ICAA

Statement of

Geoffrey I. Edelstein, CFA, CIC
Managing Director, Westcap Investors

Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Examining Soft-Dollar Practices

Before the
U.S. Senate Committee on
Banking, Housing, and Urban Affairs

March 31, 2004

INVESTMENT COUNSEL ASSOCIATION OF AMERICA, INC.
1050 17TH STREET, N.W., SUITE 725 WASHINGTON, DC 20036-5503
(202) 293-ICAA FAX (202) 293-4223

Statement of Geoffrey I. Edelstein, CFA, CIC

Before the
U.S. Senate Committee on Banking, Housing, and Urban Affairs

March 31, 2004

Chairman Shelby, Ranking Member Sarbanes, and members of the Committee, I greatly appreciate the opportunity to appear before you today to address issues related to soft dollars. On behalf of the Investment Counsel Association of America (ICAA), I wish to commend the Committee for convening this and other hearings on issues related to current investigations and regulatory actions regarding the mutual fund industry.

I am a Managing Director and Co-Founder of Westcap Investors, LLC, an investment advisory firm located in Los Angeles. Westcap was founded in 1992 and is registered as an investment advisory firm with the Securities and Exchange Commission.[1] Our firm provides investment advisory services to both individuals and institutions. Our clients include a wide variety of individual investors as well as pension and profit sharing plans, charitable organizations, corporations, state and municipal government entities, and pooled investment vehicles, such as limited liability companies and mutual funds (as a subadviser). Today, our firm employs 43 people and is majority-owned by its employees. Westcap's current assets under management total about $2.8 billion.[2]

The Investment Counsel Association of America[3] is a non-profit organization based in Washington, DC that represents the interests of SEC-registered investment advisory firms. Westcap has been a member of this organization for many years and I am pleased to offer my testimony today on behalf of the ICAA. A statement on soft dollars that was released by the ICAA earlier this month is included as part of my statement.

---

[1] Section 202(11) of the Investment Advisers Act of 1940 defines an investment adviser as "any person, who, for compensation, engages in the business of advising others. . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities. . ." This section also sets forth several exceptions to the definition.

[2] As with all other SEC-registered investment advisers, Westcap's Form ADV Part 1 is publicly available on the Investment Adviser Public Disclosure web site: www.adviserinfo.gov. This required registration and disclosure form provides information about an investment advisory firm, its principals, its clientele, any disciplinary history, and various activities.

[3] The ICAA's membership consists of more than 300 SEC-registered investment advisory firms that collectively manage in excess of $4 trillion for a wide variety of individual and institutional clients. For more information, please visit: www.icaa.org.

Summary of Positions

- Investment advisers are fiduciaries and, as such, have an obligation to seek best execution in connection with client transactions and to disclose potential conflicts of interests to both existing and prospective clients. Client brokerage is an asset of the client – not of the adviser, and thus there is a potential conflict where an adviser uses client brokerage for research. Accordingly, the ICAA supports full and appropriate disclosure of soft dollar practices by all investment advisers. Consistent with the basic approach of U.S. securities laws and market principles, we strongly believe that the SEC should ensure that there is adequate disclosure about soft dollar practices, combined with appropriate inspection and enforcement of regulations governing these practices.

- The ICAA fully supports the SEC's current initiative to examine soft dollar practices. Specifically, the ICAA believes the SEC should conduct a rulemaking aimed at ensuring that required disclosures related to soft dollar arrangements are adequate and appropriate and to clarify the current definition of "research." The consequences of abolishing soft dollars – an outcome that would require Congressional action – likely will adversely affect smaller investment advisory firms, create entry barriers for new investment advisory firms, and diminish the quality and availability of proprietary and third-party research. Consequently, the ICAA strongly believes that a rulemaking is the best option for considering and implementing changes in this important area.

- The ICAA supports appropriate recordkeeping requirements for investment advisers regarding soft dollar transactions. Investment advisers should maintain appropriate documentation of soft dollar transactions, the services received, their uses, and allocation methodologies for mixed-use items (a service or product that provides both research and other uses). In addition, the ICAA believes that investment advisers should develop and implement appropriate internal controls and procedures that are designed to ensure that soft dollar arrangements are supervised, controlled, and monitored.

