UNINTENDED AND UNDESIRABLE CONSEQUENCES OF

BANNING SOFT DOLLARS

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

Dr. Howard M. Schilit, CPA

Chairman and CEO

Center for Financial Research & Analysis (CFRA)

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Thank you for the opportunity to share my views on the role of independent research, soft dollar commissions and their interdependence.

My name is Howard Schilit. I am author of the book FINANCIAL SHENANIGANS and founder and CEO of the Center for Financial Research & Analysis (widely known as CFRA), a forensic accounting organization serving the investment management community. Our center serves as a "watchdog" organization for investors, warning about unusual accounting practices. For example, over the last decade, we warned investors about problems at Worldcom, Enron, Parmalat, Cendant, and Sunbeam.

Independent research organizations perform a vital watchdog role that greatly benefits investors. As we all know, our founding fathers had the wisdom to devise a system of checks and balances to not allow a single branch of government to exert undue power. In much the same way, the independent research industry provides checks over potentially biased and misleading information distributed by public companies and their sponsors at investment banking brokerage firms.

Independent research organizations typically are paid by third-party brokers that use soft dollar commissions. A ban on soft dollar commissions would have a devastating impact on independent research firms and, indirectly, hurt investors. I urge this committee to search for other solutions and leave soft dollar payments intact.

Historical Perspective

Historically, when investment managers trade stock they have had to purchase a *bundled package of services from one source* – full service brokerage firms. All research, trading and other brokerage services came from this one source.

Within the last generation, competition has emerged as smaller boutique brokerage firms entered the market, driving down commission rates. In order to truly compete with the full service brokerage firms, the boutiques needed to bundle some value-added services. Since customers wanted research, the boutiques outsourced these products by partnering with value-added independent research organizations.

Investment managers loved having new trading partners and new research sources. In contrast, traditional proprietary full service brokerage firms were not at all pleased with competition emerging on two fronts – brokerage and research. In the "old days," proprietary brokerage firms were the only game in town; they had a monopoly on trading and research. And investors paid exorbitant commissions for research of questionable value.

Fortunately for investors, the proprietary brokerage monopoly has been threatened. Today, competition is fierce for trading commissions, driving trading costs lower for investors. And fierce competition exists on the research front, as well, with over 300 entrepreneurial independent research firms pushed to produce the most value-added research at the best price. Investors never had it so good, with commission costs dropping and high quality independent research widely available.

Unfortunately for investors, however, the proprietary brokerage firms are fighting hard to regain their monopoly in trading and research. They are pushing for a ban on soft dollar trading – the commissions typically paid to smaller brokerage firms and later directed to independent research firms. ***The single act of banning soft dollars would irreparably hurt the competition from boutique brokers and independent research providers***. And proprietary brokers would again emerge with the monopoly they enjoyed for many years.

I urge this committee and your colleagues in Congress to create laws and policies to nurture competition. Then investors win. Banning soft dollar payments would have unintended and undesirable effects of eliminating competition for proprietary brokerage firms on both the research and trading fronts.

Recommendation No. 1: Soft dollars should be retained to provide a flexible payment option for purchasing independent research.

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Make no mistake, there are serious issues that need to be addressed to ensure that brokerage commissions charged are fair and reported in a transparent fashion and that investment managers always act in the best interest of the investing public.

Before offering certain much needed reforms, please consider the following fundamental questions:

What is the appropriate currency (brokerage commissions or cash) to be used to pay for investment research? Is it inherently wrong for investment managers to use commissions as the currency to pay for research or consulting services? I would think not, since for over 200 years most investors have used trading commissions as the sole currency for such services.

If, however, you disagree and believe that a new currency should be used – that is, cash only for research – that would be agreeable to me, provided all research purchased by investment managers is paid for with cash. Thus, if commissions were banned as the currency to pay for third-party independent research, then I urge you to establish a total ban on using commissions for any research from any source. Specifically, if an investment manager purchased research from my independent research organization and must pay cash then, in all fairness, research acquired from Merrill Lynch, Goldman Sachs or Morgan Stanley should require a cash payment, as well. I would have absolutely no objection to creating a meritocracy that allows all research providers to compete on the same playing field. Indeed, I would advocate such an approach.

Recommendation No. 2: Assuming little interest exists in a "cash only" approach, commissions should be the currency to pay for any investment research. No distinction should be made between proprietary and third-party research.

Assuming the commission-for-research model is retained, several important problems must be addressed.

1. Bundling execution costs and non-execution trading costs
2. Failure of mutual fund companies to include the non-execution portion of the commission in their reported expense ratio

3. Inflated brokerage commissions
4. Inadequate disclosure of portion of brokerage commissions directed to third-parties

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Recommendation No. 3: All brokerage organizations must unbundle execution and non-execution costs and disclose this information to investment companies. Since non-execution brokerage commissions are identical at all firms, regulations should treat them as such.

Requiring the unbundling of brokerage costs and showing the trade execution costs and the other service costs separately can easily solve many problems that this committee is addressing. Full service brokerage firms typically charge 5 cents per share to trade (down in recent years from 8 cents). Included is approximately 2 cents for execution and the remaining 3 cents for non-execution costs, such as research. Brokerage firms have not been required to disclose to investors and other stakeholders how the 3 cents per share is spent, and consequently, fail to report this information. In many cases, the 3 cents supports in-house research and operations at a proprietary brokerage firm. In contrast, at a "soft dollar" brokerage firm, the 3 cents is paid to third-party research firms. The money generally is spent for research – indeed the reason for the trade - and it clearly benefits the investor. And, if the investment manager believes the most value-added researcher works at an independent research firm, proceeds from trades should be directed to the research enterprise. That is the essence of a "soft dollar" arrangement.

With an unbundled menu, investment managers can now shop "a la carte." That is, they can trade with a broker with best execution and the lowest pricing. And they could purchase research and other investment tools from an organization (Wall Street proprietary or independent) based on the value-added quotient of those services. The logical result would be that:

- Commission costs would be lowered with more disclosure and competition
- Trading volume would be reduced with less pressure to trade
- Research quality would improve, since only the strongest research products would be purchased

Recommendation No. 4: Non-execution costs should be included in the expense ratio the mutual fund companies disclose.

If all brokers must disclose the non-execution costs that pertain to research, then mutual fund companies would have the necessary data to include such costs in their expense ratio. And, I would recommend that mutual funds should be required to include such non-execution costs in the expense ratio reported to investors.

Recommendation No. 5: Regulators and accountants should audit the records of both brokerage organizations and investment managers to ascertain proper accounting and disclosure of non-execution costs and expense ratios.

Recommendation No. 6: Severe penalties should be meted out to organizations that fail to properly account for non-execution costs or expense ratios.

Recommendation No. 7: Whatever changes are made, there must be one consistent set of rules concerning brokerage commissions and research services. No distinction should be made between proprietary and third-party research. Full disclosure of an investment manager's research expenses should be required regardless of the source. Excluding costs by proprietary brokers would discriminate against third-party independent research enterprises.

CONCLUDING THOUGHTS

A ban on allowing soft dollar payments for third-party research would be a big mistake. It would not directly solve the real problems and instead, would have the undesirable effect of eliminating an important resource for investors – value-added independent research.

I believe that my recommendations would have a number of desirable results that:

i. allow the emerging industry of independent research to solidify and provide the checks and balances that Wall Street needs
ii. give investment managers choices in trading and research that would result from unbundling and disclosure of brokers commission
iii. drive trading costs down and quality of research up with healthy competition
iv. drive out unethical commission kick-back arrangements with new mandated disclosures