

**Statement of Grady G. Thomas, Jr.**  
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**Before the Committee on Banking, Housing, and  
Urban Affairs of the United States Senate**

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I. Introduction and Background

Thank you for the opportunity to appear before this distinguished committee to discuss research-commission arrangements under Section 28(e) of the Securities Exchange Act of 1934. My name is Grady Thomas. I have been in the securities business for 40 years, and in 1986 became the President of the Interstate Group, today a Division of Morgan Keegan & Co., Inc., a subsidiary of Regions Financial Corporation. I have been active in the securities industry throughout my career. I was on the Board of Directors of the Boston Stock Exchange for 8 years; served as Chairman and President of the National Organization of Investment Professionals; was a District Chairman of the NASD; two term Governor of STA; Founding President and Chairman Emeritus of the North Carolina Security Traders Association; and am currently Chairman of the SIA Institutional Brokerage Committee.

I have been involved in providing independent research to investment managers, including mutual fund portfolio managers, for 30 years, and in that period of time I have seen innovative research flourish and commission rates fall, to the benefit of all investors. I have also seen the transparency of independent research arrangements improve to the

point where investment managers involved in independent research arrangements receive monthly statements detailing the type of research provided, its cash value and the aggregate commissions used to pay for that research. The driving force behind these beneficial developments has been the Section 28(e) safe harbor adopted by Congress in 1975. My experience has been that Section 28(e), and various interpretations of the safe harbor by the Securities and Exchange Commission, have done an excellent job of assuring that research and execution services provided by broker-dealers to investment managers provide value to the investment managers' accounts.

You will notice that throughout my testimony I use the terms "research-commission" or "independent research" arrangement rather than "soft dollars." This is intentional. In the first place, the term soft dollars has come to have negative connotations that do not reflect the reality of independent research arrangements. Second, the term soft dollars is not defined in the securities laws, and is often used as shorthand to describe many uses of commissions by investment managers, including uses that do not involve the provision of investment research or execution services. In contrast, Section 28(e) provides protection only to arrangements where broker-dealers provide brokerage and research services that benefit an investment manager's managed accounts.

## II. History of Research-Commission Arrangements and Section 28(e)

Because broker-dealers are deeply involved in the investment decision-making process through their execution and trading activities, it follows that they would also provide research and other advisory services to investors. Indeed, the practice of providing both trade execution and investment research in exchange for commissions may go back to the opening of the New York Stock Exchange in 1792. Some large full-

service broker-dealers budget hundreds of millions of dollars to providing in-house research to their brokerage clients. Other firms, such as The Interstate Group, service their institutional clients by providing research services and analytical tools developed or authored by independent organizations. Arrangements for the provision of independent research are estimated to involve approximately \$1 billion of institutional commissions on an annual basis. Commissions committed to proprietary research and execution-only trades are estimated to be about \$9 billion annually.

a. Definition of a Research-Commission Arrangement

A research-commission arrangement under Section 28(e) of the Securities Exchange Act of 1934 is one in which a broker-dealer provides research services to a fiduciary, such as an investment adviser or bank, who manages other people's money. In such an arrangement, the fiduciary must use the research to assist in the investment decision-making process on behalf of account beneficiaries. The beneficiaries pay for the research indirectly with commissions on portfolio transactions that the broker-dealer effects for their accounts.

Under a lawful Section 28(e) arrangement, a fiduciary may use commissions only to acquire services that are useful in the investment decision-making process. A fiduciary may not, for example, use commissions for administrative expenses such as carpeting, telephones, or other items which benefit the fiduciary but not the account. If a research service has the potential to provide administrative or non-research assistance to the money manager, Section 28(e) guidelines require the money manager to allocate the cost of the service according to its use. Where a research service has a "mixed-use," only that percentage of the service attributable to the investment decision-making process may be

paid for with commission dollars. The fiduciary must use its own resources to pay for that portion of the service that provides non-research assistance to the fiduciary.

b. History of Section 28(e)

Commission rates on exchanges have been competitive only since 1975. Before that time, commission rates on portfolio transactions generally were fixed by law and had been throughout the history of the New York Stock Exchange. Under the old fixed rate system, money managers were able to obtain research through expenditure of their accounts' commissions without incurring additional costs to the accounts, since commission rates were the same regardless of whether the broker-dealer provided research. Because commission rates were fixed by law, the practice of providing research services to fiduciary accounts eventually was prevalent, as much as brokers recognized the need to compete for orders on the basis of services rendered. In this way, brokers came to provide necessary support for the professional fiduciaries' internally-developed advisory functions. These business relationships and expectations that evolved between fiduciaries and their accounts continue today in the era of competitive commission rates.

