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PERSPECTIVES

The End of "Soft Dollars"?

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Like "negative amortization" and "carried interest," "soft dollars" is a seemingly benign term designed to put a happy face on a practice that is harmful—even indefensible—to clients of institutional managers. Although brokerage commissions may be "soft" to the payer, they are "hard" to the recipient, who receives substantial cash rewards.

Over the past few decades, mutual fund shareholders have paid to brokerage and investment banking firms billions of dollars in commissions that have far exceeded the costs of executing the transactions.[1] This expenditure of shareholder assets has been legally justified by a peculiar provision added to the Securities Exchange Act of 1934 shortly after fixed commission rates were abolished by the U.S. SEC on 1 May 1975.

Until then, the use of soft dollars was rife. After all, commission rates were fixed—at astonishingly high levels—without volume discounts (e.g., the commission on 10,000 shares was 100 times the commission on 100 shares). Brokerage firms scarcely competed with one another to reduce the commission rate schedule, and mutual fund managers had no incentives to find loopholes for lowering the high commissions that long tradition had embedded in the system. Thus, "give-ups" from executing brokers to brokers providing other services to fund managers were widespread.

In fact, the incentives went the other way. Higher commissions subsidized brokerage firms' sales of mutual fund shares, which fostered cash inflows and raised the amount of assets under management, which, in turn, boosted the fees that fund managers earned on the additional assets and increased their profits. Moreover, the excesses were largely covert, and fund shareholders were left completely in the dark as to this subtle but substantial waste of their assets.

Nonetheless, in the post-1975 competitive environment, fund managers were concerned about the payment of brokerage commissions above the bare-bones rates that were certain to be charged for the large institutional transactions. In particular, fund managers feared that negotiated commissions would subject them to charges that they had breached their fiduciary duties to the funds they managed by paying higher commissions in exchange for brokers' investment research services.

A "Safe Harbor"

Congress quickly responded by enacting Section 28(e) of the Securities Exchange Act of 1934, which provided a "safe harbor" for advisers who "paid up" to acquire research and other services. Although these commissions were paid by the mutual funds themselves, they were controlled and directed by fund managers, who were employees of legally separate management firms. These firms were initially owned and operated largely by their founders and other executives. For most of the firms, public ownership followed; later, giant financial conglomerates became the industry model. (Today, 41 of the 50 largest fund management firms are publicly held, 32 by conglomerates.) Acquiring this array of services in return for soft dollars reduced the hard-dollar costs of research, administration, and marketing that the advisers would otherwise presumably have had to pay out of their own coffers.

The protection afforded by Section 28(e) was apparently insufficient for fund advisers. In 1986, the SEC was persuaded to extend its interpretation of Section 28(e) to a wider range of permissible uses of soft dollars (in truth, excess brokerage commissions), including "mixed-use" products and services that covered both research and administrative costs (e.g., computer hardware, communications equipment, and publications) that the advisers would

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Note: The views expressed in this article are the author's alone and do not necessarily reflect the views of Vanguard's current management. The managers who supervise the funds under Vanguard's direct management pay commissions solely for the execution of portfolio transactions and do not pay for distribution, research, or marketing services with soft dollars.

otherwise have had to pay with their own hard dollars. This additional flexibility further blurred the distinction between soft and hard dollars.

A Case in Point

The use of soft dollars for broker support inevitably reemerged as a powerful force in fund marketing. Beginning in 2003, the SEC at last took formal action—in fact, separate actions—against five major, highly respected managers and brokers. Despite the lack of a clear regulatory path, the money managers and brokers involved agreed to settle the actions (without admitting or denying the charges) for a total of $192 million. (I recall no broad publicity about these settlements.)[2]

In 2005, the National Association of Securities Dealers (NASD) brought another enforcement case, this time against one of the nation's largest and most respected mutual fund firms. The case clearly illustrates the corrupting nature of soft-dollar payments. According to the NASD, the written record showed that the fund distributor had worked out a "business plan" with its leading retailers that guaranteed the retailers "financial support" in the form of "revenue sharing" based on the sales volume of its funds' shares. These amounts were greater than the actual sales loads and 12b-1 fees (deferred commissions, paid out of fund assets) that the retailers received for their efforts.

