Investorside
RESEARCH ASSOCIATION

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

August 11, 2004

RE: Investorside Research Association response to the Mutual Fund Directors Forum Report on Best Practices and Practical Guidance for Mutual Fund Directors

Dear Chairman Donaldson,

In the spirit of the Securities and Exchange Commission being more proactive in detecting risks and operating under the new "doctrine of no surprises," Investorside is flagging for the SEC and its Office of Risk Assessment a major problem that is developing, in part from commission action, that could severely hurt investors long term without proactive SEC leadership.

In addition to passing a rule that requires mutual funds to have a super majority of independent directors, the SEC has also asked the Mutual Fund Directors Forum for recommendations of "best practices" for independent director oversight.

One of the key recommendations of the MFDF is to implement by "best practice" an extra-legal public policy position that effectively erases federal statutes that were authorized by Congress in 1975 under section 28 (e) of the 1934 Securities Exchange Act to create a safe harbor for trading commissions to pay for investment research.

If the SEC does not take an official position of disagreeing that ending soft dollars is a "best practice" to protect investors, this recommendation could be adopted by 40,000 independent directors through inertia and a policy leadership vacuum, and eventually lead to the emasculation of the independent research industry, which is hugely dependent on the soft dollar payment mechanism. This would seriously harm investors long term, as independent research is the market's best watchdog for fraud that can devastate investors' retirement security.

The Investorside Research Association respectfully submits that the Mutual Fund Directors Forum's recent "best practice" recommendation to **eliminate all soft dollar commissions would in fact be a disastrous practice and <u>a perverse abdication of the independent director's fiduciary oversight duty to protect investors and the duty to maximize fund shareholder returns,</u> with which the SEC is newly entrusting them.**

<u>Why Banning Soft Dollars is NOT a Mutual Fund Best Practice:</u>

1) Potential dereliction of oversight and audit duty: The duty of an independent fund director is to protect investors. This fiduciary duty includes a dual responsibility of not only policing fund practices that could harm investors, *but just as important, ensuring that their fund shareholders benefit from the same industry mechanisms and investment resources (authorized by Congress and the SEC) that help enhance investment performance of funds competitive to theirs.* This new oversight responsibility will require hard work, intensive oversight and auditing of fund practices on a regular basis. <u>It is not a good sign if some independent directors consider shirking their oversight duty with easy shortcuts mischaracterized as "best practices</u>."

2) Potential dereliction of duty to maximize investor returns: By banning the use of soft dollars to pay for investment research, the independent fund director is actually subjugating his fiduciary duty to maximize investor returns. A ban of soft dollars will cause fund managers to have limited access to research that is vital to maximize investment performance. The current $<u>10</u> billion soft dollar market collectively funds thousands of providers of investment research, information, and investment management services that are in essence the market's eyes and ears and scouts to anticipate changing market conditions. Most importantly, soft dollar commissions improve investment returns because they provide fund groups a highly responsive and contemporaneous market mechanism to adapt their portfolios to rapidly changing conditions that cannot be fully anticipated in advance. If a fund eliminates soft dollars, does it increase its money management fee to compensate for the change in business practice? If it does not, does it disclose to its shareholders how it will continue to manage money at the same or better level with less research resources?

3) Enabling "Closet Indexing" Fraud: If independent fund directors of *actively*-managed funds decide to ban soft dollars for research - a key tool used in active money management - they will create for themselves a higher burden of proof to regulatory enforcement personnel that their funds are in fact *actively* managing their portfolios and not closet-indexing for an active management fee. After ending soft dollars, does the fund company compensate and spend more heavily on in-house and hard dollar research to indeed *actively* manage the portfolios, resulting in potentially higher money management costs? If independent directors of actively-managed funds place a higher internal priority on reducing money management costs than on generating market-beating investment performance, then those independent directors should consider voting to change their funds' charters to an index fund and charge investors the much lower money management fee of an index fund. The SEC is already investigating firms that charge an *active*-management fee when they are *not actively* managing the portfolio. Funds that represent and advertise their business to the public as *active* money managers and imply they are trying to outperform the market have a legal obligation under Federal and State anti-fraud statutes to actually do so.