When commission rates on exchanges were made competitive in 1975, the investment community was concerned that the flow of research would be restricted. Money managers feared that fiduciary principles would or could require fiduciaries to operate under the principle that "cheapest is best" and that only the lowest cost execution would avert a lawsuit for failure to obtain best execution. In response to these concerns, Congress passed Section 28(e) of the Securities Exchange Act of 1934, a safe harbor for fiduciaries who receive research services in consideration of portfolio commissions, to ensure the continued availability and quality of research in the competitive commission

rate environment. The Congressional hearings on this provision reflect the notion that without Section 28(e) protection, the flow of research previously furnished to institutions under a fixed commission rate structure could be cut off, and investors would be harmed.<sup>1</sup>

Both Congress and the SEC have taken steps to ensure that the legal standards that apply to Section 28(e) arrangements protect the interests of investors. Section 28(e) itself limits the definition of research that can be obtained for commissions, and requires the fiduciary to determine that the commissions paid are reasonable in relation to the research and brokerage services provided. Based on the legislative history of Section 28(e), the SEC has interpreted that research services received by investment managers under these arrangements must assist the manager in the investment decision-making process.

c. Benefits to Investors of Research Commission Arrangements

Investors reap a number of benefits from the research-commission arrangements described above:

- Flow of Research Services to Money Managers

One of Congress's principal objectives in adopting Section 28(e) was to ensure "the future availability and quality of research and other services" to the investment community.<sup>2</sup> It was adopted to address the concern that investors would suffer if the flow of research services to money managers were impeded. Events over the past 29 years demonstrate that Section 28(e) has indeed facilitated the flow of research to investment managers.

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<sup>1</sup> Securities Act Amendments of 1975, Report of Comm. On Banking, Housing and Urban Affairs, S. Rep. No. 75, 94<sup>th</sup> Cong., 1<sup>st</sup> Session 71 (1975).

<sup>2</sup> Report of the Comm. On Banking, Housing and Urban Affairs, S. Rep. 94-75 (1975).

Broker-dealers now provide literally hundreds of independent research services to money managers to assist in the investment decision-making process. The vast majority of these research services have only become available to money managers since Congress adopted Section 28(e) in 1975. These services include not only investment information but fundamental databases, portfolio modeling, and strategy software. Equally significant, the technology for the delivery, formatting, and use of information has made research more accessible to the investor and has added greatly to market efficiencies. Technology decisions relating to the investment process have become extremely important as money managers today face growing market complexities and information needs.

The Section 28(e) safe harbor has been particularly useful in assisting in the development of the independent research community. Independent research providers are often small operations using innovative and unique methodologies and targeting research at a specific segment of the market which is not given sufficient coverage by full service firms. It is extremely difficult for a small independent research provider with a limited marketing budget to gain a foothold in the market for investment research. 28(e) arrangements allow independent research providers to rely upon and obtain assistance from broker-dealers to gain market acceptance. In turn these broker-dealers provide independent research and execution services to many investors.

- Competition Among Broker-Dealers Providing Research Has Reduced Execution Costs

By becoming major competitors for institutional order flow, research brokers such as The Interstate Group have exerted downward pressure on commission rates. Since commission rates became unfixed in 1975, execution costs have declined significantly.

Prior to 1975, commission rates on institutional trades were on a sliding scale based on volume with a high of 82¢ per share. In 1998 an SEC Report found commission rates of about \$0.06 per share for those institutional accounts examined by the SEC Staff. My experience is that commission rates today average \$0.05-\$0.06 per share for institutional trades.

- Smaller Asset Managers Have Benefited from the Favorable Regulatory Environment for Providing Research in Conjunction with Execution

In its deliberations on Section 28(e), Congress recognized that without highly developed internal research resources, smaller money management firms might be required to rely entirely on Wall Street research. Congress feared that without access to research that broker-dealers provide, small investment managers would be pressured to charge higher fees than large money managers would charge.<sup>3</sup>

What was true in 1975 is true today. Many startup investment advisers cannot establish their businesses and compete against larger money managers (who command large fee bases from which they can sustain in-house research) without access to the research services that broker-dealers provide. Section 28(e) has thus facilitated small firms' entry into the investment advisory business.

d. Common Misconceptions Regarding Section 28(e) Arrangements

Over the years I have noted that many people within and without the financial industry harbor misconceptions regarding Section 28(e) arrangements. Following are a few I encounter most frequently.

- Misconception 1: Section 28(e) arrangements are used by investment managers to pay for administrative expenses such as carpeting and rent.

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<sup>3</sup> Report of the Comm. On Banking, Housing and Urban Affairs, S. Rep. 94-75 (1975).

As discussed above, the definition of “research” under Section 28(e) extends only to items that provide assistance to fiduciaries in the investment decision making process. Administrative expenses such as rent are not, and have never been, covered by the Section 28(e) safe harbor. Furthermore, in the last industry-wide examination sweep conducted by the SEC Staff in 1997, the Staff found no instances “ . . . in which [mutual] fund commissions were used to purchase non-research items, which did not benefit the funds themselves.” While it is true that some privately managed investment vehicles, such as hedge funds, engage in directed brokerage activity to pay for non-research services, this type of activity is not covered under the Section 28(e) safe harbor. Accordingly, changes to the Section 28(e) safe harbor would not effect these types of arrangements.

