DIRECTED BROKERAGE, CONFLICTS OF INTEREST, AND TRANSACTION COST ECONOMICS

D. Bruce Johnsen, Professor of Law
George Mason University School of Law

***Arizona State Law Journal*, Forthcoming**

George Mason University Law and Economics Research Paper Series

08-24

This paper can be downloaded without charge from the Social Science Research Network at http://ssrn.com/abstract_id=1125419

DIRECTED BROKERAGE, CONFLICTS OF INTEREST, AND TRANSACTION COST ECONOMICS

D. Bruce Johnsen*
Professor of Law
George Mason University School of Law
djohnsen@gmu.edu

Draft 2, Version 1
March 2008

© Preliminary draft; do not cite, quote, or redistribute without the author's permission.

* J.D., Ph.D. (Economics). I thank Patrick McLaughlin for helpful comments and the Law & Economics Center at George Mason University School of Law for generous summer research support.

DIRECTED BROKERAGE, CONFLICTS OF INTEREST, AND TRANSACTION COST ECONOMICS

D. Bruce Johnsen

Abstract

This paper relies on the economics of transaction costs to assess the likely effect on investor welfare of the U.S. Securities and Exchange Commission's (SEC's) prohibition on an innovative business practice known as directed brokerage. Its key insight is that the quality of a broker's execution of portfolio trades is difficult for a mutual fund adviser to assess until it is too late ─ that is, execution quality is an "experience good." In the meantime, low-quality brokerage can substantially reduce investor returns. To have the incentive to provide high-quality execution, a broker must expect to receive a stream of premium portfolio commissions in excess of his execution costs, much along the lines of a Klein-Leffler quality-assuring price premium. Competition between brokers for premium commissions leads them to post a performance bond with advisers equal to the present value of the expected premium stream. With directed brokerage, the bond takes the form of up-front broker effort devoted to marketing the fund's retail shares. Once having posted the bond, any broker that provides low-quality execution will eventually be terminated by the adviser and lose the premium stream that provides a normal return on the up-front bond. Low-quality brokerage is thus screened out. Contrary to its intended effect, the SEC's prohibition on directed brokerage likely reduces investor welfare by failing to recognize the problems inherent in transacting experience goods.

TABLE OF CONTENTS

I. INTRODUCTION

II. INDUSTRY STRUCTURE

III. REGULATORY HISTORY

A. The Decline and Fall of Fixed Commissions

B. The Rise of Directed Brokerage

C. SEC Scrutiny

D. Prohibition

IV. A TRANSACTION COST ANALYSIS OF DIRECTED BROKERAGE

A. Institutional Brokerage as an Experience Good

B. Adverse Selection, Screening, and Quality Assurance

C. Directed Brokerage as a Quality-Assuring Performance Bond

D. Vertical Arrangements and Interbrand Competition

V. INVESTOR WELFARE

VI. CONCLUDING REMARKS

DIRECTED BROKERAGE, CONFLICTS OF INTEREST, AND TRANSACTION COST ECONOMICS

D. Bruce Johnsen

"Money in a commercial society frequently changes hands for reasons that may seem obscure or suspicious to those not party to the deal, but it's a mistake to imagine that eliminating the most visible manifestations of a conflict of interest really eliminates the conflict. . . The idea that, with enough rules, we can eliminate conflicts of interest from commercial life is, unfortunately, wishful thinking." ─ Holman W. Jenkins, Jr.[1]

I. INTRODUCTION

It would be fair to say the world of institutional securities brokerage is as inscrutable to the average mutual fund investor as the workings of a complex watch. Quite rationally, few seem to know or care exactly how it works as long as it functions tolerably well. Yet, to anyone interested in transaction cost economics, institutional securities brokerage offers a tremendous opportunity to study the welfare effects of regulation. This is because a lot of money is at stake, among other reasons, so private ordering by market participants is both finely tuned and highly geared. Competition is intense, specialization is acute, reliance on agents is commonplace, principal-agent conflicts are inevitable, and economic organization to properly craft agent incentives is carried to the last decimal place. Regulatory changes are sure to influence the behavior of market participants and are likely to have a profound effect on investor welfare, possibly in counter-intuitive ways. Antitrust experience shows that careful transaction cost analysis can make rational sense out of otherwise puzzling business practices. Unintended consequences can thereby be identified and misguided regulation avoided.

Directed brokerage occurs when a brokerage firm (broker-dealer) commits to marketing the shares of participating mutual funds to the retail investing public in

[1] Holman W. Jenkins, Jr., Business World: *How Much Business Purity is Too Much?*, Wall Street Journal, Apr. 30, 2003, p. A17.

exchange for the fund adviser's promise to send it future portfolio trades at premium commission rates.[2] The adviser is said to "pay up" for fund sales effort. An alleged conflict of interest arises because fund shareholders implicitly pay brokerage commissions, thereby allowing the adviser to use client assets to increase the asset base to which its advisory fee is tied ─ the result is said to be unjust enrichment. What is more, the arrangement may give the broker an incentive to push unsuitable funds on retail investors.

In the wake of the mutual fund scandals sparked in September, 2003, by then New York Attorney General Eliot Spitzer,[3] the U.S. Securities and Exchange Commission (SEC) reexamined the conflicts of interest facing mutual fund advisers in their institutional brokerage allocation decisions. Although the SEC had formally condoned it for decades, directed brokerage quickly became an object of reform, no doubt owing to its innovative character. Within six months the SEC concluded administrative actions against two prominent financial firms for inadequately disclosing their directed brokerage arrangements, assessing them $50 million each in fines, disgorgement, and civil penalties and requiring them to satisfy various detailed ongoing compliance undertakings.[4] In September 2004 the SEC adopted a rule completely prohibiting directed brokerage, concluding it creates intolerable conflicts of interest.[5]

Relying on the economics of transaction costs, this paper assesses the likely effect of the SEC's directed brokerage prohibition on investor welfare.[6] Its key insight is that

---

[2] The adviser takes investors' capital and buys securities, which it places in a portfolio along with other securities. From time to time the adviser adjusts the composition of portfolio securities, normally using an institutional broker to execute the trades. See discussion *infra*, at ?

[3] *See, e.g.*, Marcia Vickers, Mara Der Hovanesian, and Amy Borrus, *How to Make the SEC Look Stodgy*, BUSINESS WEEK, September 15, 2003, Pg. 40.

[4] *In the Matter of Morgan Stanley DW, Inc.*, Securities Act Release No. 8339 (November 17, 2003), Admin. Proc. File No. 3-11335., and *In the Matter of Massachusetts Financial Services Company*, IAA Release No. 2224 (March 31, 2004), Admin. Proc. File No. 3-11450.

[5] *Prohibition on the Use of Brokerage Commissions to Finance Distribution*, Investment Company Release No. 26591 (Sept. 2, 2004).

[6] My analysis relies specifically on two seminal works in transaction cost economics: Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) and Benjamin Klein and Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J.P.E. 615 (1981). Based on a recent analysis of citations, these articles ranked third and 59th, respectively, among all articles published in 41 prominent economics journals between 1970 and 2002. E. Han Kim, Adair Morse, and Luigi Zingales, *What Has Mattered to Economics Since 1970* (Sept. 2006), NBER Working Paper No. W12526. Available at SSRN:

the quality of a broker's execution of portfolio trades is difficult for a mutual fund adviser to assess until it is too late — that is, execution quality is an "experience good." Moreover, low-quality brokerage can substantially reduce investor returns. To have the incentive to provide high-quality execution, the broker must expect to receive a premium commission in excess of his execution costs, much along the lines of a Klein-Leffler quality-assuring price premium.[7]

Where execution quality is uncertain, the adviser cannot demand the broker cut its commission because this would lead to a reduction in brokerage quality that would leave fund investors worse off. Instead, competition between brokers for premium commission business leads them to post a quality-assuring performance bond with advisers equal to the present value of the expected stream of premium commissions. With directed brokerage, the bond takes the form of up-front broker effort devoted to marketing the fund's retail shares. Once having posted the bond, any broker that provides low-quality execution risks being terminated by the adviser and losing the premium commission stream that provides a normal return on its investment. Low-quality brokerage is thus screened out.

Contrary to its intended effect, the SEC's prohibition on directed brokerage likely reduces investor welfare by requiring the adviser to forgo high-quality execution, by preventing it from "recapturing" the full value of the performance bond for the benefit of the portfolio, and by reducing brokers' incentives to make the proper suitability determination in marketing fund shares to the retail public.

In antitrust parlance, directed brokerage is a classic example of a vertical marketing arrangement. Such arrangements were once summarily condemned as anticompetitive under Section 1 of the Sherman Act, but over time economists, antitrust agencies, and federal courts have increasingly recognized them as efficiency enhancing.[8] This evolution is largely a result of the rising prominence of transaction cost economics.

---

http://ssrn.com/abstract=931371. Coase's seminal articles, *The Nature of the Firm*, 4 ECONOMICA 386 (1937) and *The Problem of Social Costs*, 3 J.L. & ECON. 1 (1960), which provide the foundation for transaction cost economics, antedated the database used for this study but are surely among the most widely cited articles in economics for all time.

[7] Klein & Leffler, *supra* note ?

[8] Leegin Creative Leather Products v. PSKS, Inc, 127 S. Ct. 2705 (2007) (reversing a near-100-year Sherman Act precedent treating minimum resale price maintenance as illegal *per se*).

Pioneered by 1991 Nobel Prize winning economist Ronald H. Coase, transaction cost economics has been likened to Einsteinian physics in its revolutionary influence and power to explain how people organize their economic affairs.[9] Whether applied to the marketplace, the business firm, or the family, transaction cost economics introduces the equivalent of friction into the neoclassical model of impersonal exchange of goods whose quality is easily evaluated at the moment trade occurs.[10] The results have been remarkable, as reflected in a virtual revolution in antitrust and other areas of law.[11]

With the SEC's added scrutiny of principal-agent conflicts, many of the salient legal issues long since resolved by transaction cost economics in the antitrust arena are now emerging for the first time in investment company regulation.[12] Relevant examples for this paper are mechanisms to assure the quality of difficult-to-evaluate goods and the social value of retail product promotion. Owing to the collective action problem they face, mutual fund investors may lack actual knowledge of these conflicts or the wherewithal to directly monitor their advisers and brokers. But in a well-functioning competitive marketplace — and the U.S. financial is surely that — business practices that give rise to persistent conflicts of interest on one dimension of a transaction, no matter how unusual or puzzling, often resolve or ameliorate more serious countervailing conflicts on other dimensions. After all, the prospect of shared gains from trade is what brings transacting parties together in the first place. Competitive forces invariably lead

---

[9] R.H. Coase, The Problem of Social Costs, 3 J.L. & ECON. 1 (1960). For a discussion of the influence of transaction cost economics in antitrust and public utility regulation, see Paul L. Joskow, Paul L. 7 J. LAW & ECON. ORG. 53 (1991).