Beginning in the early 1990s, the distributor made payments equal to 10–15 bps (0.10–0.15 percent) of its annual sales volume to its 75 highest-selling retailers from the previous year. (In addition, the distributor paid another 5 bps from its "marketing pool," paid indirectly by the funds themselves.) The NASD charged that these payments were a violation of the 1981 rule that prohibited its members from promising or arranging "a specific amount or percentage of brokerage commissions conditioned upon . . . [the] sales of [fund shares]" (2006, p. 14).

The NASD Enforcement Division calculated that the excess commissions paid by the *funds* (as directed by the *manager*, on the advice of the *distributor*) totaled more than $98 million in 2001–2003 alone and found that the funds had been damaged by at least that amount. It recommended that the distributor pay a fine of $98 million. The NASD Hearing Panel, however, reduced the penalty to $5 million, apparently based on the stated ground that the distributor's payments to brokers were "consistent with practices that had arisen in the fund industry over a number of years." This decision would be difficult to characterize as anything other than "if everyone else is doing it, I can do it too." But according to David F. Swensen, head of the Yale Endowment Fund, these long-standing "pay-to-play" revenue-sharing practices represented a "deadweight loss to investors" (2005, p. 274).

The distributor's nominal $5 million penalty was little more than a "knuckle rapping" in light of the estimated $15 *billion* in management fees received by the adviser, the distributor's corporate parent, over the 2001–07 period.[3] In its report, the hearing panel noted that the distributor's employees (including its president) "repeatedly testified that the damaging documents did not really mean what they plainly said," and the panel found this testimony "disingenuous, to say the least" (NASD 2006, p. 3). Unlike in the earlier SEC cases, the distributor appealed the hearing panel's decision, but its appeal was denied.

More Interpretations

The ensuing years have seen numerous technical reinterpretations of Section 28(e). In August 2004, the SEC barred mutual funds from using *directed* commissions to nonexecuting brokers (as opposed to excess payments to executing brokers) to compensate Wall Street firms for their research. The fund industry's Investment Company Institute saluted this tiny step as "a milestone that will benefit fund investors and strengthen the operating integrity of mutual funds" (2004).

Early in 2006, the SEC seemed to reverse that interpretation in two "no action" letters to Goldman Sachs that approved client commission-sharing arrangements (CCSAs) under which a fixed percentage of an institution's commissions may be promised to a third party that provides research services. That reversal would seem to confirm Swensen's view:

> The eleventh-hour conversion of the dirty scheme's trade association masks an ulterior agenda. . . . The investor-hostile practice of pay-to-play continues, [and the] odious obligations [remain as] fund companies find other ways to deploy their ill-gotten gains. (2005, pp. 277–278)

Later in 2006—31 years after the enactment of Section 28(e)—the SEC took yet another step to regulate the practice of pay-to-play. The new rule, 12b-1(h), prohibited any mutual fund firm from compensating brokers for any sale of shares by directing its transactions or commissions to such brokers unless the fund's "board has approved policies and procedures reasonably designed to prevent . . . taking into account the brokers' sales of shares . . . [or] entering into any agreement (whether oral or written) . . . in consideration for promotion or sale of [the fund's] shares" (SEC

2004). Thus, the rule gave funds free rein to compensate brokers but prohibited any quid pro quo. Nevertheless, one would be hard put to believe that tacit agreements—a wink and a nod followed by a commission—have been eliminated.