- As set forth in the ICAA's March 3 statement, however, we oppose the suggestion that the SEC should eliminate the use of soft dollars for third-party research. We believe this approach would harm investors and diminish the availability of quality research. It would result in an unjustifiable, unlevel playing field for many market participants. It would provide a regulatory-driven advantage for full-service brokerage firms and disadvantage third-party research providers. Ironically, eliminating soft dollars for third-party research also would result in less transparency to investors, regulators, and market participants.

Profile of the Investment Advisory Profession

The profile of the investment advisory profession is often mischaracterized and misunderstood. Investment companies (mutual funds) and the investment management companies that provide investment advice to mutual funds constitute a significant and important part of the investment advisory profession. However, mutual fund companies and their advisers comprise only a portion of the entire investment advisory profession. In fact, statistics indicate that the vast majority of SEC-registered investment advisory firms are *small* companies and that most of them do *not* manage mutual funds.

Beginning in 2001, investment advisers have been required to use an electronic filing system – the Investment Adviser Registration Depository (IARD) – when submitting Form ADV, Part 1, the basic registration and disclosure document required by the SEC.[4] Since then, the ICAA and National Regulatory Services have issued annual reports profiling the investment advisory profession based on these required filings. In 2003, we reported that there were a total of 7,852 entities registered with the SEC as investment advisers. Of this total, 5,299 (67.5%) reported having 10 or fewer employees. On the other end of the spectrum, only 260 (3.3%) of all SEC-registered investment advisory firms reported that they employ more than 250 persons. And only 1,478 (less than 20%) of all SEC-registered investment advisers reported that they provide portfolio management for mutual funds (investment companies).[5]

While a relatively few large firms dominate the investment advisory profession in terms of their collective assets under management, the fact remains that most investment advisory firms are small businesses that are extremely diverse, both in terms of the investment services they provide and the extremely wide range of investors they serve. We submit that this fact should be considered carefully in making any significant regulatory or policy decisions that affect investment advisers.

Definition of Soft Dollars/Proprietary vs. Third-Party Research

The subject of today's hearing is often misunderstood and controversial, in part due to the unfortunate term, "soft dollars." Soft dollars simply refers to the provision by broker-dealers of research in addition to execution of securities transactions in exchange for commission dollars. The SEC staff has described soft dollar arrangements as follows:

> 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.

---

[4] In general, any investment adviser that manages in excess of $25 million must file Form ADV, Part 1 via the IARD system.

[5] *Evolution/Revolution: A Profile of the U.S. Investment Advisory Profession*, Investment Counsel Association of America and National Regulatory Services (May 2003). The report is posted on the ICAA's web site: www.icaa.org.

> 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."[6]

As noted in the SEC's report, soft dollar arrangements generally can be categorized as either "proprietary" or "third party." When the broker-dealer that executes a trade also provides internally generated research in exchange for one bundled commission price, that arrangement is referred to as "proprietary." This is often also referred to as "Wall Street research." Wall Street, or full-service brokerage firms, will not break out the costs to purchase these proprietary services "a la carte" to the vast majority of its clients. Instead of proprietary research, however, the executing broker can provide independent research generated by third parties in exchange for commission dollars. In these instances, the executing broker must be obligated to pay for the third party research provided to the investment adviser in order for the arrangement to fall within the 28(e) safe harbor. These "third-party" arrangements are an important mechanism for the distribution of independent research and analytic services.

Several issues are raised by soft dollar arrangements. First, the commissions used for execution and research services are paid by the investment advisers' clients. As such, an investment adviser has the obligation to use these commissions in the best interests of its clients and consistent with its fiduciary duties. Second, because proprietary research is bundled with execution services, the costs of research, execution, and other services are not as transparent as they would be if charged separately. Third, the definition of what is allowable research has been blurred as new products and services are created, particularly those using various technological innovations. Ultimately, we believe these issues are best addressed by ensuring that investors receive full and accurate disclosure of soft dollar arrangements; by clearly delineating the types of research services that are eligible in such arrangements; and by giving the SEC appropriate tools and resources for inspection and enforcement activities.

