside's recommendations and mission is that investors are best served by investment research that is "investor-aligned," i.e., paid for by investors and that is fairly represented to investors. Investorside is a rapidly growing association of 75 independent research providers, which Investorside has certified to be free of investment banking conflicts and working for investors.

I. Overview of Investorside's Position:

Investorside believes a ban on soft dollars combined with a requirement that research be paid with hard dollars would be a destructive and indiscriminate policy that would destroy both the good and bad parts of soft dollars in a way that would take the market years to recover from. A ban of soft dollars would:

1. Unintentionally backfire, creating a new and potentially worse fiduciary conflict of interest that would harm investors going forward;
2. Exacerbate an existing conflict of interest over investment performance between investors and their mutual funds;
3. Devastate the current vibrant marketplace of investment ideas, information and debate, undermining capital formation, market efficiency, economic growth and job creation;
4. De-fund the independent research industry almost completely, in an "Orwellian-Big Brother" like attack on commercial free speech and free enterprise; and
5. Dramatically reduce research and money management competition and investor choice.

The value of soft dollar research is best preserved through substantially more fiduciary accountability of money managers and brokers, and much better *alignment* of financial interests.

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Investorside believes there is a more effective policy solution than a ban to achieve the same goals without the destructive downsides that would harm investors on an ongoing basis. The Government needs to put in place a fiduciary obligation for money managers and brokers to maintain auditable and sound internal controls systems for soft dollars.

Without internal control systems by money managers and brokers that require separate and transparent accounting of trading, research, and investment banking commissions, there can be no audit trail of what a fund bought, or what a proprietary broker provided with soft dollars. If there is no audit trail for soft dollars, investors cannot have confidence that the system adequately protects their resources and the government can not have the normal oversight, investigative and enforcement tools to detect or deter misuse of soft dollars. The current lack of an audit trail for proprietary soft dollars has invited misuse and provided too little enforcement deterrence.

The web-based software technology now exists and is commercially available and affordable to easily create the necessary accountability and internal controls systems to detect and deter soft dollar misuse, if fund managers and brokers had a fiduciary obligation to maintain auditable internal controls for soft dollars. Traditional arguments that tracking the subcomponents of soft dollar commissions is too difficult, have not kept up with advances in web-based software technology that have solved past impediments. There is no longer any technological, operational or economic barrier to creating a dramatically more transparent, accountable and performance-based soft dollar system that better ensures soft dollars actually are used to the benefit of the investor.

Moreover, the heavy regulatory focus on mutual fund costs and disclosure have missed the more fundamentally important question of better aligning mutual fund financial interests with investors interests. American investors should care most about whether the fund's primary profit incentive is to preserve and grow the value of an investor's portfolio. Reportedly only 2% of mutual funds have performance fees that provide the fund company with an aligned financial incentive to preserve and grow investors' portfolio. Investors should know and care most about whether a fund company shares the investor's goals, then they should care about investment performance and then about cost. The current focus on disclosing costs first is putting the cart before the horse.

The source of most the problems with soft dollars is that mutual fund's business models are not fully aligned with investors' financial interests in *investment performance*. Most all mutual fund companies earn the same percent management fee whether their investment performance is poor, average or excellent. This non-performance-driven business model creates financial conflicts of interests with investors and is the financial root cause behind revenue sharing. A mutual fund company can earn more profits for itself, by offloading as many of its sales, distribution and other costs to the investor, because it is simply more profitable to attract more investors through sales and distribution than it is to manage to deliver excellent investment performance.

The answer is not to ban soft dollars because they are a cost to investors, but to align mutual fund companies' financial interests directly with investors so that fund companies use soft dollars for research and services that enhance investment performance. Until regulators focus on the real root cause of problems with soft dollars - a conflict in financial goals - regulators will be treating symptoms and not the underlying malady.

The following two sections make the above cases in greater detail. First, why a ban of soft dollars and a shift to hard dollar research payments would harm investors, and second, why trading commission accountability and better alignment of financial interests are the best solutions to prevent soft dollar problems going forward.

II. Case For Why a Hard Dollar Payment System for Research Would Harm Investors:

Soft dollar critics incorrectly claim that if research was valuable it would be paid for with hard dollars. This is misleading and shows a lack of understanding of the market incentives and conflicts of interest involved in paying for investment research. A research payment shift from soft dollars to hard dollars would harm investors in five ways.

1. A shift to hard dollars would <u>create a potentially worse fiduciary conflict of interest that harms investors</u>.

- Soft dollars are investors' commissions, and a portfolio manager's primary fiduciary responsibility is to use them to increase investment performance to the benefit of the investor. Soft dollar research is an investment in performance for investors, funded by investors.
- Hard dollars are mutual fund company costs, and management's primary fiduciary responsibility is to reduce costs to improve their mutual fund company profits, not necessarily achieve investment performance. If a hard dollar system is used, research becomes a cost that needs to be cut to improve the mutual fund company's bottom line.

2. Replacing soft dollars with hard dollar payments for research would <u>exacerbate existing conflicts of interest</u> between investors and mutual fund companies.