Nothing in the rule precludes the funds from executing transactions with large brokers that sell their shares and continuing to pay huge commissions. The funds in the group that was censured by the NASD, for example, reported annual commissions in the range of $200 million on portfolio transactions over the 2005–07 period. An unknown but substantial portion of these commissions was directed to large broker/dealers known to be major sellers of shares of the mutual funds managed by the broker/dealers' investment advisers. Thus, Swensen's skepticism of whether the days of pay-to-play are over seems to be on target. He has noted that even if this preferential treatment is controlled, "the fund companies will find other measures to gain special status and the brokers will find other mechanisms to profit at the expense of [fund] clients" (2005, p. 281).[4]

"Paying Up" for Research

The other use of soft dollars—involving substantial sums, although probably far smaller than those found in broker support—is "paying up" for investment research services, which are surely difficult to put a hard-dollar value on. Although widely disseminated sell-side Wall Street research—whether independent or a product of investment banking and brokerage firms—has proved to have little, if any, demonstrable economic value, that fact does not seem to matter. When a mutual fund manager buys research with commission dollars, far less attention is paid to the cost–value equation than would be the case were the research paid for out of the management firm's own revenues. Put another way, when one is spending other people's money, one is likely to be less inclined to drive a hard bargain than when one is spending one's own money.

The more interesting issue is why the users of such research—largely the buy-side money managers, market strategists, and security analysts of the institutional investing community—place much credence in Wall Street research in the first place. The nearly universal consensus among research providers and users alike is that if Wall Street research could be purchased with hard (i.e., real) dollars only, the amount spent on it would plummet. For that reason, Wall Street continues to fight the battle to maintain the legality of soft-dollar arrangements.

That all research lacks intrinsic value, however, does not necessarily follow. Although the value of an original, comprehensive, and insightful research study obviously becomes zero at the moment it becomes available to all market participants, the value—however positive or negative it may prove to be—of the same study by the research department of a single institution remains high so long as the information remains proprietary.

Proprietary Research?

If the value of mass-marketed Wall Street research has a half-life measured in moments and if proprietary institutional research has at least some potential to add value to those lucky enough to capitalize on it (albeit at the expense of those on the opposite side of the transaction), the direction of change should be obvious. In their search for the alpha of higher risk-adjusted returns, mutual fund firms should beef up their own proprietary portfolio management, security analysis, and internal research capabilities. Doing so, of course, would take real dollars, not soft dollars. But those real dollars would be a drop in the bucket of the revenues of mutual fund managers. Last year, for example, mutual fund shareholders paid nearly $70 billion in aggregate fee revenues to their managers in the form of advisory fees. According to my rough estimates, however, only about $4 billion of that amount—less than 6 percent—was spent on investment supervision and research, the very service of "professional management" that is said to be the prime reason new investors select funds as the medium for their investing.

In a business in which the profit margins of managers can exceed 50 percent (even after the huge marketing costs that fund firms expend to bring in new money), increasing expenditures on investment management would hardly seem to be a tall order. And if larger research budgets improved fund performance even modestly, additional fee revenues on assets enhanced by higher returns—and by the cash inflows that tend to accompany superior performance—would more than repay the extra cost. Alas, however, no evidence supports the proposition that spending more dollars on research improves fund returns. More importantly, the relative paucity of research spending by the lucrative management firms speaks for itself.

Only time will tell whether a major shift from public research to private research will lead to a larger research community or to a smaller one. But the reality that makes the research dilemma so interesting is that no seller can exist without a buyer and no buyer can exist without a seller. One wins, the other loses. As a result, for the market as a whole, research—whether paid for by the funds directly or through brokerage commissions—is part of a deadweight cost that turns a zero-sum game into a loser's game.

Although the billions spent by Wall Street and institutional managers on research doubtlessly elicit useful information, stimulate trading activity, and foster liquidity, the costs of that research—together with all the other, higher costs of financial intermediation—guarantee that beating the market will remain a loser's game for investors as a whole. Thus, we ought to ask some existential questions about investment research: What is it really worth? How should it be valued? Should it be mass-produced or proprietary? Who buys it? How much does it cost? Who bears that cost?

What Is the Defense for Soft Dollars?