Fiduciary Duty

Investment advisers are subject to a fundamental fiduciary duty. This duty has been upheld by the U.S. Supreme Court[7] and reiterated by the SEC in various pronouncements over the years.[8] As described in the following excerpt, an investment

---

[6] *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds,* The Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission (Sept. 22, 1998).

[7] *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963).

[8] *See, e.g., In re: Arleen W. Hughes*, Exchange Act Release No. 4048 (Feb. 18, 1948). "The record discloses that registrant's clients have implicit trust and confidence in her. They rely on her for investment

adviser's fiduciary duty is one of the primary distinctions between investment advisers and others in the financial services industry:

> As a fiduciary, an adviser owes its clients more than honesty and good faith alone. Rather, an adviser has an affirmative duty of utmost good faith to act solely in the best interests of the client and to make full and fair disclosure of all material facts, particularly where the adviser's interests may conflict with the client's. Pursuant to this duty, an investment adviser must at all times act in its clients' best interests, and its conduct will be measured against a higher standard of conduct than that used for mere commercial transactions.[9]

Among obligations that flow from an adviser's fiduciary duty are: (1) the duty to have a reasonable, independent basis for its investment advice; (2) the duty to seek best execution for clients' securities transactions where the adviser is in a position to direct brokerage transactions; (3) the duty to ensure that its investment advice is suitable to the client's objectives, needs, and circumstances; (4) the duty to refrain from effecting personal securities transactions inconsistent with client interests; and (5) the duty to be loyal to clients.[10]

Since it was founded in 1937, the ICAA has emphasized an adviser's fiduciary duty as a cornerstone of an investment adviser's obligations.[11] In the soft dollar context, we believe that fiduciary principles require an investment adviser to make appropriate disclosure to their clients about soft dollar practices. Appropriate disclosure will allow investors to make informed judgments about such practices based on all relevant facts. In addition, fiduciary principles require investment advisers to make trade execution decisions in the best interests of their clients in light of relevant facts and circumstances.[12]

---

advice and consistently follow her recommendations as to the purchase and sale of securities. Registrant herself testified that her clients follow her advice 'in almost every instance.' This reliance and repose of trust and confidence, of course, stem from the relationship created by registrant's position as an investment adviser. The very function of furnishing investment counsel on a fee basis – learning the personal and intimate details of the financial affairs of clients and making recommendations as to purchases and sales of securities – cultivates a confidential and intimate relationship and imposes a duty upon the registrant to act in the best interests of her clients and to make only recommendations as will best serve such interests. In brief, it is her duty to act in behalf of her clients. Under these circumstances, as registrant concedes, she is a fiduciary; she has asked for and received the highest degree of trust and confidence on the representation that she will act in the best interests of her clients."

[9] Lemke & Lins, *Regulation of Investment Advisers,* at p. 174 (2003).

[10] *Id.,* at p. 175.

[11] "An investment adviser is a fiduciary and has the responsibility to render professional, continuous, and unbiased investment advice oriented to the investment goal of each client." *ICAA Standards of Practice.*

[12] *Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters,* Exchange Act Release No. 23170 (Apr. 23, 1986).

Disclosure and Transparency

Disclosure is a bedrock principle of the U.S. securities laws. As a general matter, in fulfilling its fiduciary obligations to clients, an investment adviser is required to make full and fair disclosure of all material facts necessary for informed decision-making by clients, particularly where a potential conflict of interest is involved.

One of the primary disclosure tools required of investment advisers is Form ADV, Part II, or the so-called "brochure." The brochure is the key disclosure document that all investment advisers must deliver to existing and prospective clients (and offer to clients each year).

In the soft dollar context, Form ADV, Part II requires investment advisers to disclose information related to brokerage and commissions. Specifically, Item 12 requires disclosure regarding whether: (a) the adviser or a related party has authority to determine, without specific client consent, the broker-dealer to be used in any securities transaction or the commission rate to be paid, and (b) the adviser or a related party suggests broker-dealers to clients. If the adviser engages in either of these practices, it is required to describe the factors considered in selecting broker-dealers and in determining the reasonableness of commissions charged. If the value of research products or services given to the adviser or a related party is a factor in these decisions, the adviser must describe the following:

1. The research products and services;
2. Whether clients may pay commissions higher than those obtainable from other broker-dealers in return for these products and services;
3. Whether research is used to service all of the adviser's clients or just those accounts whose commission dollars are used to acquire research products or services; and
4. Any procedures the adviser has used during the past fiscal year to direct client transactions to a particular broker-dealer in return for research products or services.