[10] Johnnie L. Roberts and Richard Gibson, *'Friction' Theorist Wins Economics Nobel*, Wall Street Journal, Oct. 16, 1991, Section B, page 1.

[11] See, generally, Richard A. Posner, ECONOMIC ANALYSIS OF LAW (7th ed, 2007), as well as any issue of THE JOURNAL OF LAW & ECONOMICS. See also *Efficiencies and Antitrust: A Story of Ongoing Evolution*, Prepared Remarks of Thomas B. Leary, Commissioner, Federal Trade Commission, ABA Section of Antitrust Law, 2002 Fall Forum, Washington, D.C., November 8, 2002, available at http://www.ftc.gov/speeches/leary/efficienciesandantitrust.shtm#N_1_ and Improving the Economic Foundations of Competition Policy, Remarks by Timothy J. Muris, Chairman, Federal Trade Commission George Mason University Law Review's Winter Antitrust Symposium January 15, 2003, Washington, D.C., available at http://www.ftc.gov:80/speeches/muris/improveconfoundatio.shtm.

To be more precise, Coase's work on the economics of transaction cost also sparked economists to apply neoclassical economic theory, more generally, to antitrust and other areas of law, a trend that may have started with Aaron Director at the University of Chicago Law School. Edmund W. Kitch, *The Fire of Truth: A Remembrance of Law and Economics at Chicago*, 1932-1970, 26 J.L. & ECON. 163 (1983) (recounting the intellectual history of the Chicago School of law and economics).

[12] See Joskow, *supra* note ? (a primary focus of transaction costs economics is principal-agent conflicts).

them to resolve conflicts of interest if, and to the extent that, the cost of transacting allows.

A careful transaction cost analysis suggests it is a mistake to prohibit directed brokerage in the interest of investor protection simply because it gives rise to conflicts of interest. Despite the lofty pronouncements one hears from securities regulators and market commentators, the current crusade to eliminate all conflicts of interest in financial markets is an impossible undertaking.[13] The best that can be hoped for is that regulation is structured to reduce the transaction costs market participants face prospecting for better ways to avoid actual agent self-dealing in their inexorable pursuit of wealth-enhancing trade.[14] Properly balancing conflicts of interest is a task best left to a fund's adviser and ultimately to its board of directors, subject, of course, to the requirement that truly material conflicts must be adequately disclosed.

With these thoughts in mind, this paper proceeds as follows. To lay a foundation, Part II sketches the structure of the mutual fund and institutional brokerage industries. Part III provides a brief history of directed brokerage regulation. Part IV provides a

---

[13] Weinberg, *Pensions, Pols, Payola*, Forbes Vol. 179, (March 12, 2007), p. 42 (Richard Moore, now Treasurer of North Carolina, and a "man [who] has built his career crusading against conflicts of interest on Wall Street" stated before the U.S. Senate Commerce Committee in 2002 "We are demanding that broker/dealers and money managers eliminate actual and potential conflict of interest from the way they pay analysts and conduct their affairs."); Lou Dobbs, The Dobbs Report: *Reform Wall Street; Usually a foe of regulation, I think the government may need to act.* Money (July, 2002), p. 65 ("In my view, the Merrill settlement did not produce the kind of meaningful change needed to eliminate conflicts of interest and restore investor confidence."); U.S. Securities and Exchange Commission, Speech by SEC Chairman William H. Donaldson: *Closing Statement at Open Commission Meeting* (Washington, D.C.: August 18, 2004)("The two proposals the Commission approved today will help to further eliminate conflicts of interest that can compromise best execution decisions in fund portfolio transactions . . . ."); Simon Threadgold, *Brokers: Vertical Integration; A Level Playing Field, Post Magazine* (February 3, 2005), p. 26 ("The FSA also insists that brokers must operate in a way that eliminates conflicts of interest"); U.S. Securities and Exchange Commission, Speech by SEC Staff: Paul Roye, *Remarks before the Mutual Fund Directors Forum Fifth Annual Policy Conference: Critical Issues for Investment Company Directors,* (Washington, D.C.: February 17, 2005)("I hope . . . your fund groups and their service providers have addressed or eliminated conflicts of interest and practices that can compromise investor interests."); U.S. Securities and Exchange Commission, Speech by SEC Commissioner Roel C. Campos: *Remarks Before the Mutual Fund Directors Forum First Annual Directors Institute* (Coral Gables, Florida: February 28, 2007) ("government regulation in the U.S. and around the world employs as a critical part of their programs [sic] governance rules to protect investors and eliminate conflicts. . . . the purpose [of the fund governance provisions] is not to improve performance, but to eliminate a glaring conflict of interest."). Shapiro from BNA.

[14] Under agency law, a conflict of interest exists when the agent's interests are adverse to the principal, but an actionable breach of loyalty occurs only if the agent takes action adverse to the principal without the principal's knowledge. THE AMERICAN LAW INSTITUTE, RESTATEMENT OF THE LAW, SECOND, AGENCY (1958) §§ 23, 389.

transaction costs analysis of directed brokerage and reveals the conditions under which it is an efficient form of organization, reducing conflicts of interest by providing the parties with high-powered incentives to benefit investors. Part V examines evidence in support of the efficient organization hypothesis and assesses the likely effect on investor welfare of the SEC's directed brokerage prohibition. Part V provides concluding remarks.

II. Industry Structure

Mutual funds are investment pools organized as corporations or trusts under state law. To raise capital the fund issues shares to the investing public, with the proceeds placed in a more or less diversified portfolio of risky assets (primarily corporate stocks and bonds, government debt, etc.) and cash to which shareholders have a pro rata claim. The unique thing about mutual funds is that they stand open to issue and redeem shares at the daily net asset value of the fund next computed based on the reported prices of the underlying portfolio securities.[15] For this reason they are also known as *open-end funds*.[16] Owing to investor search costs, someone, normally a retail broker, must market the fund to public investors. Much of Americans' savings are held by mutual funds and managed by advisory firms regulated under the Investment Company Act (ICA, 1940)[17] and the Investment Advisers Act (IAA, 1940)[18] (collectively, "the `40 Act").

The ICA formally mandates that the adviser to a mutual fund be a vertically separate firm. The adviser provides management services through a long-term written contract periodically approved by the fund's board of directors or a majority of fund shareholders.[19] In reality, however, the adviser normally creates and promotes the fund, and fund boards almost invariably renew advisory contracts. What is more, even though Section 15(a) of the ICA prohibits direct assignment of the advisory contract, Section

[15] ICA Rule 22c-1, *Pricing of Redeemable Securities for Distribution, Redemption and Repurchase, and Time-Stamping of Orders by Dealers*, Investment Company Act Release No. 5519 (1968), 33 FR 16331, CFR §270.22c-1. [hereinafter *Pricing of Redeemable Securities*]
[16] In contrast, closed-end funds do not offer shareholders a redemption option. To cash out, a shareholder must sell his or her shares to other investors in the market.
[17] 15 U.S.C. Section 80a-1 through 80a-64 (1940) [hereinafter ICA].
[18] 15 U.S.C. Section 80b-1 through 80b-21 (1940) [hereinafter IAA].
[19] ICA Section 15(a), 15 U.S.C. Section 80a-15 (1940).

15(f) allows the advisory firm owners to profit from a sale of control in the advisory firm that results in an indirect assignment of the advisory contract. The relationship between the adviser and the firm lies somewhere in an economic netherworld between vertical integration (an extended firm) and long-term contract (market exchange).[20] Mandated vertical disintegration also applies to the function of marketing mutual fund shares, which must be performed by an "underwriter" that is legally separate, though in some cases affiliated with, the adviser.[21]

Advisory services include record keeping, custody of portfolio securities, and other ministerial functions, but in an actively-managed mutual fund they consist most importantly of portfolio management, normally provided by an employee of the advisory firm.[22] As an agent for the fund, an active adviser's primary charge is to hold an efficiently diversified portfolio, to use his best efforts to perform or acquire research to identify mispriced securities, and to buy or sell those securities to make a profit for the portfolio before the market fully corrects the pricing error. Once having identified a potentially profitable trade the adviser traditionally hires an institutional securities broker to "execute" it. In selecting between brokers, the adviser has a fiduciary duty to the fund to assure "best execution" of portfolio trades.

The executing broker is also an agent of the fund. Like the adviser, he is subject to a fiduciary duty of "best execution" in performing portfolio trades. This requires him to search for willing sellers or buyers and to contract with them for the purchase or sale

[20] See R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937) and Benjamin Klein, Robert G. Crawford, and Armen A. Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 JOURNAL OF LAW & ECONOMICS 21 297 (1978).

[21] ICA Section 12 -- Functions and Activities of Investment Companies: b. Distribution by investment company of securities of which it is issuer: It shall be unlawful for any registered open-end company . . . to act as a distributor of securities of which it is the issuer, except through an underwriter . . . . 15 USCS § 80a-12.

[22] Mutual funds can be divided into active and passive styles. An index fund attempts to duplicate a specific benchmark such as the Standard & Poor's (S&P) 500 Index and therefore involves little in the way of active management. Most actively managed mutual funds are part of a family of funds that contract for management services with a central advisory firm. Each separate fund has one or more portfolio managers, who are employees of the advisory firm (or possibly independent contractors), each with specific responsibilities and separately-negotiated compensation paid by the adviser. In a stand-alone fund the adviser and the manager may be one and the same. For simplicity, I use the term "adviser" and "manager" interchangeably unless the context requires greater care.

of the security on the best possible terms for the benefit of investors.[23] In consideration, the broker typically receives a commission averaging five or six cents per share.[24] Although the manger may be able to trade through a proprietary network or with a discount broker for as little as a penny a share, institutional brokers provide the benefit of specialization, access to a variety of securities exchanges and other exclusive trading networks, and, perhaps most important, anonymity. There is little doubt these specialized agents effectively reduce the total costs of transacting portfolio securities in the vast majority of trades.[25]

Both the brokerage industry and the mutual fund industry are highly competitive by any discernable standard. There are literally thousands of brokerage firms and mutual funds in the U.S. economy. Industrial concentration is low and declining over time, and both innovation and entry are prolific. With many mutual funds being part of a "complex" or "family" of mutual funds managed by a central adviser, the concentration of fund complexes is substantially higher than for mutual funds, alone, but fund family concentration is nonetheless low and declining.[26]

To see how directed brokerage works, it is essential to understand that most full-service brokerage houses employ two types of specialized brokers. Retail brokers sell new securities, including mutual fund shares, to their clients ─ everyday members of the retail investing public ─ many of whom have individual brokerage house accounts.