4) Presumption of guilt: Before even examining the facts or auditing a fund's use of soft dollars to see if there are problems, the Mutual Fund Directors Forum purports to decide for Congress, the SEC, and all independent directors, that soft dollar conflicts are impossible to oversee, manage or adequately disclose, and therefore must be banned. In other words, their directors' funds are presumed guilty of soft dollar abuses in advance, without any review of the facts, and with no opportunity for a fund manager to prove to its independent board that it is indeed innocent of the alleged abuses. Prejudging without facts or any actual review or effort is certainly not a "best practice." Since soft dollar payments to independent research are already transparent and accountable to fund directors and regulators - in contrast to proprietary research which remains opaque – a best practice would be to actually do the work to oversee and audit that these soft dollar expenditures are in fact beneficial to investors.

5) Increase Investor Vulnerability to Fraud: Banning soft dollars is effectively arguing for the emasculation of the independent research industry as soft dollars represent the overwhelming funding source for independent research. Independent research is the only research truly aligned with investor interests, and is the single most legitimate and investor-valuable use of soft dollars. The independent research industry is the market's best watchdog to keep conflicted Wall Street research firms honest. It was independent research firms that warned investors early of the dangers of **Enron, WorldCom, Tyco** and the tech bubble long before they destroyed so many Americans' nest eggs, while Wall Street research, for the most part, was silently complicit. Banning soft dollars is effectively anti-independent research and anti-fraud detection.

6) Unilateral Competitive Disarmament: Since independent directors cannot coerce all other funds to ban soft dollars, those funds that do are choosing to put their fund at a serious competitive disadvantage to those that continue to have access to the full range of the market's investment research services. Banning soft dollars would also put mutual funds at an increasing competitive disadvantage to the hedge fund industry which supports the use of soft dollars. Moreover, independent directors of large fund companies recommending a ban on soft dollars as a "best practice" are actually acting as the proverbial wolf in sheep's clothing since they are recommending an anti-competitive practice under the guise of investor protection. Banning soft dollars would enable large fund groups that have more money management resources to put smaller money managers at a serious competitive disadvantage by limiting their free market option of outsourcing parts of their research needs on an as needed basis.

Conclusion:

Congress authorized a "safe harbor" for soft dollars under section 28 (e) of the Securities and Exchange Act in 1975. The SEC's soft dollar task force is currently in the process of refining the definition of research and deciding what additional disclosures may be needed. The SEC has indicated that it is not going to recommend to Congress to repeal 28 (e) or ban soft dollars. Soft dollars, with appropriate oversight from independent fund directors and government auditors, would best serve investors. What is needed is soft dollar accountability, not a soft dollar ban.

A "best practice" Investorside would recommend is to have independent directors oversee and audit their funds use of soft dollars to ensure that they are in fact spent in the interests of investors. Moreover, a "best practice" would be to disclose to investors what percent of the funds use of soft dollars are spent on investment research that is aligned with investor interests.

Finally, Investorside recommends the "best practice" to regularly inform investors what percent of a fund management's profits result from excelling in money management, i.e. fund performance, and what percent is driven by acquiring new assets to manage. In other words, a best practice for directors is to disclose to investors the extent to which the fund company's own financial interests are truly aligned with the investor interest in fund performance.

Sincerely,

John Eade,
Co-Founder and Chairman, Investorside Research Association
President, Argus Research

Scott Cleland
Co-Founder and Director, Investorside Research Association
Chief Executive Officer, Precursor

Harold Cochran
Director, Investorside Research Association
President and CEO, Weiss Group

Stanton Green
Director, Investorside Research Association
President and Managing Director, Vista Research

Lisa Shallet
Director, Investorside Research Association
Chairman and Chief Executive Officer, Sanford C. Bernstein, LLC

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