The SEC has proposed enhancements to these soft dollar disclosures by investment advisers. While the proposal has not yet been finalized, the ICAA anticipates final action later this year. Following is an excerpt from the SEC's regulatory proposal that describes these enhancements (all footnotes omitted):[13]

> *Soft Dollar Practices*. Advisers often receive "soft dollar" benefits from using particular brokers for client trades. Client brokerage, however, is an asset of the client – not of the adviser. When, in connection with client brokerage, an adviser receives products or services that it would otherwise have to produce itself (or pay for), the adviser's interest may conflict with those of its clients. For example, soft

[13] *Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV*, Advisers Act Release No. 1862 (Apr. 5, 2000).

dollar arrangements may cause an adviser to violate its best execution obligation by directing client transactions to brokers who are not able to adequately execute the transactions, or may give the adviser incentive to trade client securities more often than it would absent the benefits the adviser receives. Because of these conflicts, we have required advisers to disclose their policies and practices on use of client brokerage to obtain soft dollar benefits.

During 1997-98, our staff conducted a wide-ranging examination of advisers' soft dollar practices and disclosure. Our Office of Compliance Inspections and Examinations found widespread use of soft dollars by investment advisers that manage client portfolios. The Office concluded that advisers' disclosure often failed to provide sufficient information for clients or potential clients to understand the adviser's soft dollar practices and the conflicts those practices present. In its report, the Office noted that most advisers' descriptions were simply boilerplate, and urged that we consider amending Form ADV to require better disclosure. Today we are acting on those recommendations.

Item 11 would require an adviser that receives research or other products or services in connection with client securities transactions (soft dollar benefits) to disclose the adviser's practices and discuss the conflicts of interest that result. The brochure's description of soft dollar practices must be specific enough for clients to understand the types of products or services the adviser is acquiring and permit them to evaluate conflicts. Disclosure must be more detailed for products or services not used in the adviser's investment decision-making process.

Item 11 would describe the types of conflicts the adviser must disclose when it accepts soft dollar benefits, and require the adviser to disclose its procedures for directing client transactions to brokers in return for soft dollar benefits. The item would require the adviser to explain whether it uses soft dollars to benefit all clients or just those accounts whose brokerage "pays" for the benefits, and whether the adviser seeks to allocate the benefits to client accounts proportionately to the brokerage credits those accounts generate. The item would also require the adviser to explain whether it "pays up" for soft dollar benefits.

These enhanced disclosures will put more detailed information in the hands of clients, permitting clients to decide whether they approve of their advisers' use of their commissions.

In addition to disclosure and other regulatory requirements, there are a number of market factors that play a significant role in soft dollar arrangements. For example, many investment advisory clients (or their consultants) request and receive extensive information relating to soft dollar practices. These requests often extend to information that go beyond disclosures required by regulations, including specific client information. The fact of the matter is that investment advisers often supply a great deal of information regarding soft dollar practices in response to requests from clients or their consultants.

Similarly, it should be recognized that excessive trading or paying excessive commissions to "earn" soft dollar credits for research takes an adverse toll on an investment adviser's investment performance (by creating additional trading costs that must be deducted from any appreciation in value of a client's account). This fact alone serves as an important "market" deterrent from abusing soft dollar arrangements. Investment performance is clearly the single most significant factor that investors (and their consultants) use to hire or fire an investment adviser. Accordingly, investment advisers whose clients are able to monitor their portfolios and investment performance will be sensitive to potential negative effects that may follow from trading activities associated with soft dollar arrangements. In addition, clients (including mutual fund directors) receive independent custodial reports and can judge for themselves the appropriateness of commissions paid and the turnover of securities in their portfolios.

The ICAA supports full and appropriate disclosure of soft dollar practices by all investment advisers. Consistent with the basic approach of U.S. securities laws and market principles, we believe that the SEC should ensure that there is adequate disclosure about soft dollar practices, combined with appropriate inspection and enforcement of such regulations.