---

[23] For a statement of the adviser's duty of best execution, see *See Interpretation Concerning the Scope of Section 28(e)*, Exchange Act Release No. 23,170, 51 Fed. Reg. 16,004 (Apr. 30, 1986) [hereinafter Scope of Section 28(e)], at 13-14.. For economic analyses of the broker's duty of best execution, see Kenneth D. Garbade and William L. Silber, Best Execution in Securities Markets: An Application of Signaling and Agency Theory, 37 J. FIN. 493 (1982) and Jonathan R. Macey and Maureen O'Hara, The Law and Economics of Best Execution, 6 J.F.I 188 (1997).

[24] Rich Blake, *Misdirected Brokerage*, INSTITUTIONAL INVESTOR (June, 2003), at 47, 48. In 2003, the SEC reported that institutional commissions ranged from as low as one cent per share to as high as 12 cents per share, with an average of five to six cents per share. *Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs*, Investment Company Act Release No. 26313 (Dec. 18, 2003), 68 Fed. Reg. 74819 (Dec. 24, 2003), at 74820-21, at n. 25 [hereinafter *Concept Release*]. There is no doubt commission rates have gradually declined over time and continue to do so.

[25] Total transaction costs include the brokerage commission, which is an out-of-pocket expense, but it also includes any adverse change in the price (whether bid or ask) at which the broker sells or buys a security between the moment the manager decides to trade and the moment the trade is fully executed ─ so-called "price impact." Price impact is a difficult-to-observe opportunity cost rather than an out-of-pocket expense. See SEC *Concept Release* and discussion *infra* at ?

[26] See, e.g., Coates, John C., and R. Glenn Hubbard, *Concentration in the Mutual Fund Industry: Evidence and Implications for Policy* (John M. Olin Center for Law & Business, Harvard University, discussion paper No. 592, August 2007), at 13-14.

They also trade all kinds of already-issued securities on behalf of these clients. Institutional brokers trade pretty much the same kind of securities on behalf of mutual funds and other institutions when their advisers want to adjust portfolio holdings. Institutional brokers tend to trade much larger blocks than retail brokers, and advisers often have regular trading relationships with many different brokers.

Figure 1 illustrates relations between the parties. P represents a mutual fund's portfolio of securities, whose beneficial owners consist of any number of dispersed shareholders, S. The fund enters into a contract in which it promises to pay the adviser, A, a fee consisting of a periodic share of the portfolio's net asset value, say 75 basis points per year,[27] in exchange for providing active portfolio management. Having identified a profitable trade, the adviser hires an institutional broker, IB, at a brokerage firm, B, to execute it in exchange for commission payments borne by the portfolio.

In a traditional mutual fund marketing arrangement, the brokerage firm's retail brokers, RB, provide effort selling the fund's shares to the investing public, S, in exchange for a sales load,[28] normally about five percent of the purchase price of the shares. In a directed brokerage arrangement, however, the retail broker provides effort selling the fund's shares in exchange for the adviser's commitment to send the brokerage firm future premium commission business, to be executed by the firm's institutional brokers.[29] Until it was prohibited, directed brokerage was one of several "no-load" methods an adviser could use to compensate brokers for their sales effort, often in the context of proprietary "fund supermarkets" that feature funds from a variety of fund families managed by reputed advisory firms. In this context, directed brokerage can be seen as one form of "payment for shelf space," the other being "revenue sharing" arrangements in which the adviser pays the broker directly out of its own pocket to market fund shares.

---

[27] A basis point is one one-hundredth of a percentage point.

[28] ICA Section 2 – Definitions: a (35). "Sales load" means the difference between the price of a security to the public and that portion of the proceeds from its sale which is received and invested or held for investment by the issuer. 15 USCS § 80a-2(a)(35).

[29] Until recently, the term "directed brokerage" referred to the situation in which a pension plan sponsor directed the manager of its pension portfolio to send commission business to specific brokers in exchange for various benefits they provided to the plan sponsor. This practice has come to be differentiated as "plan sponsor-directed brokerage" as more attention has been focused on advisers allocating brokerage as a quid pro quo for brokers' sale of fund shares.

Courts and regulators have long regarded brokerage payments as assets of the fund,[30] so-called "client commissions."[31] Advisers' use of client commissions for directed brokerage has been heavily criticized as a conflict of interest that may lead the adviser unjustly to favor itself over fund investors, a situation the `40 Act was generally designed to prevent.[32] The prospect of unjust enrichment is said to malign advisors' incentives, leading them to pay excessively high brokerage commissions, to engage in too much trading, and to use portfolio assets to promote the sale of fund shares to increase total assets under management, and hence their asset-based fees, at the expense of fund shareholders.[33] It is also said to encourage brokers to recommend funds to their clients based on the expectation of future portfolio trading commissions rather than an objective assessment of the funds' suitability or expected performance. The picture that emerges is one in which the entire commission premium is a net drag on fund performance, reducing investor returns dollar for dollar.

III. REGULATORY HISTORY

A. The Decline and Fall of Fixed Commissions

There is little doubt the deregulation of fixed commissions in May 1975 represented a tectonic shift for the U.S. securities industry whose reverberations are still

[30] See, e.g., Moses v. Burgin. 445 F.2d 369 (1971); Tannenbaum v. Zeller, 552 F.2d 402 (1976); Fogel v. Chestnutt, 533 F.2d 731 (1975); *Prohibition on the Use of Brokerage Commissions To Finance Distribution*, Investment Company Act Release No. 26591 (2004), 69 FR 54728, 17 CFR Part 270 (2004) [hereinafter *Prohibition on Directed Brokerage*]; *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*, Securities Exchange Act Release No. 54165 (2006).

[31] *See Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*, Securities Exchange Act Release No. 54165 (2006), at note 3 [hereinafter *Commission Guidance*]. Discussed *infra*.

[32] Section 1 of the Act, titled "Findings and Declaration of Policy," states in part that "investment companies are affected with a national public interest in that, . . . such companies are media for the investment in the national economy of a substantial part of the national savings and may have a vital effect upon the flow of such savings into the capital markets . . . . [I]t is hereby declared that the national public interest and the interest of investors are adversely affected . . . when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, . . . brokers, or dealers, . . . rather than in the interest of all classes of such companies' security holders." 15 USCS § 80a-1.

[33] *See Prohibition on the Use of Brokerage Commissions to Finance Distribution*, Investment Company Act Release No. 26591 (Sept. 2, 2004) [hereinafter *Prohibition on Directed Brokerage*].

being felt to this day.[34] From its inception in 1792, the association of stockbrokers and dealers now known as the New York Stock Exchange (NYSE) operated under a system of fixed minimum commissions that, according to many, bore conspicuous resemblance to a naked price fixing cartel.[35] Until 1934, the NYSE's authority to impose fixed commissions derived from a private agreement between its members and an agnostic antitrust policy toward securities exchanges.[36] With passage of the Securities Act (SA) in 1933 and the Securities Exchange Act (SEA) in 1934, authority to impose fixed commissions devolved to the SEC.[37]

Prior to passage of the ICA in 1940, most securities were held and traded by private investors through individual brokerage-house accounts. With passage of the ICA, securities ownership by mutual funds and other institutional portfolios began to grow and continues to this day. Emerging opportunities in investment research brought on by the ever accelerating "electronics revolution" helped make the growth of institutional portfolios possible. Instead of relying on these brokers' proprietary in-house stock picks, fund advisers increasingly began to combine generic inputs in the investment research process — computer software, hardware, the latest price quotes, databases, research reports, etc., having limited intrinsic information content — with their own labor effort to generate stock picks internally.[38]

Possibly owing to scale economies in securities trading, institutional portfolio advisers tended to trade in relatively large blocks, for which per share execution costs are thought to have been substantially lower than the 40 cent minimum commission then

---

[34] As part of the 1975 Securities Acts Amendments, Congress mandated that the SEC implement a "national market system" for securities trading. In 2005 The SEC released Regulation NMS with the hope of finally achieving this goal thirty years later. See *Regulation NMS*, Securities Act Release No. 51808 (June 29, 2005).

[35] Hans R. Stoll, REGULATION OF SECURITIES MARKETS: AN EXAMINATION OF THE EFFECTS OF INCREASED COMPETITION (1971); Gregg A. Jarrell, *Change at the Exchange: The Causes and Effects of Deregulation*, 27 J.L. & ECON. 273, 274 (1984), at 273; Jonathan R. Macey & David D. Haddock, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. ILL. L. REV. 315, 316-17 (1985); but see J. Harold Mulherin, Jeffry M. Netter, and James J. Overdahl., *Prices are Property: The Organization of Financial Exchanges from a Transaction Cost Perspective*, 34 J.L. & ECON. 591, 596 (1991).

[36] See U.S. v. Chicago Board of Trade, 246 U.S. 2231 (1918).

[37] SEA Rule 19b-3, 17 CFR Part 240.

[38] See D. Bruce Johnsen, Property Rights to Investment Research: The Agency Costs of Soft Dollar Brokerage, 11 YALE J. ON REG. 75 (1994).

prevailing.[39] Large-block trading by institutions began to dominate the NYSE and other trading networks. As institutional advisers became less dependent on Wall Street's in-house investment research, established brokers, unable to compete for lucrative institutional business by cutting commissions, predictably turned to nonprice competition in the form of various commission rebates. These rebates allowed advisers to more or less "recapture," for the benefit of the portfolio, the excess portion of the commission above the broker's cost of execution.

One method of commission recapture was the "reciprocal," consisting of two primary forms of in-kind brokerage rebate, various forms of research and the sale of fund shares to the retail investing public. Reciprocal commission recapture allowed mutual funds to realize much of the benefits of scale economies in block trading by paying dramatically lower net commissions. The trend toward vertical integration further eroded the NYSE's grip on the industry and resulted in a series of SEC rulings prescribing negotiated commissions on the portion of an order above a set minimum dollar value. Over the years the SEC successively lowered this minimum until Congress made commissions entirely negotiable in May 1975 as part of the Securities Acts Amendments to the SEA.[40] Commissions fell dramatically and trading volume surged.

