Statement of

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I. Introduction

Chairman Shelby, Ranking Member Sarbanes and members of the Committee, I am Joseph Velli, Senior Executive Vice President of The Bank of New York. Thank you for inviting me to testify about research commissions, commonly called "soft dollars," an issue important to investors, investment managers, independent research firms and broker-dealers. We appreciate the Committee's efforts to examine issues concerning mutual fund fees, expenses and governance. We also applaud the efforts of the Securities and Exchange Commission ("SEC") in proposing rules changes designed to curb abusive behavior, address conflicts of interest and ensure that investors are given a fair shake. We think The Bank of New York can add to the dialogue in a meaningful way.

A. The Bank of New York and BNY Securities Group

The Bank of New York is the oldest bank in the United States. It was founded in 1784 by Alexander Hamilton and was the first corporate stock to be traded on the New York Stock Exchange in 1792. Together with its parent company, The Bank of New York Company, Inc., The Bank of New York has a distinguished history of serving clients around the world through its five primary businesses: Securities Servicing and Global Payment Services, Private Client Services and Asset Management, Corporate Banking, Global Market Services, and Retail Banking. The Bank of New York Company, Inc. is a global leader in securities management services operating in more than 100 markets and servicing issuers, institutional investors and broker-dealers. The Company plays an integral role in the infrastructure of the capital markets safekeeping over $8 trillion in investors assets. Through its nearly 23,000 employees, the Company provides quality solutions for global corporations, financial institutions, asset managers, governments, non-profit organizations, and individuals.

I am a Senior Executive Vice President of The Bank of New York and head of BNY Securities Group. Over the past several years, The Bank of New York has greatly enhanced its brokerage and clearing capabilities through both targeted acquisitions and internal growth. This focused strategy is part of The Bank's continued efforts to provide clients with the resources and highly personalized service required to succeed in the investment marketplace. BNY Securities Group's core business lines include institutional agency brokerage, clearing and financial services outsourcing businesses.

B. Agency Brokerage

BNY Securities Group's execution businesses focus on agency brokerage.[1] We act as our clients' agent in the marketplace, representing their interests in seeking best execution of their orders. An agency broker receives orders from its clients – in our case, investment managers, pension plans and corporations – and executes the transactions with the "Street," other broker-dealers in the marketplace who may be acting on their own behalf (i.e., principal) or on behalf of their customers (i.e., agent). We earn a commission for this service, which is fully disclosed to our clients.

In contrast to an agency broker's role, a broker-dealer acting as principal buys from its customer (in the case of a sell order) or sells to its customer (in the case of a buy order) using the firm's capital. The broker-dealer makes money in such transactions by charging a mark-up or markdown, that is, adding to or subtracting from the price to the customer. In most cases, the broker-dealer's charge and the customer's cost are not disclosed to the customer.

Agency brokerage provides investors two primary benefits they do not receive when transacting with a principal: (1) transparency of the explicit cost of execution[2]; and (2) absence of a conflict between the interests of the broker and those of the client. In an agency transaction, the client receives a confirmation setting forth, among other things, the amount of commission charged by the broker.

This information enables the client to take a methodical approach in assessing execution quality: first, to review the execution quality against appropriate benchmarks (e.g., volume weighted average price, market opening price, market closing price, or some other relevant measure), and second, to review whether the explicit cost of execution – the commission – was reasonable in relation to the value of the services provided

Agency brokerage also gives clients the comfort of knowing their broker is working on their behalf. An agency broker has no incentive other than to obtain the best execution reasonably available on behalf of the client. Moreover, agency brokerage significantly reduces the risk of economic incentives that adversely affecting the client.

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[1] BNY Securities Group does not engage in investment banking business or principal underwriting business. One of the Group's members, Pershing Trading Company, L.P., acts as a market maker and specialist to facilitate the Group's broker-dealer clearing business. The Group's other broker-dealers, however, act solely as agent or "riskless" principal (i.e., the economic equivalent of agent).

[2] Implicit transaction costs, such as market impact and opportunity cost are borne by a broker-dealer's customer regardless of the mode of execution. Although such implicit costs indeed are costs to the customer, the customer's broker-dealer is not the beneficiary; such costs flow to market participants other than the executing broker-dealer.