Definition of "Research"

Section 28(e) of the Securities Exchange Act of 1934 was enacted by the Congress in 1975 following the abolition of fixed commission rates. The section provides that: "no person . . . in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law . . . solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of the commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercise investment discretion."

In order to rely on the safe harbor under section 28(e), an investment adviser must satisfy the following conditions:

- The adviser must be supplied with "brokerage and research" services;
- The services must be "provided" by a broker-dealer;
- A "broker-dealer" must be the provider of the service;
- The investment adviser must have "investment discretion" in placing the brokerage;

- The commissions paid must be "reasonable" in relation to the services provided;

- "Commissions" must be used to purchase the services; and

- The brokerage commissions paid must relate to "securities transactions."

One of the most important aspects of the safe harbor is the definition of "research" services. The leading pronouncement on this issue is the SEC's 1986 interpretive release. According to the 1986 release, the test for determining "whether something is research is whether it provides lawful and appropriate assistance to the money manager in the performance of his decision-making responsibilities."[14] The SEC noted that what constitutes lawful and appropriate assistance "in any particular case will depend on the nature of the relationships between the various parties involved and is not susceptible to hard and fast rules." In later decisions, the SEC has noted that "research" does *not* cover a wide variety of expenses, including overhead (such as office rent, utilities, and salaries), administrative expenses, exam review courses, association membership dues, electronic proxy voting services, consulting services designed to assist an investment adviser in client marketing, legal expenses, accounting and tax software, as well as items such as travel, meals, hotel and entertainment expenses associated with attending a research seminar or conference.[15]

The 1986 interpretive release specifically identified so-called "mixed-use" products and services that may have both research and non-research purposes. Among such mixed-use products are: computer equipment used for research undertaken on behalf of clients and for non-research functions, such as bookkeeping or administrative operations; quotation systems that provide information pertinent to the valuation of securities while facilitating the adviser's reports to clients; and information management systems that integrate trading, execution, accounting, recordkeeping, and other administrative functions. The SEC requires investment advisers that receive a mixed-use product or service to make a reasonable allocation of the cost of the product or service according to its use.

Since the enactment of section 28(e) in 1975, investment advisers have begun to use investment styles that require quantitative analytic tools that are in some ways quite different from the traditional research tools used by investment advisers. In addition, the way that research is delivered has significantly changed since 1986, when the SEC last defined "research." The predominant form of research in 1975 – paper documents covering one issuer – have now developed into a myriad of research services, including

---

[14] *Supra,* fn.10.

[15] *In re Kingsley, Jennison, McNulty & Morse, Inc.,* Advisers Act Release No. 1396 (Dec. 23, 1993); *In re Goodrich Securities Inc.,* Exchange Act Release No. 28141 (June 25, 1990); *In re Patterson Corp.,* Advisers Act Release No. 1235 (June 25, 1990).

electronic delivery and software that provides consolidations of research covering entire sectors, industries, and other categories into searchable, analytical databases. These changes have presented many challenges for advisers attempting to interpret the SEC's guidance from 1986.

The ICAA supports the SEC's efforts to ensure that soft dollars are used only for legitimate research purposes. We also recognize the difficult challenges associated with this task. Particularly given advances in technology, including communications and electronics, the line between research and non-research products and services is more difficult to discern and to delineate. We support a rulemaking by the SEC to clarify the definition of research to preclude the use of soft dollars for non-research products and services while retaining enough flexibility so as not to preclude the development of innovative and valuable research services.

1998 SEC Report on Soft Dollar Practices

The best starting point for evaluating actual practices related to soft dollars is the report issued by the SEC's Office of Compliance Inspections and Examinations (OCIE) in 1998.[16] From November 1996 through April 1997, OCIE conducted an extensive inspection sweep to gather information about the current uses of soft dollars, based on on-site examinations of 75 broker-dealers and 280 investment advisers and investment companies. In September 1998, OCIE issued a written report detailing the results of their sweep and setting forth recommendations for consideration by the SEC. Among the key findings set forth in the report are the following:

1. "Almost all" investment advisers obtain products and services (both proprietary and third-party) other than pure execution from broker-dealers and use client commissions to pay for those products and services.