In addition to providing for freely negotiated commissions, the 1975 amendments added section 28(e), the so-called "paying up" amendment, to the SEA. Congress designed Section 28(e) as a safe harbor to allay widespread concern by investment advisers that their state common law and statutory fiduciary duties of best execution, as well as criminal sanctions under the ICA for the accepting outside compensation, would limit them to paying only the lowest available commissions for portfolio brokerage

---

[39] Jarrell, *supra* n. ?, at 277.

[40] Securities Acts Amendments of 1975, Pub. L. No. 94-29, section 7, 89 Stat. 11 (codified as amended at 15 U.S.C. section 78k-1(a)(2) (1988)). This legislation amended section 19(b) of the Exchange Act with section 6(e) and also prompted the SEC to adopt Rule 19b-3. *Adoption of Rule 19b-3, Exchange Act*, Rel. No. 11,203, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) paragraph 80,067 (Jan. 23, 1975). Section 19(b) was the original source of the SEC's authority to review commissions, while section 6(e) specifically prohibited fixed commissions. Rule 19b-3, eliminating fixed commissions, was adopted by the SEC in anticipation of congressional passage of section 6(e). See Gordon v. New York Stock Exch., 422 U.S. 659 (1975), at 675.

regardless of execution quality or the value of any research or brokerage services they received.[41] Section 28(e) provides, in relevant part:

> (1) No person [who exercises] investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law . . . solely by reason of having caused the account to pay a member of an exchange, broker, or dealer an amount of commission . . . in excess of the amount of commission another member of an exchange . . . would have charged . . . if such person determined in good faith that it was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion. . . .
>
> (3) For purposes of this subsection a person provides brokerage and research services insofar as he —
>
> > (A) furnishes advice, either directly or through publications or writings, as to the value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of securities or purchasers or sellers of securities; or . . .
> >
> > (C) effects securities transactions and performs functions incidental thereto (such as clearance, settlement, and custody) or required in connection therewith by rules of the Commission or a self-regulatory organization of which such person is a member . . . .[42]

Although Congress designed Section 28(e) to provide fairly broad protection to fund advisers in allocating commissions business in exchange for brokerage and research services, any formal contractual commitment to patronize a particular broker necessarily falls outside its safe harbor. Exclusive dealing contracts are surely prohibited, but even in the absence of a formal agreement any fund adviser found to have placed an excessive share of his trades with a single broker risks legal action by the SEC and fund shareholders for breach of its fiduciary duty of best execution. The exact scope of section

---

[41] *Final Guidance*, at 41980-81. Industry concern over paying up was no doubt sparked by three celebrated fiduciary suits involving commission recapture that began in the late 1960s. *See* Moses v. Burgin, 445 F.2d 369 (1971); Fogel v. Chestnutt, 533 F.2d 731 (1975); and Tannenbaum v. Zeller, 552 F.2d 402 (1976).
[42] SEA Section 28(e) (1975), 15 U.S.C. section 78bb(e) (1988) (as amended).

28(e) protection of brokerage and research services has evolved over the years with a number of SEC no-action letters, cases, and administrative proceedings.

B. The Rise of Directed Brokerage

What is now referred to as directed brokerage got its start as one form of reciprocal commission recapture — along with soft dollars — under the old fixed commission system. The practice was at the center of several early civil suits against various fund advisory firms beginning in 1967 for breach of fiduciary duty under the ICA and state common law. In *Moses v. Burgin* (1971),[43] *Fogel v. Chestnutt* (1975),[44] and *Tannenbaum v. Zeller* (1976),[45] federal appeals courts found that a fund's unaffiliated board members are free, in their exercise of informed business judgment, to forgo cash recapture in favor of using client commissions to reward the sale of fund shares. But they also found that any failure of the advisory firm to provide the unaffiliated directors (or shareholders when approving the advisory contract) with sufficient information regarding the possibility of cash recapture to enable them to exercise informed business judgment constituted a breach of its fiduciary duty.

Pending a final resolution of these cases, in 1972 the SEC published its *Policy Statement on the Future Structure of the Securities Markets to Selection of Brokers and Payment of Commissions by Institutional Managers* advocating the elimination of directed brokerage.[46] It urged that fund advisers be required to allocate brokerage commissions based solely on "the reliability and quality of those services and their value and expected contribution to the performance of the account they are managing."[47] It was not long before the NASD responded by adopting the Anti-Reciprocal Rule (then

[43] 445 F.2d 369 (1971).
[44] 533 F.2d 731 (1975).
[45] 552 F.2d 402 (1976).
[46] *Policy Statement on the Future Structure of the Securities Markets to Selection of Brokers and Payment of Commissions by Institutional Managers*, Investment Company Act Release No. 7170, [1971-72 Transfer Binder] Fed. Sec. L. Rep. (CCH) 78,776 (May 17,1972).
[47] *Prohibition on Directed Brokerage*, at n. 16.

Rule 26(k) of the NASD Rules of Fair Practice) prohibiting its members from "from selling a fund's shares based upon brokerage received or expected."[48]

When brokerage commissions failed to fall to the "execution-only" rate following deregulation, it became clear that reciprocal practices such as soft dollars and directed brokerage were here to stay. No doubt with an eye to the then recent federal appeals courts' rulings, in 1981 both the SEC and the NASD did an about-face. This was at least in part a result of the SEC's 1980 adoption of Rule 12b-1, which established a blanket exemption when advisers use fund assets to pay broker-dealer sales charges for marketing shares to the investing public, provided they meet specific governance conditions, including a "plan of distribution" approved by the fund's board.[49] Its 1981 release *In the Matter of National Association of Securities Dealers* approved an NASD amendment to the Anti-Reciprocal Rule (eventually Rule 2830(k) of the NASD Rules of Conduct). The SEC reasoned that "since the recently adopted Rule 12b-1 under the 1940 Act authorizes open-end management investment companies to bear expenses associated with the distribution of their shares. . . it is not inappropriate for [them] to seek to promote the sale of their shares through the placement of brokerage *without the incurring of any additional expense* [emphasis added]."[50] [citations omitted]

Although revised Rule 2830(k) continued generally to prohibit NASD members from conditioning the sale of fund shares on brokerage commissions "received or expected," sub-section (7)(B) specifically permitted them to "sell the shares of . . . an investment company that follows a policy, disclosed in its prospectus, of considering sales of shares of the investment company as *a factor* [emphasis added] in the selection of broker-dealers to execute fund portfolio transactions, subject to the requirements of best execution."[51] Accordingly, the SEC found that in the exercise of its informed business judgment a fund's board of directors may adopt a policy allowing the adviser to consider the sale of fund shares as a factor in allocating commission business, provided

---

[48] 1981 Release at n. 2.
[49] *Bearing of Distribution Expenses by Mutual Funds*, ICA Release No. 11414, 45 FR 73898 (November 7, 1980).
[50] *In the Matter of National Association of Securities Dealers*, SEA Release No. 17599, 45 FR 82777 (March 4, 1981), at 4.
[51] *Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Investment Company Portfolio Transactions*

the policy is fully disclosed in the prospectus and designed in shareholders' interest to achieve best execution and avoid excessive trading.

The 1981 Release also briefly addressed a standing NASD interpretation prohibiting advisers from making special payments to selected broker-dealers for the sale of specific mutual fund shares where those same payments were unavailable to other broker dealers. In the SEC's view, the revised Anti-Reciprocal Rule "would not require such uniformity and would permit special arrangements with individual selling dealers of investment company shares if accompanied by adequate specific prospectus disclosure."[52]

C. SEC Scrutiny

For over 20 years advisory firms widely and increasingly used directed brokerage to promote the sale of fund shares, with little in the way of disciplinary action by the SEC. The practice became even more pronounced in the early 1990s with the advent of fund supermarkets. Facing competition from rival brands (e.g., Fidelity versus Vanguard versus Putnam, etc.), advisors began making direct cash payments out of their own assets to broker-dealers through so-called "revenue sharing" arrangements and using directed brokerage to lock in virtual shelf space for their fund offerings. In June 2003, a prominent trade publication rediscovered the alleged evils of directed brokerage, incorrectly concluding that

> "mutual fund companies are using trading commissions to pay brokerages to distribute their funds. This practice, known as directed brokerage, is . . . against the law . . . . That's because the money spent on those commissions doesn't belong to the fund company. Legally, it is an asset of the mutual fund shareholders. . . . Fund companies that could avail themselves of cheaper alternatives to do trades for as little as a penny a share pay what amounts to a trading premium to a [broker] to obtain shelf space for their funds."[53]

[52] 1981 Release, at 3.
[53] Rich Blake, *Misdirected Brokerage*, INSTITUTIONAL INVESTOR (June, 2003), at 47, 48.

In September 2003, New York State Attorney General Eliot Spitzer uncovered apparent trading improprieties in various mutual fund families.[54] What would quickly come to be characterized as the "mutual fund scandals" caught the SEC off-guard, as Spitzer, more nimble, repeatedly grabbed the media spotlight by using the threat of criminal prosecution under New York's onerous Martin Act to extract quick settlements and incriminating evidence from his expanding chain of targets.[55] Facing intense regulatory competition from Spitzer, the SEC was compelled to do *something*.

---

[54] Specifically, Spitzer found evidence of undisclosed late trading, market timing, and sticky asset agreements between fund advisers and certain large investors in their managed funds that arguably violated New York's Martin Act prohibiting financial fraud. *See, e.g.*, Marcia Vickers, Mara Der Hovanesian, and Amy Borrus, *How to Make the SEC Look Stodgy*, BUSINESS WEEK, September 15, 2003, Pg. 40.

[55] The Martin Act is found in New York Consolidated Laws, General Business Law Article 23-A: ARTICLE 23-A: FRAUDULENT PRACTICES IN RESPECT TO STOCKS, BONDS AND OTHER SECURITIES. Section 352-c. Prohibited Acts Constituting Misdemeanor Felony, reads in part:

1. It shall be illegal and prohibited for any person, partnership, corporation, company, trust or association, or any agent or employee thereof, to use or employ any of the following acts or practices:

(a) Any fraud, deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale;

(b) Any promise or representation as to the future which is beyond reasonable expectation or unwarranted by existing circumstances;

(c) Any representation or statement which is false, where the person who made such representation or statement: (i) knew the truth; or (ii) with reasonable effort could have known the truth; or (iii) made no reasonable effort to ascertain the truth; or (iv) did not have knowledge concerning the representation or statement made; where engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation or purchase within or from this state of any securities or commodities, as defined in section three hundred fifty-two of this article, regardless of whether issuance, distribution, exchange, sale, negotiation or purchase resulted.