The institutional investment community recognizes the value of agency brokerage – we believe the agency brokerage business as a percent of the total institutional brokerage business has increased significantly in the past few years.

II Research Commissions and Section 28(e)

The provision of securities-related research is an integral part of the brokerage business. This is perfectly natural, for a broker's business is to assist clients in the purchase and sale of securities. Brokers are expected to know the "market," to understand and provide valuable information about securities trading activity and the factors affecting the prices of the market generally as well as individual securities. Indeed, customers demand it. As a result, brokers long have distinguished their services from competitors' by highlighting the quality of their research.

What has been true for decades is true today: investors want their brokers to provide them with high-quality research. One need only turn on the television to see major retail financial services firms publicizing the quality of the research they provide customers to enable them to make well-informed investment decisions. Research Commissions [3] ("soft dollars") are no different. Institutional brokers distinguish their services, among other ways, by providing their clients – asset managers – with research that helps the asset managers make better investment decisions on behalf of their clients (e.g., mutual fund investors).

A. Background of Section 28(e)

It would be helpful to provide some background on the history and scope of Section 28(e) of the Securities Exchange Act of 1934. In 1975, when Congress abolished fixed commission rates, investment managers were concerned that they would be deemed to have violated their fiduciary duty to act in the best interests of their clients if they caused their clients to pay a commission higher than the lowest commission available. The concern was driven by the existing practice of an adviser obtaining from its brokers research as well as brokerage services. In some cases, the research would be directly related to transaction and the account generating the commission, while in other cases the adviser would use the research to benefit its advised accounts generally. Congress responded by enacting Section 28(e), a "safe harbor" that shields an investment adviser from breach of fiduciary duty claims for causing its clients to pay a higher commission to a broker-dealer that provides "brokerage and research services" within the meaning of the statute.

To rely on the safe harbor, an adviser must determine in good faith that the commissions paid are reasonable in relation to the value of the brokerage and research services provided. Section 28(e) permits an adviser to obtain services, particularly research services, with client commission dollars so long as the adviser determines that the services provide "lawful and appropriate assistance" to the asset manager in the

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[3] A Research Commission is one in which an investment adviser receives securities brokerage and research services from a broker-dealer in exchange for the investment adviser directing some portion of its clients' brokerage transactions to the broker-dealer.

investment decision-making process.[4] Section 28(e) is a tacit recognition that securities brokers legitimately have always been in the business of providing research to their clients – the person making the investment decisions. In retail brokerage, the investment decision maker usually is the individual owner of the account. In institutional brokerage, the investment decision maker often is an investment adviser acting on behalf of its clients. In both cases, brokers are assisting the decision maker – the client -- by providing research that the client deems valuable.

B. Scope of Section 28(e)

Many misunderstand the scope of "soft dollars" and Section 28(e). The safe harbor applies to any transaction pursuant to which an adviser causes a client to pay a higher commission than the lowest available in exchange for brokerage and research services. Specifically, it applies to commissions where the adviser receives proprietary research ("Proprietary Research Transactions") as well as commissions for third party research services ("Independent Research Commissions"). Advisers executing transactions with integrated investment banks at full service rates are engaging in soft dollar transactions primarily with respect to the provision of proprietary research and, to a far lesser extent, with respect to the provision of third party research. Integrated investment banks dominate the institutional commission market. In fact, Independent Research transactions account for only about 12% of the institutional commission market, $1 billion out of a total of $8.4 billion in 2003, with the vast majority of the remaining 88% going to investment banks.[5]

Despite the clear application of Section 28(e) to both Proprietary Research Commissions and Independent Research Commissions, critics of these commissions sometimes focus on the latter. We believe the criticisms of Independent Research Commissions are unfounded. In particular, we believe the vast majority of market participants – investment advisers, broker-dealers and independent research providers – conduct their business in compliance with the SEC's guidance pursuant to Section 28(e).