The amount of institutional commissions generated by *trading* in stocks (the polar opposite of *investing* in stocks) is massive. In 2007, mutual funds alone bought stocks worth some $3.8 trillion and sold another $3.7 trillion, a total trading volume of $7.5 trillion, which constitutes well over 100 percent of the $5.5 trillion value of all common stocks held by actively managed funds.[5] Greenwich Associates has estimated that commissions for 2008 for all institutional investors will total $12 billion (Ramage 2008). This astonishing trading volume generates a lot of commissions to be spread around and likely encourages fund managers to relax their fiscal self-discipline.

Can such pervasive soft-dollar practices be defended? I believe the answer is no. The payment of excess brokerage commissions for marketing enriches both managers and brokers, and payment for external research relieves managers of their own perceived need for internal research, all of which inevitably reduces shareholder returns industrywide. Fund managers are *agents* who are spending other people's money—the assets of their *principals*—for their own benefit. Such practices violate the fiduciary duty of agents to serve the interests of their principals, a duty dating back to English common law.

I have yet to see a single serious defense of soft dollars for marketing, except for vague allegations (bereft of either supportive evidence or quantification) that fund management fees are systematically reduced *by larger amounts than the cost of the soft dollars*—allegations that I simply do not believe. Absent such a cost–benefit equation, we can only conclude that the payment of soft dollars for marketing is a waste of shareholder assets.

A Defender of Soft Dollars for Research

The formal defense of soft dollars for research has been left to a single academic advocate (as far as I can tell from my internet sleuthing). D. Bruce Johnsen (forthcoming) asserts that soft dollars for research are an innovative and efficient form of economic organization that benefits fund investors.[6] He essentially argues that any attempt to prohibit soft dollars for research completely ignores a substantial body of economic theory that has been widely embraced by antitrust regulators and federal courts. That theory—"transaction cost economics"—suggests that paying up for "experience goods" such as institutional portfolio brokerage is quite rational and—more likely than not—beneficial to investors.[7] He discounts the likelihood of self-dealing:

> Under the common law of agency, conflicts of interest reflect merely the potential for self-dealing. They are inevitable in a specialized intermediary economy and only rarely result in actual agent self-dealing or other forms of disloyalty. (forthcoming, p. 7)

I am no expert in the law, in the field of "experience goods," or in the inevitability of agent self-dealing in a specialized economy. (Such self-dealing, however, is clearly rife in the financial sector; for example, disloyalty of fund manager to fund shareholder is evident when soft dollars are used for marketing support.) But Johnsen makes a strong argument:

> Properly balancing conflicts of interest is a task best left to portfolio managers, [to] fund advisers, and ultimately to fund directors, subject to the requirement that truly material conflicts must be disclosed. (forthcoming, p. 8)

Nevertheless, given the advisers' temptation to use soft-dollar commissions for their own benefit (or, more commonly, that of their corporate parents) rather than for the benefit of the owners of the investment funds, putting the advisers in charge of distributing the huge transaction flows of the funds they manage—separately owned corporations of trusts—strikes me as "sending the goat to mind the cabbage patch." Although fund directors ought to monitor the payments, they continue to be the captives of the information provided by the very advisers who manage the funds. In short, I find in Johnsen's paper no persuasive justification for the use of soft dollars for research.

Conclusion

The sooner the SEC finds a better way than the 2008 standard to enforce a prohibition on the payment of soft dollars in return for selling fund shares, the better off the industry will be. Given the fund industry's self-interested creativity, finding that better way will be no easy task. Although the use of soft dollars for Wall Street research is firmly embedded in the investment industry, the handwriting on the wall suggests that such use of soft dollars—directed to either the executing broker or the research firm—will eventually come to an end because of higher fiduciary standards, more complete disclosure, and greater governance independence of funds from their managers.

I am not completely opposed to Wall Street research; the constant updating of financial information by talented, often brilliant, security analysts and strategists clearly enhances market efficiency and lowers execution costs. But the failure of the analyst community to foresee the unhappy results of the flawed financial statements of Enron Corporation, WorldCom, and, more recently, scores of banks and investment banks hardly suggests a high-value-added research product.