As one commentator characterized Spitzer's actions:

> The purpose of the Martin Act is to arm the New York attorney general to combat financial fraud. It empowers him to subpoena any document he wants from anyone doing business in the state; to keep an investigation totally secret or to make it totally public; and to choose between filing civil or criminal charges whenever he wants. People called in for questioning during Martin Act investigations do not have a right to counsel or a right against self-incrimination. Combined, the act's powers exceed those given any regulator in any other state.
>
> Now for the scary part: To win a case, the AG doesn't have to prove that the defendant intended to defraud anyone, that a transaction took place, or that anyone actually was defrauded. Plus, when the prosecution is over, trial lawyers can gain access to the hoards of documents that the act has churned up and use them as the basis for civil suits. "It's the legal equivalent of a weapon of mass destruction," said a lawyer at a major New York

Just two months after Spitzer broke the mutual fund scandals, the SEC did *something* that would grab back some headlines, concluding administrative and cease-and-desist proceedings against Morgan Stanley Dean Witter (MSDW), a prominent broker-dealer (sell-side firm), for accepting directed brokerage in exchange for favoring the sale of specific funds. *In the Matter of Morgan Stanley DW, Inc.*,[56] it ordered MSDW to cease and desist, censured it, assessed it $50 million in disgorgement, pre-judgment interest, and civil penalties, and required it to satisfy a list of 28 detailed compliance undertakings for having adequately failed to disclose to investors at the point-of-sale certain incentives it used to compensate its retail brokers. The release makes no mention of an actual injury to any MSDW customer.

The conduct at issue consisted, in part, of what came to be known as MSDW's "Partners Program" with selected mutual fund advisory firms. The program was a standard example of the so-called "fund supermarket" that had recently become popular. According to the SEC, MSDW designed the Partners Program to promote the sale of specific advisory firms' mutual funds through enhanced sales compensation to its retail brokers (so-called "financial advisors," or "FAs") and branch managers, as well as through increased visibility in its extensive retail distribution network. Out of a total of 115 fund advisory firms with which MSDW had distribution agreements, only 16 participated in the Partners Program (including two MSDW advisory affiliates). MSDW placed Program participants' (Partners') mutual funds on its FAs' "preferred list" and gave them a "higher profile" at FA workstations. Partners received greater access to the

---

> firm who represents defendants in Martin Act cases (and who didn't want his name used because he feared retribution by Spitzer). "The damage that can be done under the statute is unlimited."

Nicholas Thompson, *The Sword of Spitzer*, LEGAL AFFAIRS, May/June 2004 (available at http://www.legalaffairs.org/issues/May-June-2004/feature_thompson_mayjun04.msp). See, also, Robert A. McTamaney, *New York's Martin Act: Expanding Enforcement in an Era of Federal Securities Regulation*, LEGAL BACKGROUNDER (Washington Legal Foundation), Vol. 18, N o. 5, February 28, 2003 (available at http://www.clm.com/pubs/2-28-03mctamaney.lb.pdf).

[56] *In the Matter of Morgan Stanley DW, Inc.*, SA Rel. No. 8339 , SEA Rel. No. 48789 (November 17, 2003), Admin. Proc. File No. 3-11335 [hereinafter *In the Matter of Morgan Stanley*].

"sales system," including access to MSDW's branch system, access to FAs via training and customer seminars, inclusion in FA events, and invitations to participate in programs broadcast over MSDW's internal systems. In the SEC's disapproving view, all of these preferences provided the FAs with "significantly more information on the Partners' funds than non-participating funds and provide[d] Partners' funds with enhanced access to Morgan Stanley DW's FAs."[57]

In exchange for access, Partners or their funds paid MSDW 15 to 20 basis points in fees on the sale of fund shares and in addition paid MSDW five basis points per year in trailing fees on fund shares retained by the investor for more than one year, with trailing fees being fully forwarded to the FA responsible for the account. In some cases Partners paid these fees directly in cash. In other cases they paid using their funds' commissions, i.e., directed brokerage, although MSDW discouraged this practice. In addition to directed brokerage, participating funds paid MSDW board-approved 12b-1 fees, servicing fees, and account maintenance fees. Those FAs with more than $1 million in yearly sales received 42% of the fees paid on Partners' share sales as opposed to 40% on non-Partners' share sales, thus "FAs generally receive[d] a higher payout from the sale of Partners' funds than non-Partners' funds."[58] This system transmitted up the organization to branch managers, whose compensation also rewarded them more for the sale of Partners' funds than non-Partners' funds. Again in the SEC's disapproving view, Partners therefore "enjoyed the prospect of greater sales as a result of compensation incentives [MSDW] provide[d] to the sales force on the sale of Partners' funds."[59]

Those advisory firms seeking to use directed brokerage to pay accrued fees on fund sales were required to generate brokerage commissions of, say, one-and-a-half times the fees they would have paid directly in cash. One-third of this went to the trading desk at Morgan Stanley & Co., a MSDW affiliate, to pay for execution, with the remainder going to MSDW. A Partner that agreed to pay 15 basis points in commission premiums for the sale of fund shares, for example, would have to generate gross commissions of

[57] *In the Matter of Morgan Stanley*, at 10.
[58] *In the Matter of Morgan Stanley*, at 11.
[59] *In the Matter of Morgan Stanley*, at 8.

22.5 basis points, with 7.5 basis points being retained by the trading desk and 15 basis points being directed to MSDW to compensate for past sales of fund shares.[60] All else being equal, the more aggressively FAs marketed a partner's fund shares the more commission business the fund adviser would have to generate if it intended to use only directed brokerage to pay for fund sales. It is worth noting that when Partners called in trades to Morgan Stanley & Co. intended for use as Program payments, they typically designated those trades "for the benefit of" MSDW.

The SEC found the Partners Program created a conflict of interest for MSDW because its sales staff "received additional compensation for the sale of the mutual funds of a select group of fund complexes." The participating mutual funds provided various general disclosures in periodic reports to the SEC, and in their prospectuses, concerning payments to the brokerage firms that distributed fund shares. In the SEC's opinion, however, "none adequately disclose[d] the preferred programs as such, nor [did] most provide sufficient facts about the preferred programs for investors to appreciate the dimension of the conflicts of interest inherent in them."[61] By failing adequately to disclose to its customers the specific conflicts of interest its sales staff faced, the SEC found MSDW had violated Section 17(a)(2) of the SA, which makes it unlawful "to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they made, not misleading."[62] It also found MSDW violated SEA Rule 10b-10, which makes it unlawful "to induce the purchase or sale by [a] customer of, any security . . . unless such broker or dealer, at or before completion of such transaction, gives or sends to such customer written notification disclosing . . . source and amount of any other remuneration received or to be received by the broker in

[60] Assuming the fund share is priced at $26.67, MSDW would receive four cents per share (about 15 basis points) to compensate for the sale of the share, and its affiliated trading desk would receive two cents to cover execution costs.
[61] *In the Matter of Morgan Stanley*, at 15.
[62] It is "unlawful for any person in the offer or sale of any securities . . . to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they made, not misleading." 15 U.S.C.S. § 77q(a).

connection with the transaction."[63,64] Finally, it found MSDW violated NASD Rule 2830(k)'s prohibition on conditioning the sale of mutual fund shares on brokerage commissions "received or expected."

Several months later, the SEC brought administrative and cease-and-desist proceedings against Massachusetts Financial Services (MFS), a prominent fund advisor (buy-side firm), for entering into so-called "Strategic Alliances" with roughly 100 broker-dealers in exchange for virtual shelf-space. The terms of the strategic alliances were almost identical in substance to MSDW's Partners Program. According to the SEC's release *In the Matter of Massachusetts Financial Services Company*,[65] MFS negotiated for preferential access to Strategic Allies' sales staffs and "heightened visibility" for its fund offerings within their distribution systems. In exchange for this so-called "shelf-space," MFS paid between 15 and 25 basis points for the sale of its fund shares and three to 20 basis points per year in trailing fees for fund shares held by Allies' customers more than one year. In some cases MFS paid Allies in cash from its own account, but in others it paid with directed brokerage, and there was apparently some evidence to suggest it may have preferred this method. In any event, MFS made clear to its employees that Allies' sales of fund shares could be considered only as "a factor" in allocating portfolio brokerage and that best execution was not to be compromised. MFS cautioned its personnel not to enter into legally binding agreements with Allies to promise a specific amount of commission business nor to refer to their arrangements with Allies as binding. Nevertheless, some MFS employees casually labeled commission allocations to Allies as "obligations," "commitments," or amounts "owed." What is more, from time to time MFS requested that its trading desk increase trading with certain Allies to satisfy commission targets.

---

[63] "It shall be unlawful for any broker or dealer to effect for or with an account of a customer any transaction in, or to induce the purchase or sale by such customer of, any security . . . unless such broker or dealer, at or before completion of such transaction, gives or sends to such customer written notification disclosing . . . the source and amount of any other remuneration received or to be received by the broker in connection with the transaction" 17 C.F.R. § 240.10b-10.
[64] The SEC noted that neither 17(a)(2) nor Rule 10b-10 require "scienter."
[65] *In the Matter of Massachusetts Financial Services Company*, IAA Rel. No. 2224, ICA Rel. No. 26409 (March 31, 2004) [hereinafter *In the Matter of Massachusetts Financial Services Company*].

MFS informed its fund boards that, subject to best execution, it considered the sale of fund shares as a factor when allocating its funds' portfolio brokerage. It also showed them the exact amount of commission business allocated to every broker-dealer for which consideration of fund sales was a factor. The SEC found these disclosures inadequate because MFS failed to specifically state that the amounts were "used to satisfy bilateral arrangements under the Strategic Alliances."[66] What is more, the SEC found that MFS avoided using its own assets in consideration for its Strategic Alliances by financing the sale of fund shares with directed brokerage. It therefore failed adequately to communicate its reliance on directed brokerage to its funds' boards. Finally, although MFS disclosed to its shareholders in periodic reports that it considered its broker-dealer's sales of fund shares as a factor in allocating its funds' portfolio brokerage, the SEC found it failed to "adequately disclose [that it] had entered into bilateral arrangements in which it agreed to allocate specific negotiated amounts of fund brokerage commissions, subject to best execution, to broker-dealers for 'shelf space' or heightened visibility within their distribution systems."[67]

The SEC marshaled no evidence indicating that the MFS Strategic Alliance program had compromised best execution, injured any investor, or unjustly enriched MFS. As a result of the disclosure violations it nevertheless found that MFS had violated Section 206(2) of the IAA, which prohibits any investment adviser from engaging in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." It also violated Section 34(b) of the ICA, which makes it unlawful for any person to omit to state in any registration statement "any fact necessary . . . to prevent the statements made therein . . . from being materially misleading."[68] Much as it had done with MSDW, the SEC ordered MFS to cease and desist, censured it, assessed it $50 million in disgorgement and civil penalties, and required it to satisfy nine detailed compliance undertakings, in addition to various remedial undertakings it had already implemented.