2. Most products and services obtained by investment advisers with soft dollars fall within the definition of research, *i.e.*, they provide lawful and appropriate assistance to the adviser in the performance of its investment decision-making responsibilities.

3. While most of the products acquired with soft dollars are research, OCIE found that a significant number of broker-dealers (35%) and investment advisers (28%) provided and received non-research products and services in soft dollar arrangements. In such cases, OCIE found that investment advisers failed to provide meaningful disclosure to their clients.

4. OCIE also reported shortcomings by investment advisers with respect to "mixed use" items, *i.e.,* products that have both research and non-research uses.[17]

[16] *Supra,* fn. 4.

[17] *Id.,* at p. 3.

The staff report set forth the following recommendations for the SEC to consider:

"1. We noted many examples of advisers claiming the protection of the safe harbor without meeting its requirements. We also found that industry participants were not uniformly following prior Commission guidance with respect to soft dollars. As a result, we recommend that the Commission publish this report to reiterate guidance with respect to the scope of the safe harbor and to emphasize the obligations of broker-dealers, investment advisers and investment companies that participate in soft dollar arrangements. We also recommend that the Commission reiterate and provide further guidance with respect to the scope of the safe harbor, particularly concerning (a) the uses of electronically provided research and the various items used to send, receive and process research electronically, and (b) the uses of items that may facilitate trade execution.

"2. Many broker-dealers and advisers did not keep adequate records documenting their soft dollar activities. We believe that the lack of adequate recordkeeping contributed to incomplete disclosure, using soft dollars for non-research purposes without disclosure, and inadequate mixed-use analysis. We recommend that the Commission adopt recordkeeping requirements that would provide greater accountability for soft dollar transactions and allocations. Better recordkeeping would enable advisers to more easily assure compliance and Commission examiners to more readily ascertain the existence and nature of soft dollar arrangements when conducting inspections.

"3. We noted many instances where advisers' soft dollar disclosures were inadequate or wholly lacking – especially with respect to non-research items. We recommend that the Commission modify Form ADV to require more meaningful disclosure by advisers and more detailed disclosure about the products received that are not used in the investment decision-making process. In addition, the Commission should require advisers to provide more detailed information to clients upon request.

"4. In light of the weak controls and compliance failures that we found, we recommend that the Commission publish this report in order to encourage advisers and broker-dealers to strengthen their internal control procedures regarding soft dollar activities. We suggest that advisers and broker-dealers review and consider the controls described in this report, many of which were observed as effective during examinations."[18]

At the time it was issued, the OCIE report clearly represented the best available information on soft dollar practices. In light of the fact that the report was published more than 5 years ago, one of the key questions today is whether any of the practices described in the report have changed. Some of the key issues that may warrant re-

---

[18] *Id.,* at pp. 4-5.

examination include whether documentation, disclosure, and control procedures relating to soft dollar arrangements have improved.

Current SEC Initiatives

Following the recommendations set forth in the 1998 OCIE Report, the SEC issued an extensive proposal in April 2000 to revise the so-called "brochure" (Form ADV, Part 2), the disclosure document that all investment advisers must offer to provide to clients and prospective clients each year.[19] As discussed above, the proposed rule would amend the brochure requirements to mandate more specific disclosure regarding soft dollar practices and any resulting conflicts. The ICAA expects the SEC to finalize this important rule later this year.

In addition, the SEC recently finalized a major new rule that requires all investment advisers to adopt written compliance policies and procedures that are reasonably designed to prevent violations of the Investment Advisers Act of 1940, to review such policies and procedures at least annually, and to designate a chief compliance officer who is responsible for administering the policies and procedures.[20] The written release accompanying the SEC's new regulation lists a number of areas that investment advisers should consider in developing written policies and procedures, including best execution and soft dollar practices. Clearly, the new rule will encourage investment advisers to enhance – and review on a continuing basis – their written policies and procedures relating to soft dollar practices and will provide the SEC with an additional tool in identifying potential problems in this area.