- Mutual fund companies earn a fixed percent of assets, the same fee whether they under-perform or out-perform the market (only about 2 % of mutual funds have performance incentive-based fees.) Thus, a <u>mutual fund company can earn a greater and steadier profit for its shareholders by collecting more assets through selling and distribution</u> than by buying research to grow the value of their portfolios.

3. A shift to hard dollars would <u>destroy the currency of the "capitalism of investment ideas, information and debate</u>."

- U.S capital markets are the most active, liquid and vibrant in the world in part because soft dollars are a fluid, on demand, completely market-based pricing mechanism that provides investors an intensely competitive research marketplace to access the best research minds at the lowest cost.
- Hard dollar proponents imply that all research is equal, regardless of whether or not it creates value; they suggest investors pay similar prices up front for research that says buy Enron or sell Enron. A <u>business model where pricing is not linked to value creation produces mediocrity and a brain drain</u>. Soft dollars are an engine of capital formation, market efficiency, economic growth and job creation

4. Banning soft dollars would de-fund most of the independent research industry by imposing an "Orwellian-Big Brother" like ban on a type of commercial free speech, free enterprise and free flow of ideas.
   - Portfolio managers and investors share a financial incentive to invest in whatever investment research that can protect or grow the value of the portfolio.
   - Banning soft dollars would remove the payment mechanism from the actual reason for the payment: the investment idea. The reason why research has been paid with trading "soft dollars" for 211 years is because research is, the cause of, and reason for, the trade to occur.
   - Soft dollars are responsive to market conditions and are an efficient "pay as you need" system. A hard dollar research budget would be a less responsive, increasing the risk of buying unnecessary research upfront, leaving less money for unanticipated research needs.

5. Finally, a ban of soft dollar payments for research would reduce competition and limit investor choice by disadvantaging small money managers with smaller research budgets.
   - Only the largest companies could afford to buy the necessary breadth of hard dollar research. Furthermore, a ban would limit choice by disadvantaging independent research with fewer sales resources.
   - Only the biggest firms would have the resources to serve a hard dollar research market. The result would be less diversity and competition in research, and fewer research voices.

III. Recommendations for Preventing Soft Dollar Problems While Preserving Benefits:

Soft dollars are investor resources that either can be used to benefit investors, or misused to the detriment of investors. As with any financial instrument, the key to its integrity is a system of accountability and internal controls and also ensuring that financial interests remain aligned. The current problems surrounding soft dollars stem from both a serious lack of fiduciary accountability and a hidden misalignment of financial interests.

1. Accountability:

Soft dollar problems occur and reoccur because both funds and proprietary brokers know there is little accountability of these roughly $10 billion in commingled investor commissions, and that there currently is no easy way that they can be effectively audited. Disclosure has become more about indemnifying companies from accountability than fairly representing a business practice to investors. Disclosure without accountability is like jaws without teeth.

Without separate and transparent accounting of trading, research and banking commissions, there is no audit trail of what a fund bought or what a proprietary broker provided with soft dollars.

Without the accountability of a separate and transparent audit trail:

- The fund or broker cannot create or manage a system of internal controls to protect investors from the conflicts of interest of commingling trading, research and banking commissions;
- Investors cannot test or check to see if their commissions are being used appropriately; and

- Enforcement cannot detect or prosecute misuse because little potential evidence is created.

The lack of an audit trail enabled problems such as exorbitant index fund fees, revenue sharing, conflicted research and IPO spinning; all of which went undetected for years, because there was little accountability and few internal controls designed to detect and deter misuse of soft dollars.

The technology now exists to easily create the necessary accountability and internal controls systems, if fund managers and brokers had a fiduciary obligation to maintain auditable internal controls for soft dollars. For example, a U.K. company, Rontech, has created a software solution called "4teus," a web-based software solution that enables fund managers to fully account for and assess the value of brokers' research and services for the first time. Such software is currently available for deployment, is inexpensive and easy to use, and could be up and running for a company in a month, and for the entire industry in a matter of months. Technology solutions such as these can make the broker assessment process more effective and objective, enhance the evaluation process of paying for research performance, improve the quality, quantity and timeliness of relevant evaluation information, while reducing management and IT costs. Skychange is another company with a software solution.

2. Alignment of financial interests:

The lack of performance-based mutual fund fees means that market forces are working against investors' interests when they could easily be realigned to work *for* investor interests. If fund fees were required to be performance based, it would align both the interests of the investor and the mutual fund company to protect and grow the value of the investor's portfolio. The current fixed percentage, which is paid regardless of whether investment performance is poor, average, or excellent, creates little incentive to enhance performance when a fund company can make a more consistent profit by simply collecting more assets through more sales and distribution. If funds' financial interests were aligned better with investors' interests to grow the value of investors' portfolio, there would be much less market incentive to misuse soft dollars.

In sum, Investorside strongly recommends increasing transparency, accountability and investor-alignment of soft dollars, and not to replace them with a hard dollar for research payment system. Increased accountability and investor-alignment of soft dollars would enable investors to be better consumers, government to be better overseers; and market forces to better protect investor interests. Investorside looks forward to working constructively with the Government to help restore trust in investment research and U.S. capital markets.

Sincerely,

Scott Cleland
Chairman, Investorside Research Association
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John Eade
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SCC for Lisa Shalett

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