---

[66] *In the Matter of Massachusetts Financial Services Company*, at 14.
[67] *In the Matter of Massachusetts Financial Services Company*, at 16.
[68] *In the Matter of Massachusetts Financial Services Company*, at 17-18.

D. Prohibition

In late 2003, the SEC's Office of Compliance Inspections and Examinations had been asked to conduct an examination sweep of 15 different broker-dealers to determine what payments fund advisers had made to them, the form of those payments, the "shelf space" benefits the broker-dealers provided, and most importantly, "just what these firms tell their investors about these practices."[69] OCIE's findings appear not to have been published, but no doubt relying on them, and having laid the necessary foundation in its administrative proceedings against MSDW and MFS, in September 2004 the SEC finally banned directed brokerage entirely. In its release *Prohibition on the Use of Brokerage Commissions to Finance Distribution*,[70] it pointed out that the pressure on funds to distribute their shares has caused them to rely more heavily on directed brokerage, which "has been assigned explicit values, recorded, and traded as part of increasingly intricate arrangements by which fund advisers barter fund brokerage for sales efforts." In the SEC's view, "[t]hese arrangements are today far from the benign practice that we approved in 1981 when we allowed funds to merely consider sales in allocating brokerage."[71] The SEC concluded the associated conflicts of interest are intolerable.

The release notes that fund brokerage is an asset of the fund and that the use of fund assets to pay for brokerage falls under Rule 12b-1. As such it is subject to Rule 12b-1's specific provisions designed to address conflicts of interest that may injure investors. It finds that directed brokerage can harm investors in at least four ways. First, because advisers' compensation is normally based on the level of fund assets, they have an incentive to promote the sale of fund shares to increase their advisory fees. "Competition among advisers to secure a prominent place in selling brokers' distribution networks . . . can adversely affect [their] decisions on how and where to effect portfolio

[69] Testimony before the Senate Committee on Banking, Housing, and Urban Affairs Concerning Recent Commission Activity to Combat Misconduct Relating to Mutual Funds, Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities & Exchange Commission, November 20, 2003.
[70] *Prohibition on Directed Brokerage*, *supra* n. ?
[71] *Prohibition on Directed Brokerage*, *supra* n. ?, at n. 5.

securities transactions, or how frequently to trade portfolio securities," thereby jeopardizing best execution. Second, directed brokerage allows fund advisers to circumvent NASD rules adopted pursuant to Section 22(b) of the ICA that limit excessive sales charges. Third, directed brokerage compromises transparency by allowing fund advisers to bundle distribution costs into brokerage commissions, which are treated as capital items rather than as reportable expenses. Finally, "receipt of brokerage commissions by a broker-dealer for selling fund shares creates an incentive for the broker to recommend funds that best compensate the broker rather than funds that meet the customer's investment needs."[72]

Because of the lack of transparency of brokerage commissions, the SEC concluded that broker-dealer customers are unlikely to recognize the existence or extent of the underlying conflicts of interest directed brokerage poses. What is more, because of the practical inability of fund boards to actively monitor portfolio transactions to understand the motivations behind advisers' brokerage allocation decisions they cannot be relied on to police directed brokerage practices. Accordingly, the SEC adopted new Rule 12b-1(h)(1) prohibiting "funds from compensating a broker-dealer for promoting or selling fund shares by directing [portfolio] brokerage transactions to that broker."[73] As it

---

[72] *Prohibition on Directed Brokerage*, *supra* n. ?, at nn. 15 – 23 (citing Ruth Simon, Money Magazine, for authority).

[73] *Prohibition on Directed Brokerage*, *supra* n. ?, at **nn**. 15 - 24. The addition reads as follows:

§ 270.12b-1 Distribution of shares by registered open-end management investment company.

* * * *

(h) Notwithstanding any other provision of this section, a company may not:

(1) Compensate a broker or dealer for any promotion or sale of shares issued by that company by directing to the broker or dealer:

(i) The company's portfolio securities transactions; or

(ii) Any remuneration, including but not limited to any commission, mark-up, mark-down, or other fee (or portion thereof) received or to be received from the company's portfolio transactions effected through any other broker (including a government securities broker) or dealer (including a municipal securities dealer or a government securities dealer); and

(2) Direct its portfolio securities transactions to a broker or dealer that promotes or sells shares issued by the company, unless the company (or its investment adviser):

(i) Is in compliance with the provisions of paragraph (h)(1) of this section with respect to that broker or dealer; and

might otherwise interfere with best execution, the rule does not completely prohibit an adviser from allocating portfolio brokerage to a broker-dealer that also sells its funds' shares as long as the adviser implements policies and procedures, approved by the fund's independent directors, designed to ensure that it's selection of executing brokers is not influenced by the sale of fund shares.[74] According to the SEC's cost-benefit analysis, "[t]he amendments will benefit funds and their shareholders. . . . Fund advisers that overtrade fund portfolio securities in order to generate additional sales of fund shares, or that fail to optimize transactions costs, impose real costs on fund investors, which these rule amendments seek to eliminate."[75] As to the cost implementing policies and procedures to prevent the selection of institutional brokers from influencing the sale of fund shares, the SEC concluded with not factual support that "[w]e do not anticipate that drafting or implementing these policies and procedures will be costly."[76]

Section 2(c) of the ICA requires the SEC to consider the effect of its rules on "efficiency, competition, and capital formation."[77] The SEC declared that competition and efficiency could be enhanced by reducing institutional brokerage commission rates, reducing portfolio turnover rates, leading to the unbundling of distribution from portfolio execution, and allowing the adviser to obtain other services more beneficial to fund shareholders.[78]

(ii) Has implemented, and the company's board of directors (including a majority of directors who are not interested persons of the company) has approved, policies and procedures reasonably designed to prevent:

(A) The persons responsible for selecting brokers and dealers to effect the company's portfolio securities transactions from taking into account the brokers' and dealers' promotion or sale of shares issued by the company or any other registered investment company; and

(B) The company, and any investment adviser and principal underwriter of the company, from entering into any agreement (whether oral or written) or other understanding under which the company directs, or is expected to direct, portfolio securities transactions, or any remuneration described in paragraph (h)(1)(ii) of this section, to a broker (including a government securities broker) or dealer (including a municipal securities dealer or a government securities dealer) in consideration for the promotion or sale of shares issued by the company or any other registered investment company.

[74] *Prohibition on Directed Brokerage*, *supra* n. ?, at n. 37. pp. 24-25.
[75] *Prohibition on Directed Brokerage*, *supra* n. ?, at nn 35, 36, pp. 22-23.
[76] *Prohibition on Directed Brokerage*, *supra* n. ?, at n. 37. p. 25.
[77] 15 U.S.C. 80a-2(c).
[78] *Prohibition on Directed Brokerage*, *supra* n. ?, at nn. 37-39, pp. 26-28.

IV. A TRANSACTION COST ANALYSIS OF DIRECTED BROKERAGE

The seminal contribution of transaction cost economics is that it introduces the equivalent of friction into the neoclassical model of impersonal exchange of goods whose quality is easily evaluated at the moment trade occurs.[79] In the neoclassical model, the act of exchanging, itself, is costless, and competition ensures price is equal to marginal production cost. There is no need to rely on specialized agents, and no conflicts of interest arise because all dimensions of the exchange can be fully specified. Once transaction costs are introduced, among other things buyers must evaluate quality, sellers must evaluate buyers' ability to pay, and trade is often supported by legally-enforceable contracts, reputational capital, long-term relationships, and various forms of economic organization that rely on specialized agents imperfectly motivated. Price cannot equal marginal production cost because transaction costs drive a wedge between the price the buyer pays and the net compensation the seller receives. Conflicts of interest are inevitable.

This does not mean unjust enrichment occurs in any significant way, because the parties have strong incentives to avoid it. In 1976, Jensen & Meckling published the seminal work on principal-agent conflicts.[80] Their positive (descriptive) analysis relies on "agency costs" (a form of transaction costs) to explain how the parties organize their business affairs to maximize the gains from trade. Agency costs consist of "monitoring costs" incurred by the principal, "bonding costs" incurred by the agent, and "residual losses." The principal can limit divergence from his interest by establishing appropriate organizational incentives for the agent, such as sharing profits or other benefits, and by incurring monitoring costs designed to limit harmful activity by the agent. In many situations it will pay the agent to spend resources bonding himself against actions that would harm the principal. In many agency relationships the parties incur both monitoring and bonding costs (non-pecuniary as well as pecuniary). In addition, it is inevitable that some beneficial trade does not occur that would have occurred absent agency costs.

[79] Johnnie L. Roberts and Richard Gibson, *'Friction' Theorist Wins Economics Nobel*, Wall Street Journal, Oct. 16, 1991, Section B, page 1, supra at ?.
[80] Jensen & Meckling, *supra* n. ?

These are the residual losses. As long as residual losses persist, the parties have an interest in innovating new forms of organization to reduce them, that is, to increase the gains from trade. The cost of transacting inhibits this process.

B. Institutional Brokerage as an Experience Good

It would be difficult to find an industry that departs more radically than institutional securities brokerage from the neoclassical model of perfect competition. Institutional brokerage is what economists recognize as an "experience" good, one that is too costly for the buyer to fully evaluate at the moment trade occurs and whose precise quality will become apparent only with time or repeated use.[81] For certain experience goods, moreover, the receipt of unexpectedly low quality can impose substantial incidental costs on the buyer. The SEC's own *Concept Release* on transaction costs in securities trading recognizes institutional brokerage as just such an experience good.[82] There, the SEC correctly points out that brokerage commissions are only a small component of the costs of transacting securities. In addition, executing portfolio trades gives rise to implicit and difficult-to-measure transaction costs, most importantly so-called "price impact," wherein a broker's trading effort causes the price of the security to move adversely to the client's interests to a greater or lesser extent.

Not only is the quality of a broker's execution costly for a fund adviser to evaluate owing to the inherent noisiness of securities prices, but price impact on large block trades can easily overwhelm brokerage commissions and create a substantial drag on investor returns.[83] It is an artifact of the high transaction costs the adviser faces enforcing the portfolio's exclusive property rights to profitable trading opportunities.

