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Statement of the Shadow Financial Regulatory Committee

The Disclosure of Soft Dollars by Investment Advisors

February 13, 2006

The term "soft dollar" expenditures refers to funds taken out of brokerage fees and used to purchase research-related services for the adviser. According to *The Institutional Investor* (December 2005, p. 37), advisers typically use about 70 percent of brokerage commissions to buy research and other non-trading services. Congress has sanctioned the brokerage industry practice of charging one fee for both execution of trades and research-related services and thereby authorized investment advisers to pay more for brokerage services than necessary. This gave rise to the phenomenon of "soft dollars" and created a safe harbor that protected broker-dealers and investment advisers from liability for violating fiduciary or statutory duties in managing collective investment funds such as mutual funds, pension and funds, and endowments.

This obscures information that would help markets work better. And it creates incentives for labeling many services as "research-related," thereby shifting costs from the investment adviser to investors in the collective investment funds.

Combining brokerage and research-related expenses in a single fee makes it difficult for investors to evaluate the compensation of the investment advisor and to assess how conscientiously the adviser is representing investor interests. Originally, the definition of research-related expenses was quite narrow. But in guidance provided in 1986 the SEC broadened it to include expenditures made for any "lawful and appropriate" assistance to the investment adviser "in the performance of his investment decision-making responsibilities." This greatly expanded the scope for shifting expenses from the broker-dealer to the owners of the collective investment vehicles and exacerbated conflicts of interest between the investment advisers and the investors they serve. It also made it much more difficult for trustees and directors of collective investment funds to police these conflicts of interest.

The SEC October 2005 draft release regarding soft-dollar guidance addressed concerns about widespread abuses of soft-dollar expenditures such as labeling as legitimate research expenses some of the investment adviser's overhead or administrative expenses. Dubious items include payments for certified financial analyst review courses, membership dues, office rent, utilities, phone expenses, carpeting, marketing entertainment, meals, copiers, office supplies, fax machines, couriers back-up generators, salaries, legal and travel expenses and performance analysis used for marketing purposes. The new guidance would restrict safe-harbor protected research services to advice, analyses and reports and would rule out expenditures for overhead items such as salaries of research staff and computer hardware. The SEC has indicated that guidance on soft-dollar disclosure may follow.

Narrowing the definition of research-related expenditures protected by the safe harbor does limit the scope for conflicts of interest. But it does not address the issue of transparency.

To help markets monitor brokerage fees and expenditures of soft dollars, broker-dealers should be required to breakout the costs of trading expenses and itemize the research related expenses purchased with soft dollars. Investment advisors, in turn, should be required to disclose this information to the boards which oversee the collective investment funds and the investors in these funds. The recent agreement between Fidelity Investment Advisors and Lehman Brothers indicate that this disclosure is entirely feasible. Also the Financial Services Authority in London recently required that investment advisers in the United Kingdom breakdown commissions on each trade into execution costs and soft commissions (soft dollars).

Over time we would expect separate disclosure of trading and research expenses to increase competition and allow better control of the trading and research costs of investment funds. Itemizing soft dollar expenditures would subject them to greater scrutiny and enable investors and boards to evaluate whether they are worth the cost. Moreover, it is likely to induce investment advisers to follow Fidelity's example and pay directly for research which they value.

We urge the SEC to follow up its recent guidance on the kind of research that qualifies for the safe harbor, settling disclosure requirements that will enable investment advisers, oversight boards and investors in funds to monitor brokerage costs and soft-dollar expenditures. Greater clarity about costs should ultimately enable fund investors to obtain investment services at lower cost. If such disclosures were mandatory and hard to ignore, it is likely that the ultimate outcome will be that the investment advisor pays for research expenses and the investment funds pay for trading expenses.