C. The SEC's 1998 Sweep Report

In 1996 and 1997, the SEC's Office of Compliance Inspections and Examinations ("OCIE") conducted a sweep examination of the soft dollar industry. OCIE issued a report in 1998 detailing its findings (the "Sweep Report"). OCIE found that approximately 2% of commissions paid in purported reliance on Section 28(e) was in fact for "non-research products and services." OCIE's finding merits comment.

- First, OCIE's finding of only 2% of commissions being used for services outside the safe harbor is remarkably low, particularly considering that, prior to issuance of the Sweep Report, the legislative history and other guidance on

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4 See S. Rep. No. 75, 94th Cong. 1st Sess. 248 (1975); Securities Exchange Act Release No. 23170 (April 23, 1986).

5 U.S. Equity Investors: Soft Dollar Market Trends, Greenwich Associates, 2003.

the definition of research for purposes of Section 28(e) was sparse. Indeed, the Sweep Report is the most extensive guidance on the topic to date.

- Second, among the items to which OCIE objected as being outside the safe harbor are proxy services, membership and licensing fees related to investment management certification programs, and services related to regulatory compliance. In most cases, the industry was acting in the good faith belief that many of these products and services were within the safe harbor.

- Third, a corollary to the first two points is that the industry's practices have improved a great deal since the Sweep Report was issued. Once guidance was issued and standards were set, even informally, the industry responded. Independent agency brokers generally, and BNY Securities Group's brokers in particular, have adopted policies and procedures designed to ensure that their practices are consistent with the requirements of Section 28(e) for those clients required or desiring to stay within the safe harbor.

The Sweep Report made a series of recommendations to the SEC regarding potential soft dollar reforms. The primary recommendations were: (1) publication of the Sweep Report to provide guidance to investment advisers and broker-dealers; (2) enhanced recordkeeping by investment advisers and broker-dealers with respect to soft dollar arrangements; (3) enhanced disclosure by investment advisers of research products and services; and (4) enhanced internal controls.

Advisers and agency brokers responded to the Sweep Report's guidance by adopting procedures and controls designed to ensure compliance with the requirements of the safe harbor. Agency brokers, such as those within BNY Securities Group, provide detailed information to investment adviser clients regarding their brokerage commissions and the services they receive; we also retain detailed records of the products and services provided and information about the research providers. Exhibit A is a sample monthly report, which shows in great detail the commissions generated by the client and each research service, with the associated cost, provided to the client.

The Securities Industry Association has issued a Best Practices guide on soft dollars that many brokers have adopted wholesale. The Association of Investment Management and Research also issued soft dollar standards shortly after the issuance of the Sweep Report, which have been adopted by some in the investment adviser community. In addition, the SEC recently adopted rules requiring investment advisers to adopt formal compliance programs.[6] Investment advisers are required to comply by October 5, 2004. Accordingly, we believe the current system works as intended. We believe, however, that enhanced disclosure about transaction costs would benefit investors (see below).

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6 See Investment Advisers Act Release No. 2204 (December 17, 2003).

III Independent Research Commissions Should be Encouraged

At BNY Securities Group, we believe Independent Research Commissions benefit investors and play a valuable role in the marketplace. Such commissions combine best execution and choice of independent research in an unbundled, transparent fashion. Accordingly, Congress and the SEC should encourage their use.

A. Best execution

Research Commissions can only exist in an environment where investment advisers are required to obtain, and broker-dealers are required to provide, best execution of the underlying securities transactions. In the case of Independent Research Arrangements, agency brokers must compete on the basis of best execution. Advisers can obtain third party research services from any number of sources, including other broker-dealers. Therefore, execution quality has a central role in differentiating market participants.

Agency brokers involved in Independent Research Commissions– sometimes called "soft dollar" brokers – provide best execution by using people and technology to find liquidity in a fragmented marketplace. BNY Securities Group's broker-dealers operate business models designed to provide choice to investment advisers. BNY Securities Group allows advisers to execute through a fully integrated agency broker with direct access to the NYSE floor, through a network of over thirty third-party executing brokers pursuant to correspondent clearing arrangements, or through an electronic communications network. Investment advisers are able to choose the model best designed to obtain the best prices reasonably available for their clients, depending on such factors as the size of the transaction, the liquidity of trading in the security, and the speed at which the adviser must execute.

