



Soft Dollars: Industry Pushes Back, Congress Questions Cox

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By Amanda Gerut

The SEC chairman took a toned-down approach to soft dollars in testimony before the House Financial Services Committee this month.

Meanwhile, the industry has begun to push back against SEC Chairman Christopher Cox's surprising call in May for a repeal or revision of the statute that allows soft dollars.

The discussion over soft dollars seems to be moving in the same direction, which is keeping soft dollars in place but improving disclosure to fund boards and investors. In addition, there seems to be a desire to set up a disclosure regime that gives fund boards a better sense of how to value what shareholders are paying for. However, Cox's recent stance has left many scratching their heads, particularly among independent research firms, which would suffer if the practice of soft dollars disappeared.

At the SEC, work on disclosure guidance has not been halted due to Cox's public comments calling for a repeal or revision of the statute, spokesman Kevin Callahan confirmed in an e-mail. Callahan said he didn't have a timeline for when disclosure guidance might be forthcoming.

SEC officials have previously stated that the long-awaited guidance would be released by the end of this year. It's unclear whether the Commission now has other plans.

During the four hours the five SEC commissioners sat before members of the Financial Services Committee — the first time in more than 10 years all five commissioners have done so — the soft-dollar issue was raised at least three times. The first mention came during a statement from all five commissioners at the outset of the June 26 congressional oversight hearing.

"Recently, the Commission acted unanimously to publish interpretive guidance that clarifies that money managers may only use soft dollars to pay for eligible brokerage and research services — and not for such extraneous expenses as membership dues, professional licensing fees, office rent, carpeting, and even entertainment and travel expenses," Cox read in the statement, according to a copy from the SEC. "At the same time, we are examining the adequacy of current accounting and disclosure for soft dollars."

The statement was noticeably less sharp than what Cox has said publicly about soft dollars over the past six weeks and in letters to Congressional leaders. This milder stance may be an indication that Cox's views on soft dollars are not shared by all the commissioners, as some have maintained.

Following Cox's reading of the joint statement, the commissioners fielded questions from the members of the House Committee for more than three hours. Two congressmen, Spencer Bachus (R-Ala.) and William Lacy Clay (D-Mo.), both asked about soft dollars, it seems. Indeed, according to an unofficial transcript of the hearing and a close listening to the proceedings, both congressmen asked the same question with nearly identical words.

In a speech last July, regarding the Commission's soft-dollar initiative, said both congressmen to Cox, you said that the initiative was designed to remove some of the uncertainties about how the 30-year-old law authorizing soft-dollar arrangements applies in the current environment. What happened in the year since you made that comment to warrant a call for the complete repeal of the safe harbor provision? And are you indicating that there are no further steps the Commission can take to add clarity to the provision

or further changes of the matter currently under discussion at the Commission?

Cox answered both questions the same way. Essentially, he said that the Commission was focused on disclosure guidance. However, it is limited by the statute in what it can require in soft-dollar practices.

The Commission's flexibility and freedom of action is limited by a very specific statutory provision of the Securities Exchange Act of 1934, Section 28(e), said Cox during his testimony.

In the days leading up to the congressional hearing, the industry began its official response to Cox's call in May to repeal or revise the law. A June 20 letter from the Alliance in Support of Independent Research discusses many of the points Cox brought up in his letters to both Barney Frank (D-Mass.) and Christopher Dodd (D-Conn.) and points raised during a speech in May.

The Alliance letter explores the history of soft dollars and the tradition of paying for research bundled with commissions. The letter states that the cost of research, if paid by fund advisors, would be passed on to investors, could open the door to numerous lawsuits and would give hedge funds another advantage over mutual funds. In addition, the Alliance letter says Cox's statements came as an unwelcome surprise, considering the finalized soft-dollar guidance last summer.

"Given the fact that the extensive dialogue and debate leading up to the July 2006 Interpretive Release was virtually without challenge to the underlying premise that Section 28(e) would remain in place, your call for the repeal of Section 28(e) came unexpectedly," the letter states. "Business models and soft-dollar arrangements have been implemented based upon what was thought to be a workable and effective regulatory setting derived from the July 2006 release."

The Alliance letter also notes that the SEC could do quite a bit to promote better disclosure and transparency on research received from large Wall Street firms, which typically don't value their services.

Leonard Amoruso, general counsel of Knight Capital Group, whose firm is a member of the Alliance, said in an e-mail response to questions that the SEC could mirror what the Financial Services Authority in the United Kingdom has done with soft dollars. The FSA now requires advisors to disclose to clients what they pay for execution and research.

Such disclosure would, at the very least, give boards something concrete to review and ask questions about, notes John Meserve, director of BNY ConvergEx Group, parent company of BNY Jaywalk, another member firm of the Alliance.

There are two columns in the FSA model, says Meserve. One column deals with research and the other column deals with execution. Directors could add up the numbers in the research column and ask the advisor: What are we getting for this number?

It doesn't seem that the industry is moving toward valuing each analyst or each report or meetings with CEOs, Meserve says.

"But there needs to be some type of method to the madness," he says. "We need to take an approach and apply it consistently."

Indeed, Wall Street firms don't have a very compelling reason to put a value on a meeting with the chief executive of a company, a call with an analyst or a conference, for example. These services and traditional research reports are paid for with a higher price per share in trades. If a firm put a price on the services it provides, a possible next step could be a cap on the amount fund firms are willing to spend for the services, which could limit the revenues of the bigger firms providing research and services.

Plus, putting a value on these kinds of services is inherently difficult. If a portfolio manager gets a good idea after a meeting with a CEO or a specific idea from a broad research report, what is the value of the

information?

Boards, which are charged with determining that shareholders are receiving value for the dollars they spend in commissions, are handicapped by these dynamics out of their control, observers and SEC officials have said repeatedly.

For its part, the SEC expects that boards have a general idea of the amount of commissions across all clients that are being used to pay for their research, says Gene Gohlke, the SEC's Office of Compliance, Inspections and Examinations associate director. The SEC also requires that the value of the services shareholders pay for be reasonably related to what they paid, says Gohlke.

Advisors should have a process in place to evaluate research and products from brokerage firms through soft-dollar arrangements, he says.

In this area, examiners primarily review the process in place to vet the research, says Gohlke. Advisors don't need to quantify down to the nearest penny. Boards should understand the process in place and periodically review the research and services paid for with commissions, he says.

And it seems that if clients demand Wall Street firms to move in the direction of transparency, they will begin to oblige.

Amoruso says it seems that large investment advisors in the U.S. have begun to change the way they deal with research and services, determining beforehand how much they want to spend for proprietary research. The issue seems to be even more prevalent among global advisors concerned with having uniform disclosure standards, he says.

In fact, several firms with different techniques have cropped up offering services that aid in valuing the research that comes in to a fund firm. First Coverage, a Canadian company, provides such a service. (Please see our story "Products Pave Way for Greater Soft-Dollar Transparency" for more details.)

Randy Cass, the CEO of First Coverage, notes that mutual fund boards often tell him they want to implement a better process for demonstrating that shareholders are getting value for what they pay to brokerage firms. Much of the attention has come from boards, says Cass.

First Coverage helps portfolio managers or analysts isolate what research and services they think is important, such as face-to-face meetings with companies. From there, First Coverage works to provide the value of what the firm is getting and to compare it with what they're getting from other firms. The product is sold to buy-side firms. And then buy-side firms invite their sell-side counterparts to provide their information through First Coverage.

"Investors should be able to understand what funds got in return for spending their money as opposed to just the list of who they spent it with," says Cass.