Nevertheless, I see no reason why Wall Street firms should not compete openly in cost and quality; and that competition would be better done if the financing was above board, with full disclosure, and with hard dollars paid to the firms by the fund management company, whose very designation implies that it accepts responsibility for the management of the fund. Nor am I suggesting that fund managers cut back on their research.[8] Active investing and trading in stocks in an information vacuum do not seem particularly realistic, although passive managers (i.e., indexers) do just that. Passive managers usually minimize shareholder costs, and the record shows that such managers have provided superior returns to fund shareholders. These demonstrably superior returns, together with minimal management fees and negligible transaction costs (and high tax efficiency), are also certain to continue.

One has only to glance at the long and substantial history of soft dollars—industry practices, SEC releases, comments, regulatory decisions, articles in the media—to wonder whether the many artifices that have been developed in spreading billions of soft dollars throughout the financial system must finally fall because of their own ponderous weight. Perhaps, at long last, they are beginning to do exactly that.

Two relatively new harbingers of change would seem to be moving in that direction. One is client commission-sharing arrangements, whereby institutional managers and brokers set aside a specified share of commissions for research services. CCSAs—which at least provide precise and measurable data that ought to be fully disclosed—are growing at a rapid rate: Greenwich Associates estimates that 30 percent of institutional investors already use CCSAs and another 60 percent will soon adopt the practice (Sorondo 2007). Nevertheless, CCSAs, although apparently more respectable than soft dollars because they are more transparent, are still "kissing cousins" of soft dollars. But because CCSAs do not get to the heart of the soft-dollar problem, they will probably prove to be only a bridge to a better approach.

One such better approach is Fidelity Investments' decision, following the SEC's 2006 guidance, to separate research from trading commissions and to *pay for research directly in cash*. Although I see little, if any, evidence that other large institutional managers are following Fidelity's lead (for obvious reasons), pressure from regulators, public opinion, and even enlightened self-interest may force other major institutions to adopt Fidelity's policy. Ultimately, the era of soft dollars, for marketing and research alike, must come to an end, simply because soft dollars ill serve fund investors. The end of soft dollars cannot come too soon.

This article qualifies for 0.5 CE credit.

Notes

1. Although soft-dollar commissions are also paid by other institutional managers, the mutual fund industry appears to be the largest generator of such payments by far and faces the most obvious conflicts of interest.
2. In the interest of full disclosure, I have discussed these cases with Ari Gabinet, the SEC lead attorney who developed them. He is now a senior attorney at Vanguard.
3. The hearing panel seemed confounded by the parties' byzantine corporate structure, in which (1) the distributor (which arranged the payments) could merely request that (2) the adviser direct the payments to the retailers, with all the payments actually made by (3) the funds themselves. Although all three were independent legal entities, only the distributor (and neither the manager nor the funds) was an NASD member.
4. For example, fund managers continue to use "marketing pools" by making payments directly from the management fees they receive from fund shareholders. Presumably, this practice is considered legal. But fee reductions to shareholders would obviously have the same immediate impact on their own lives.
5. These are the author's calculations using data from Strategic Insight and the Investment Company Institute's 2008 Fact Book.

6. Professor Johnsen, a law professor at George Mason University, has written an erudite, albeit highly theoretical, paper. I urge interested readers to peruse all 81 pages of it.
7. In contrast to "experience goods," whose value is difficult to assess immediately, the value of "search goods" can be easily assessed at the point of sale.
8. Another troubling aspect of the payment of soft dollars by managers of fund complexes has attracted little attention. Simply put, the larger funds in the complex often generate the lion's share of the commissions but the smaller funds benefit from substantial Wall Street research. Would it not be improper (and a violation of fiduciary duty) if the research benefiting the smaller funds were paid for by the commissions generated by the larger funds? In its 2008 proposed guidance for fund advisers, the SEC expressed its concerns about this issue and recommended that fund advisers consider such conflicts.

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