B. Independent Research Commissions provide transparency.

Most Independent Research Commissions are negotiated by the investment adviser and broker-dealer based on a ratio of commission dollars to value of research services provided (e.g., 1.5:1). The ratio, which represents the value of execution and research services provided, is explicit. Moreover, investment advisers engaged in such commissions receive extensive information from the providing brokers regarding the commissions they generate, the products and services they receive, and the cost of those services. This information typically is provided in detailed monthly account statements. Proprietary Research Commissions with integrated investment banks, by contrast, are opaque. Integrated investment banks generally do not charge a separate fee for research. Rather, trade execution and research are "bundled." The investment adviser is left to its own devices to determine what it is being charged for each service and whether the amount charged is reasonable. Accordingly, Independent Research Commission arrangements facilitate the adviser's determination, required by Section 28(e), that the cost of the brokerage and research services is reasonable in relation to the value of such services.

C. The Global Research Analyst Settlement

In settling the case of tainted research with ten major investment banks earlier this year, the SEC, the New York Attorney General, and other regulators insisted that the settling firms spend $432.5 million for their client on independent research over the next five years. The Global Research Analyst Settlement evinces the value of independent research product versus the value of in-house research product of investment banks. I discuss below the value inherent in independent investment research. It is important that Congress not place an additional unfair burden on independent research that could discourage the growth of the market for independent research, a result that is at odds with the fundamental principles of the Global Research Analyst Settlement. I believe that independent, conflict-free research is an essential element in restoring investor confidence in the markets. We should encourage, not discourage, its use.

D. Access to independent research.

Independent agency brokers offer access to hundreds of sources of independent research, including fundamental and technical research on individual issuers, industry and sector analyses and broad-based economic research. We believe that access to such a wide variety of ideas encourages better decision making on the part of the adviser. Many of the sources of independent research are small businesses with little or no research distribution capability. Such boutiques might not survive but for the business provided by independent agency brokers. Independent agency brokers can assist advisers in sourcing independent research and, where available, achieve volume discounts. Independent Research Commissions provide critical access to research and remain the most viable distribution vehicle for the independent research providers.

E. Small investment advisers benefit the most.

Small investment advisers typically have small research departments. Many do not have the resources to create an elaborate in-house research infrastructure. Small advisers benefit the most from having continued access to a wide variety of independent research. Independent Research Commissions allow small advisers to compete with the bigger players

IV. Powerful Combination for Investors

BNY Securities Group combines best execution brokerage with an opportunity for institutional customers to select from the highest performing sources of independent research in an environment where all costs are completely transparent. If the expression "soft dollars" was created on Wall Street as jargon for those services whose costs or values are undefined, then it does not exist at the Bank of New York. Indeed, we prefer to use the term "research commissions," because it more accurately describes the practice of providing clients with research that complements our execution services, and disclosing the costs of each.

BNY Securities Group, other leading agency brokers and full service firms that offer independent research have made a business out of disclosure and commission management. Our clients expect us to account for every penny of their client's commissions, and we do. Like many other brokerage firms, we give our clients detailed monthly statements – reporting all of their trading activity, the independent research providing the cost of each. A sample client statement is attached hereto as Exhibit A.

A. The intrinsic values of independent research:

BNY Securities Group has grown to be one of the largest aggregators of independent research in the world. We see four intrinsic values in this kind of research:

First, it is free of conflicts. While we believe the Global Settlement and recently adopted SEC and SRO rules [7] provide a framework for reform of research on Wall Street, the possibility of conflicts arising again is as enduring as human nature.

Second, independent research must stand on its own merits – it performs well or is no longer selected. Our clients are not required to purchase one product or service as a condition to receiving another. One of the products we offer our clients is access to a proprietary rating system, which allows the client to sort and analyze research on approximately 6000 issuers covered by over 150 research providers according to factors they select. Utilizing this rating system, our clients can measure performance of independent research and choose only those who are providing real value.

Third, independent research is serious, innovative and often completely different from Wall Street Research. Due to its independence -- and because of the system of commission payments – Market data providers were able to grow from ideas into a revolutionary and highly successful research services business.