---

[81] Philip Nelson, *Information and Consumer Behavior*, 78 J.P.E. 311 (1970).

[82] *Concept Release*, *supra* n. ?, at 74820-21 (soliciting outside comments on whether, and to what extent, mutual funds should be required to report the full cost of transacting portfolio securities).

[83] From SEC *Concept Release*, n. 32 "Virtually all the major institutions have a transaction-cost measuring system in place. They compare their actual execution costs to pre-trade benchmarks from models or peer comparisons from different firms. That puts pressure on the trading desks to control costs. So the guys who aren't doing it are being left behind." Sahoo, supra note ?? (quoting Ananth Madhavan). ". . . [M]ore pension funds and investment managers are measuring transaction costs -- either by using proprietary systems or third party services . . . . Since the wrenching bear market of 2000 - '02, institutions have

Despite the SEC's willingness to acknowledge transaction costs in the narrow realm of trade execution, it has yet to consider how transaction costs influence market participants' choice of economic organization more generally. Precisely because transacting is costly, the parties must balance myriad countervailing conflicts; it simply does not pay them to incur a dollar's worth of transaction costs to eliminate conflicts of interest whose expected cost is only fifty cents. A foremost example is adviser's decision, almost invariably, to use a broker to execute difficult trades rather than trading directly for his own account. The adviser benefits from the expertise of a specialized agent and at the same time gains an important measure of anonymity. Anonymity reduces price impact, but it comes at the cost of insinuating a self-interested broker into the equation.

An altogether different conflict of interest results from the adviser's inability to evaluate the broker's execution quality, even after an extended series of trades. If high-quality trades are more costly to perform than low-quality trades, a broker might tout himself as willing to execute high-quality trades and cheat the adviser by doing a careless job that leads to excessive price impact. The broker earns a high commission but saves on execution costs, and before the adviser can discover the breach his investors have suffered.

Despite this possibility, there is little doubt the reduction in transaction costs from using brokers leaves portfolio investors substantially better off. This is no doubt why, by long-standing industry custom, institutional portfolios bear the cost of brokerage commissions. The quick point is that conflicts of interest can be an inescapable artifact of efficient economic organization, and it is therefore a mistake to prohibit business practices merely because they give rise to conflicts of interest.

The market for brokers and fund advisers is competitive in the sense that there are large numbers of each, with active entry and exit and ample organizational innovation. Under competition, the parties will tend to choose the form of economic organization that limits the losses from price impact, all else being equal. If the cost of legally verifying the quality of broker executions was reasonably low, advisers could enter into binding

learned that transaction costs can be a significant drag on performance, and they have begun managing them as intently as they research stocks."

warranties with their brokers and seek money damages on behalf of the portfolio against those whose carelessness or greed led to excessive price impact. Absent egregious conduct by a broker ─ frontrunning being a potentially verifiable example[84] ─ it is impossible for an adviser to seek legal recourse against a careless broker because the cost of verifying mere carelessness to an outside party in such a noisy setting is prohibitive.[85] The best the adviser can do to protect the portfolio is threaten to terminate brokers whose execution quality proves to be sub-par over an extended series of trades.

B. Adverse Selection, Screening, and Quality Assurance

The problem of assuring the quality of experience goods is one economists have examined in detail. Various economic models demonstrate the effectiveness of reputational capital, long-term relationships, performance bonding, hostages, screening, and other forms of organization at overcoming the moral hazard and adverse selection problems experience goods present. The solution often requires the buyer to pay a premium price that provides the seller with a surplus, or "economic rent," for honoring his quality commitment. This should come as no surprise. The average consumer routinely buys hundreds of experience goods for which he happily pays a premium price to assure quality ─ gasoline, golf balls, fine perfume, and even garden-variety aspirin are just a few such goods. No serious golfer facing an important round would buy used or X'ed-out balls, even though they may be perfectly adequate and their price is a fraction of what a new sleeve of top-quality balls would cost. Few drivers of late-model cars buy off-brand gasoline, and aspirin buyers often pay a premium price for branded tablets, although the generic equivalent is far cheaper. Studies suggest that even those consumers

[84] Frontrunning occurs when a broker or his tipee purposely trades a security ahead of the client's trades in anticipation of a price correction. The inevitable result is price impact.
[85] Agency relationships can be seen as those whose legal enforcement focuses on the inputs provided by the promisor, whereas contractual relationships focus on the promisor's outputs. For a theory of the firm based on differences in the cost of measuring inputs and outputs see Yoram Barzel, *Measurement Costs and the Organization of Markets*, 25 J. LAW & ECON. 27 (1982).

who buy generic aspirin for themselves tend to favor branded aspirin over generic for their children, where quality assurance is considered particularly important.[86]

If people acting on their own behalf often "pay up" for goods so they can be confident of quality, it is reasonable that agents acting on behalf of their principals should do the same. Those who condemn fund advisers for using investors' money to pay premium commissions for trades assert that identical execution can be found for as little two cents per share or less. The inference is that any excess commission payment above this amount provides no compensating benefit to investors, serving merely to unjustly enrich advisers. This is a normative claim that has little or no foundation in positive economic theory. A simple adverse selection model familiar in the economics literature easily shows why, under plausible assumptions, investors would suffer if the fund adviser was required to pay the lowest available brokerage commission and why they are better served if he instead pays up for brokerage.[87] By paying up, the adviser can screen out low-quality brokerage that would undermine investor returns, thereby reducing its monitoring costs and freeing up its time for more productive activities such as investment research.

Imagine a fund adviser facing an indefinite series of identical trading rounds. Each round consists of two fiscal quarters in which he must choose between alternative brokerage arrangements, depicted in Table I. At the beginning of each quarter he must select an unfamiliar broker to execute a million-share block trade, which will yield a gross gain per quarter of 10 cents per share, or $100,000, before deducting transaction costs. For convenience, the discount rate is zero and all parties are assumed to be risk neutral. There are two brokers from which to choose. One does high-quality (HQ) trades and the other low-quality (LQ) trades. The adviser knows the HQ broker must charge at least four cents per share to cover his execution costs, while the LQ broker must charge at least two cents per share. He also knows price impact on HQ trades is zero, but on LQ trades it is 12 cents, so that total transaction costs to the portfolio on LQ trades is 14 cents

[86] See Klein & Leffler, at n. 18 (in 1978 the market share of generic aspirin for children was less than 1% compared to a 7% share for generic adult aspirin) and Benjamin Klein http://www.econlib.org/Library/Enc/BrandNames.html.

[87] It is possible to introduce any number of complications and refinements such as moral hazard by brokers, but this would add little to the example.

per share.[88] As in any economic model, brokers' cost reflects a normal return on all foregone opportunities.

At the beginning of each round the adviser announces the brokerage commission he is willing to pay for the entire round and any terms and conditions he requires. This constitutes a solicitation of a bona fide offer from the brokers. If both brokers offer to trade on the announced terms, the adviser chooses randomly between them. If the adviser accepts a broker's offer he is legally bound to employ him for the first quarter at the announced commission rate. Although the adviser does not know either broker's type at the outset, he knows the probability of selecting the HQ broker is one-half. Broker quality is revealed only at the end of the first quarter, at which time the adviser can switch brokers for the second quarter but cannot adjust the brokerage commission.

To maximize investor returns, the adviser must decide the price he is willing to pay for brokerage. As shown in Panel A, if he sets a price of two cents per share to minimize brokerage commissions, the HQ broker will never accept his offer, in essence withdrawing from the market. Only the LQ broker can afford to trade at that price and will be the only one to make an offer to the adviser. The portfolio will pay only $20,000 per quarter in commissions but will suffer an additional $120,000 per quarter in price impact. Total transaction costs during the round will be 14 cents per share for a total of $280,000 (14 cents times 2 million shares). The portfolio will suffer a loss of $80,000. Being able to anticipate this result, the adviser will choose not to trade and investors are deprived of a potential trading gain. This is the standard adverse selection result.

The first-best solution, would be for the adviser to offer four cents per share and trade only through the HQ broker, but owing to search costs (a form of transaction cost) he cannot identify the HQ broker. As shown in Panel B, there are two possible outcomes that result from following a four cents per share trading policy, each of which carries a probability of .5. In Outcome 1 the adviser correctly picks the HQ broker and employs him for both quarters. Commission costs are $40,000 in both quarters and total transaction costs for the round are $80,000. Investors enjoy a trading gain of $120,000.

[88] In reality, even HQ brokerage is likely to lead to some price impact. For the purposes of this example, price impact on LQ brokerage can be thought of as the excess above what
ould occur on HQ brokerage.

Over a series of rounds, the adviser selects the HQ broker in the first quarter only half the time. The remainder leads to Outcome 2, in which he selects the LQ broker. At four cents per share, the LQ broker is happy to trade. With execution costs of only two cents per share, he stands to earn a surplus of $20,000 before being terminated at the end of the first quarter. In Outcome 2 the adviser pays $40,000 in brokerage commissions during the first quarter, but the portfolio suffers price impact of $120,000. Total transaction costs are $160,000, and investors suffer a trading loss of $60,000. In the second quarter the adviser switches to the HQ broker and pays $40,000 in commissions with zero price impact.[89] Total transaction costs during the round are $200,000, for an average of seven cents per share.

If the adviser sets the commission at four cents per share round after round, half the time total transaction costs will be $80,000 and half the time they will be $200,000, for an average of $140,000, or seven cents per share. At the start of any round, this represents the adviser's expected transaction cost from following a four-cent per share commission strategy. Although less than ideal, this solution keeps the HQ broker in the market and allows the portfolio to benefit from his superior execution at least 75 per cent of the time. Investors earn an expected gain of $60,000.