Early this year, Chairman Donaldson announced that he has directed SEC staff to explore various issues relating to soft dollars. SEC staff have been meeting with a number of interested parties to discuss issues related to soft dollar practices, including contracts for soft dollar arrangements, recordkeeping practices, and disclosure practices. At the March 10 hearing before this Committee, the Director of the SEC's Division of Investment Management noted in his prepared testimony that:

> Chairman Donaldson has made the issue of soft dollars a priority and has directed the staff to explore the problems and conflicts inherent in soft dollar arrangements and the scope of the safe harbor contained in Section 28(e) of the Securities Exchange Act. The Divisions of Market Regulation and Investment Management, along with the Office of Compliance, Inspections, and Examinations, are working together to conduct this review. A primary area of focus is whether the current definition of qualifying "research" under the safe harbor is too broad and should be narrowed by rulemaking. The Commission has also sought public comment on

---

[19] *Supra,* fn. 11.

[20] *Compliance Programs of Investment Companies and Investment Advisers*, Advisers Act Release No. 2204 (Dec. 17, 2003).

whether it would be possible to require mutual fund managers to identify the portion of commission costs that purchase research services from brokers so as to enhance the transparency of these arrangements.[21]

We understand that as part of this review, the SEC is considering certain public comments that have been filed with the SEC that set forth a number of suggestions for improving disclosure of soft dollar arrangements and for narrowing the scope of allowable research.[22] Among these comments is a suggestion that proprietary research costs be "unbundled" from execution costs.[23] Although we have not had an opportunity to fully consider this proposal, we strongly believe that any such reform should place full responsibility to calculate the cost or price of non-execution services on the broker-dealer providing the services, rather than requiring investment advisers to make a subjective estimate regarding such services.

The ICAA fully supports the SEC's current initiative to examine soft dollar practices and issues. Specifically, the ICAA would support an SEC rulemaking aimed at improving disclosure of soft dollar practices and arrangements to investors and to clarify the current definition of "research."

Conclusions and Summary

In summary, the ICAA supports a rulemaking by the SEC that would:

- Enhance soft dollar disclosure requirements, as envisioned by the SEC's proposal to revise Form ADV;
- Strengthen books and records requirements related to soft dollars; and
- Clarify the scope of allowable "research" within the section 28(e) safe harbor.

We believe that these rule changes, combined with appropriate inspection and enforcement of these regulations will strengthen the transparency of soft dollar arrangements and deter abuses in this area.

---

[21] *Testimony Concerning the Securities and Exchange Commission's Recent Regulatory Actions to Protect Mutual Fund Investors*, Paul F. Roye, Director, SEC's Division of Investment Management, before the U.S. Senate Committee on Banking, Housing and Urban Affairs (Mar. 10, 2004).

[22] *See March 2, 2004 Comment Letter from Fidelity Management and Research Company to SEC re: Concept Release on Measures to Improve Disclosure of Mutual Fund Transaction Costs, Release No. 33-8349; 34-48952: IC-26313; File No. S7-29-03*.

[23] *Id.*

However, we believe that the SEC should reject suggestions to eliminate the use of soft dollars for third-party research.[24] As described in the ICAA's March 3, 2004 statement, we believe such a suggestion is fundamentally flawed:

> It would result in a diminution of quality research and thus is contrary to our strong support for independent research that benefits investors. If adopted, the proposal would unfairly advantage full-service brokerage firms and disadvantage third-party research providers, as well as clients of investment advisers who benefit from third-party research.

Finally, the ICAA believes that an SEC rulemaking is a better approach than repealing section 28(e). While the consequences of eliminating soft dollars cannot be predicted with certainty, we believe the SEC is in the best position to consider the complex issues related to this important question. Abolishing soft dollars may well diminish the amount of quality research that is made available to investment advisers and thus may hurt investors. In addition, repealing section 28(e) may disproportionately disadvantage thousands of smaller investment advisory firms and their clients while favoring the relatively few larger firms that have greater resources to produce and acquire research.

In closing, the ICAA wishes to commend the Committee for conducting this hearing on these important issues. We would be pleased to provide any additional information that may be helpful to you in your continuing deliberations.

---

[24] *See December 2, 2003 Comment Letter from the Investment Company Institute to the SEC re: soft dollars.*

.