Fourth, independent research serves the public interest. Independent research firms pioneered the concept of "forensic research," hunting through complex financial documents searching for mismanagement or worse. Long before the public or regulators reacted, various independent research firms uncovered the frauds of Enron, Worldcom, Tyco, HealthSouth and many more. We don't need less independent research we need more.

B. Research should be paid for with commissions:

We believe permitting fiduciaries to use client commissions to obtain independent research provides proper incentives to the asset management and brokerage communities to promote the development and distribution of products and services that benefit investors.

[7] Amendments to NYSE Rule 472 and NASD Rule 2711, and SEC Regulation AC

The first reason research should be paid for with commission dollars is that the value of research is included in the cost of the commission. Research has just as much "right" to be paid out of the proceeds of the trade, as does the cost of executing the trade. In fact, with recent increases in trading efficiencies and declines in overall commission rates, research is often the primary value received for the commission. Disclosure will better allow the investor to judge the value of the research and will make the asset manager and broker more accountable. Some assert that mutual fund managers engage in this practice for their own benefit or without knowledge of the investor or the mutual fund's board. The correct answer to these concerns is disclosure plus stricter fund governance.

There will be considerable negative consequences to banning the use of commissions to pay for research. Among the losers will be: investors, independent research, smaller mutual funds, agency brokers, and funds reliant on sophisticated market analytics.

We believe such a radical change will severely impair a growing and important independent research industry. We have heard from prominent independent researchers who believe that the damage will be even greater, possibly even fatal. Agency brokers and independent researchers are used to competing on an uneven playing field. The integrated investment banks dominate the market for many reasons but partially because they offer a number of highly valuable services which we do not. Allowing advisors to use commissions to pay for the research from integrated firms, but not for independent research, would simply be unfair and create a complete disadvantage.

It is not in the interests of investors in a mutual fund to require a mutual fund manager to add to the expenses of the fund when commission dollars can be, and always have been, used to defray the costs of research. Some propose a requirement that any and all research be paid for in cash and that it be included in the expense line of the fund. They assert that such requirements will push down commission rates. We believe it is far more likely that the net return to the investor will go down. We believe this will strike a hard blow to independent research just as it is coming into full bloom and will lead to the full service firms further reducing the amount of research they produce. This cannot be good for investors.

Most mutual funds often have limited internal research staffs. They rely almost exclusively on independent research. Some of the larger mutual fund complexes employ hundreds of their own researchers. Yet some of the highest returns in the industry are generated by the smaller funds. Reducing choice and hurting smaller mutual funds are not good ideas.

According to a 1998 SEC report, the smallest advisory firms use over half of their commissions for independent research, while the largest advisory firms use on average, just 8.3%. In other words, independent research provides essential support to smaller asset management firms; abolishing independent research commissions would extend the dominance of the largest mutual fund complexes, reducing choice and hurting smaller mutual funds are not good ideas.

Finally, but certainly not least important, is that since the costs of independent research are disclosed, they can be, and are, audited.

C. Comment on unbundling

The Bank of New York believes that commissions used to pay for research should be accounted for. We do not support full unbundling of commissions by integrated investment banks. Even though we, as agency-brokers, might benefit, we believe that full unbundling would be highly disruptive to the capital markets, difficult to accomplish and would likely lead to a drastic reduction in research.

V. Conclusion:

Soft dollar practices should continue to be regulated, but let's establish the problem first. The problem is that commission dollars used to acquire research are only disclosed in 10% of the cases -- when independent or third-party research is involved.

The Bank of New York agrees with the Securities Industries Association, which supports the current safe harbor for research created by section 28(e) and proposes that the SEC mandate reasonable additional disclosure. We are confident that the SEC can manage this responsibility well and we look forward to working with the Commission on this.

If we are to ban anything, let's ban the term "soft dollars." Let's call them what they are -- Independent Research Commissions -- and let's encourage their greater use.

Mr. Chairman, Senator Sarbanes, Members of the Committee, thank you. I would be delighted to answer any of your questions.

Attachments

A. Sample Client Statement
B. BNY Power Point Presentation entitled: <u>Independent Research Commissions</u>
C. BNY White Paper entitled: <u>Independent Research Commissions</u>