

Testimony of

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June 28, 2006

The Relationship between the Independent Investment Research Profession and Investment Managers

Testimony before the United States Senate Committee on the Judiciary
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Senator Specter and other esteemed members of this committee, I am grateful for the opportunity to participate in this important hearing entitled, "Hedge Funds and Analysts: How Independent is their Relationship?"

My name is Howard Schilit. I am author of the book FINANCIAL SHENANIGANS: How to Detect Accounting Gimmicks & Fraud in Financial Reports, and founder and former president of one of the largest independent investment research firms, the Center for Financial Research & Analysis (widely known as CFRA). Since our founding in 1994, our research center has helped thousands of investors, lenders, insurance underwriters, and others analyze and interpret complex accounting issues and make better economic decisions.

Prior to founding CFRA, I spent 17 years as an accounting professor at American University in Washington, researching ethical (and sometimes unethical) behavior of auditors and publicly-traded companies and their executives. My research first led to the publication of my book FINANCIAL SHENANIGANS, and later to the founding of my research boutique.

As an author and one of the pioneers in the independent investment research profession, I have learned much about the behavior of investment managers (including long-only and hedge fund professionals) and independent research firms. I would like to share my observations about both the investment managers and the research providers, focusing on the current state and some recommendations to eliminate (or at least lessen) conflicts of interest that ultimately hurt smaller investors.

Investment Managers:

Investment managers can be segmented into two groups: those that can only own stocks (long-only managers), or those that can both own stocks and short stocks (typically, but not necessarily in a hedge fund structure). In recent years, both the long-only and hedge fund manager have searched for and found independent research, no longer relying exclusively on either their own in-house analysts or on sell-side (brokerage-company) research. The rise of high quality independent research boutiques has been a real benefit, not only for investment managers, but investors, in general.

Please note that investment managers (both long-only and hedge funds) are grouped together and should be evaluated as such. Aberrant behavior can occur just as easily in either group.

Independent Research Organizations:

Perhaps as many as five hundred investment research organizations are now selling a wide variety of products and services to investment managers. While most are still one or two person "mom-and-pop" operations, some have grown to generate tens of millions of dollars in revenue.

Some research firms have well thought out conflict of interest policies, while others may demonstrate little or no scruples.

I believe the most important result of this committee's work would be to move the investment research profession to establish policies and procedures to eliminate both real and perceived conflicts of interest.

Recommendations

Please allow me to offer a number of recommendations that will likely make it much more difficult for research organizations to be labeled as Independent:

1. For firms selling a subscription product, all subscribers should receive the product at the same time and in the same form. No subscribers should be given advance copies, nor should they ever be tipped-off of an upcoming report.
2. Research firms should refrain from using non-public information to trade in their own accounts, particularly, in advance of disseminating a report to clients.
3. Moreover, research firms that make recommendations for stock purchase or sale should not be permitted to also manage an investment fund. While this may sound self evident, today some research firms are also investment firms (either long-only or hedge funds).
4. Fees received from investment management clients should never contain a "percentage of profits earned from a research idea." Becoming a "partner" with a client would immediately strain the objectivity and independence of the research analyst.
5. Research firms that also provide investment banking services should be prohibited from using the "Independent" label.
6. Company-sponsored research creates special conflict-of-interest problems and should generally render the research firm as "not independent."
7. Just as an oversight board exists for auditors (the PCAOB) and many other professionals, such a board is needed to review policies, procedures and practices of investment research firms.

While this list is far from complete, I believe it provides a good starting point.

Relationship between Investment Manager and Research Firm

I would now like to talk briefly about the relationship between the investment manager and the research firm. Today, pressure can be brought to bear on research firms by investment managers, such as hedge fund professionals, to write or not write on certain companies, and perhaps even to provide non-public information to a high-paying client. My experience in running a large research center for over a decade is that by establishing transparent and verifiable rules for both clients and employees, rarely will clients push the research firm to act unethically. It is critical that at the beginning of a relationship with a client, he or she knows the rules of the game and also knows that they will always be enforced. That means occasionally firing a client who is unwilling to play by the ethical rules established by the research firm.

Concluding Thoughts

While there may be only isolated cases of bad behavior by investment managers or research providers, the need exists for a careful review of the practices of each group and how they interact. For sure, from time to time, investment managers will act badly and try to pressure the research providers to act unethically, to the detriment of other clients, or investors, in general. This problem is not too different than the one we all face as parents, as our usually wonderful children sometimes act badly and try to pressure us to do things we later regret doing. The absence of rules or failure to enforce them not only emboldens children to misbehave, but also some investment managers.

In conclusion, while I do not believe widespread unethical practices by independent investment research firms exist today, I think it is imperative for each firm to show transparent policies and procedures to lessen concerns about real or potential conflicts-of-interest.

I hope that these thoughts and recommendations help this committee and would be happy to answer any questions. Thank you.