- Misconception 2: Section 28(e) arrangements lack transparency and are not disclosed to investors.

Independent or “third-party” research arrangements are among the most transparent arrangements in use in the investment industry today. Investment managers involved in such arrangements receive monthly statements detailing the dollar value of research provided, the aggregate commissions used to pay for the research and an identification of the research provided. While it is true that some proprietary research arrangements lack this level of transparency, all Section 28(e) arrangements, both proprietary and independent, must be disclosed by investment advisers in their Form ADV, and by mutual funds in their Form N-1A.<sup>4</sup>

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<sup>4</sup> See Part II of Form ADV, Item 12(b); Form N-1A Item 16.



- Misconception 3: Investment Managers who execute trades with Wall Street firms, and receive proprietary research services, do not engage in “soft dollars.”

Every so often I will encounter an investment manager who will declare that his firm does not use “soft dollars.” When I probe the issue, I usually discover that the manager does indeed execute portfolio trades with large Wall Street firms, and receives services such as research reports, access to research analysts, etc., from these firms. Proprietary research arrangements require the protection of the Section 28(e) safe harbor to the same extent as do independent research arrangements. However, because investment managers involved in proprietary research arrangements do not typically receive statements detailing the value and type of research they receive, they do not understand that they are indeed involved in a “soft dollar” arrangement.

- Misconception 4: Requiring investment managers to pay cash for research would benefit investors.

Denying investment managers the use of portfolio commissions to purchase research would have a devastating effect on the securities markets and investors. Smaller investment managers would lack the resources to compete with larger peers, driving them out of business. Independent research firms, which have flourished in recent years, would lose the invaluable marketing mechanism provided by broker-dealers seeking to provide research to their institutional customers. Small independent research firms would fail, and the now vibrant market of new types of research would dry up.

If required to finance research expenses from their own resources, investment managers would be forced to raise management fees, or to reduce their use of investment research. Neither of these outcomes would be helpful to investors or the markets. If

managers merely passed research costs along to investors through higher management fees, investors would end up paying more for research and commissions than they do now, as studies have shown that combining research and execution services leads to economic efficiencies that would be lost if they were provided separately. Furthermore research costs would be less, not more, transparent than under the current structure, as they would be lumped in with all of the managers' other overhead costs.

If managers were to reduce their use of research, investors would also suffer. Studies have shown that the use of research has a positive correlation with investment return. A reduction in research used by managers would result in inferior performance for investor's accounts. Many managed funds would resort to a form of indexing, trying to mimic, rather than beat, the overall market. While index-type investing certainly has a place in the investment management field, investors and the markets as a whole have greatly benefited from growth, value and other more research-centric investment strategies in the past. The diminution of the amount of research available to managers would disproportionately affect managers who rely on these types of strategies, to the detriment of investors and the price discovery mechanism of our securities markets.

Finally, I believe this argument ignores the fact that there is nothing stopping investment management firms from determining on their own to pay for research with cash, and for competing for clients on that basis. In fact, some firms do so today. As discussed above, investment advisers and mutual funds must disclose to investors whether or not they receive research in exchange for portfolio commissions. If investors truly believe that they would benefit from using an investment manager who pays only cash for research, they can easily find such a manager. On the other hand, if managers were required to pay only cash for research, investors would lose the opportunity to select

a manager or investment vehicle that benefits from the practice of combining research and execution services.

### Conclusion

Research is the foundation of the money management industry. Providing research is one important, long-standing service of the brokerage business. Soft dollar arrangements have developed as a link between the brokerage industry's supply of research and the money management industry's demand for research.<sup>5</sup>

Congress' adoption of Section 28(e) in 1975 has fostered the development of innovative and useful research products by both independent and proprietary research providers. Section 28(e), and SEC interpretations thereof, have done an excellent job of assuring that research services are readily available to investment managers and provide value to investors by supporting managers in the investment decision making process.

The last major study of Section 28(e) arrangements conducted by the SEC staff did not observe any instances in which mutual fund commissions were used to purchase non-research items, which did not directly benefit the funds themselves. The SEC Staff did, in section VIII of its 1998 Inspection Report, make a number of recommendations pertaining to the provision of investment research for portfolio commissions. I encourage the SEC to give further consideration to these recommendations, and note that many of them have already been adopted by The Interstate Group and other broker-dealers involved in the provision of independent research.

Thank you for the opportunity to appear before you and express my views on behalf of The Interstate Group.

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<sup>5</sup> Statement made by the SEC Office of Compliance, Inspections and Examinations in the "Inspection Report on The Soft-Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds," (September 22, 1998, Section I.)