The adviser can do better. As shown in Panel C, he can offer to pay seven cents per share — to *pay up* — and condition acceptance on the broker's willingness to post a $60,000 performance bond paid to the portfolio at the start of the first quarter. In the event the manger selects the LQ broker, he will discover the broker's type by the end of the quarter and terminate him in favor of the HQ broker. This strategy completely screens out the LQ broker, who stands to earn a trading surplus in the first quarter of only $50,000 (seven cents per share minus his execution cost of two cents per share times a million shares). There is no way the LQ broker can earn back a $60,000 up front bond. The LQ broker will withdraw from the market. The adviser will invariably choose the HQ broker, who, after paying $60,000 for the privilege of trading, earns a surplus above his variable execution costs in each quarter of $30,000, exactly earning back his up-front

[89] The manager's problem would be even worse if he had a large number of brokers from which to choose. With LQ and HQ brokers evenly distributed, he would by no means be assured of picking a HQ broker in the second quarter.

bond by the end of the round. At seven cents per share, total brokerage commissions for the round are $140,000. With zero price impact total transaction costs to the portfolio are $140,000. Even if the adviser were to pocket the entire $60,000 up-front bond investors would be no worse off than above, where the adviser pays four cents per share in commissions. With directed brokerage, and other forms of up-front bonds popular in the industry, investors receive the benefit in the form of fund share marketing or investment research that may, in fact, be worth more to them that the cash value of the bond itself. If so investors earn a trading gain of at least $30,000 per quarter for a total of $60,000 and also enjoy the benefit of the $60,000 performance bond, for a total of $120,000. The portfolio is clearly better off paying up for a quality-assuring performance bond.

C. Directed Brokerage as a Quality-Assuring Performance Bond

The use of a quality-assuring performance bond is subject to three competitive conditions.[90] First, the bond must be large enough relative to the expected commission so that the HQ broker earns no surplus. Second, the bond must be nonsalvageable in the sense that the broker cannot recover once it has been paid. Otherwise, there are no consequences for delivering low quality execution. Finally, the bond will take the form that provides the greatest possible value to the portfolio.

Prior to the SEC's prohibition on directed brokerage the practice very likely served, in part, as a method of bonding execution quality. It appears to have met the necessary competitive conditions. First, there is little doubt brokerage firms competed intensely for fund advisers' trading business by offering to sell shares issued by their funds to the investing public, and both the commission premium and the terms of the arrangement were the subject of ongoing negotiation and innovation. Owing to this and other forms of nonprice competition, brokerage firms could expect to earn only a competitive return on their forgone alternatives over the long run. In economic terms, the size of the bond would approximate the discounted present value of the expected stream of premium commissions. Second, as revealed in the *Morgan Stanley* and *Massachusetts*

[90] Klein & Leffler.

Financial Services cases, retail brokers' sale of fund shares to the investing public came in advance, with the fund adviser following up by directing portfolio trades to the firm's institutional brokers based on their *past* success selling fund shares. Owing to their fiduciary duties of best execution, neither the adviser nor the fund could be legally compelled to place the promised portfolio trades with selling brokers. Indeed, NASD Rule 2830(k) prohibits brokers from conditioning the sale of fund shares on brokerage commissions "received or expected." A broker's costly effort selling fund shares was therefore nonsalvageable in the sense that the adviser could terminate the broker with the balance of the trading "obligations" unfulfilled if the adviser discovered him providing low-quality executions.

The final question is whether a dollar's worth of extra trading commissions used to compensate brokers for their sales effort might have been worth more to the portfolio than a dollar paid to the portfolio in cash. The SEC's own 1981 release, *In the Matter of National Association of Securities Dealers*, strongly suggests so. Recall that this release approved an NASD amendment to what would become Rule 2830(k) of the NASD Rules of Conduct allowing brokers to sell the shares of a fund that followed a policy of considering the sale of funds shares as "a factor" in the allocation of trading business if the fund disclosed this policy in its prospectus. The SEC reasoned that because it had adopted Rule 12b-1 in 1980 authorizing mutual funds to bear expenses associated with the distribution of their shares they may also "seek to promote the sale of their shares through the placement of brokerage *without the incurring of any additional expense*" [emphasis added].[91] If it can be shown that tying fund sales effort to portfolio executions generated efficiencies (e.g., created value for fund investors), it necessarily follows that directed brokerage promoted the sale of fund shares at no *additional expense*, and if fact provided net benefits.

Because mutual funds stand ready at all times to issue and redeem shares at net asset value (NAV), in the absence of concerted sales effort by the adviser or its affiliates most equity mutual funds would experience net redemptions approaching 18 percent per

[91] *In the Matter of National Association of Securities Dealers*, SEA Release No. 17599, 45 FR 82777 (March 4, 1981), at 4.

year.[92] Perhaps more important, uncertainty over near-term redemptions requires a fund adviser to hold higher cash balances than otherwise. Relative to risky securities, cash yields a low expected return. By spending resources selling fund shares to the investing public, an adviser can manage its net redemptions to reduce cash balances and increase investor returns. One of the most basic propositions in transaction cost economics (specifically, the economics of principal-agent relations) is that, if anything, agents have too little incentive to undertake activity that benefits the principal.[93] Because advisers' fees provide them with only a fraction of the investment returns they generate, they have too little incentive to spend their own resources selling fund shares. By subsidizing fund share sales, investors reduce the associated conflict of interest.

This must be at least part of the reason the SEC approved 12b-1 fees in the first place, allowing the fund's board to approve 12b-1 plans on an ad hoc basis. The important point is that spending some portion of the imbedded performance bond imbedded on fund sales effort generates a net return for the fund. As long as a dollar's worth of sales effort provides the fund with benefits exceeding a dollar in cash, directed brokerage costs the fund nothing and in fact provides net benefits. Recall that the size of the performance bond is set by competition, and the brokerage commission therefore cannot be reduced without suffering a loss of execution quality. As a loyal economic agent, the adviser's charge is to spend the competitively-determined performance bond on any of a long list of items according to the benefits they provide the portfolio. Some forms of research surely occupy the top of the list, as recognized and protected by the Section 28(e) safe harbor, but there is no reason to think, *a prior*, that retail broker sales effort should be precluded from advisers' consideration under the umbrella of "brokerage services" if investor welfare is the policy objective. Presumably, the fund adviser's specialized expertise in balancing the associated trade-offs is one of the benefits investors hope to capture from investing in the fund in the first place.

A widespread but misguided criticism of allowing advisers to use fund assets to promote the sale of fund shares ─ whether through 12b-1 fees or directed brokerage ─ is that it gives the adviser a perverse incentive to increase fund assets through share sales, to

[92] See 2007 Investment Company Institute Fact Book (47th ed), at 117.
[93] Jensen & Meckling.

which its compensation is tied, rather than to increase fund assets through investment performance. As noted above, these two outcomes are not mutually incompatible. By allowing the adviser to reduce cash balances, fund sales effort is an efficient form of performance bond that benefits investors more than dollar-for-dollar. More important, when the adviser sells new shares its added fees consists of a percentage fee based on the larger asset holdings in the current period *and* additional fees for each subsequent period in which the larger asset holdings persist. The adviser's compensation is therefore "back-end loaded" and conditional on continuing investor satisfaction. Making an unsuitable share sale to a new investor does little to increase the adviser's long-run compensation (*i.e. wealth*) because the investor is likely to become dissatisfied with an unsuitable fund and withdraw sooner rather than later. This is what is termed in the economics literature as an opportunity for ex post settling up.

The SEC's conclusion that directed brokerage will lead advisers to "overtrade fund portfolio securities in order to generate additional sales of fund shares, or [to] fail to optimize transactions costs" has absolutely no support in economic theory or in fact. As already discussed, the clear implication from transaction cost economics is that, as agents, fund advisers will tend to engage in too little profitable trading of portfolio securities. That is exactly why mutual funds are organized to require shareholders to pay brokerage commissions and why competition allows advisers to receive benefits whose costs are bundled into commissions. The genuine problem fund investors face is not that their advisers will overtrade, but that they will undertrade by secretly indexing the portfolio to a standard benchmark rather than spending the effort to gather information on profitable trading opportunities. What is more, it is essential to understand that to generate good investment performance advisers must engage in some amount of uninformed (noise) trading; any adviser who trades only when informed will quickly be marked by those seeking to trade in advance in advance of his informed trades.[94] If every trade is informed, the result will be price impact, the very category of transaction cost the SEC's *Concept Release* highlights as a cause for concern. Any attempt by a fund adviser

[94] D. Bruce Johnsen, Property Rights to Investment Research: The Agency Costs of Soft Dollar Brokerage, 11 YALE J. ON REG. 75 (1994).

to increase trading beyond the point that optimizes on these margins will sacrifice efficiency and reduce both portfolio performance and its advisory fees.

A second and more subtle source of efficiency from directed brokerage is the indirect effect it likely had on the brokerage firm's incentive to provide high-quality portfolio trades. Having sold shares of Fund X to its client-investors, a firm that expects future portfolio commission business from Fund X is in position to increase the fund's returns (or prevent them from being eroded) by ensuring that its institutional brokers do a more careful job of executing its portfolio trades. By minimizing price impact, it can improve its client-investors' fortunes.

Critics of this rationale might say brokers have a fiduciary duty to do a careful job of executing trades for all funds that use their services, and that they should always do so. But caretaking in the form of artful trading is costly, and increased caretaking costs more in terms of forgone alternatives. Once having met the fiduciary threshold of best execution, the greater the reward the broker stands to receive from taking greater care in execution the more artfully he will trade and the lower will be price impact. People respond to incentives. There is nothing sinister about that. In any event, this rationale appears consistent in substance with the SEC's 1981 finding that revised NASD Rule 2830(k) should "permit special arrangements with individual selling dealers of investment company shares if accompanied by adequate specific prospectus disclosure."[95]

Finally, as the SEC's actions against both Morgan Stanley and Massachusetts Financial Services reveal, the partner arrangements targeted by the SEC also provided selling brokers with back-end loaded compensation. Brokers who sold fund shares retained by investors for more than one year received trailing fees of five basis points per year as long as the investor held the shares. In many cases these fees were paid by way of directed brokerage arrangements. Brokers' compensation therefore increased the longer fund investors held their shares. Holding a broker's sales effort and other influences constant, there can be no doubt that the more suitable the sale to a particular client-investor (i.e., the higher the "quality" of the broker's advice), the longer the client

[95] *In the Matter of National Association of Securities Dealers*,, at 3.

would have held on to the shares and the higher the discounted present value of the broker's total compensation. The converse is also true; the less suitable the sale the lower the broker's total compensation because the investor would have been more likely to become dissatisfied and withdraw from the fund. The broker then would have lost any trailing fees. The broker's willingness to accept trailing fees bonds the credibility of his promise to provide a high-quality suitability determination.

D. Vertical Arrangements and Interbrand Competition

The weight of the scholarly literature from transaction cost economics and the antitrust case law suggest that innovative vertical arrangements ─ whether price or nonprice restraints ─ aimed at retail product promotion are likely to enhance consumer welfare by increasing output, improving quality, and lowering price.[96] In its administrative proceedings against Morgan Stanley Dean Witter and Massachusetts Financial Services, the SEC concluded that the Partners Programs necessarily gave MSDW's FAs an incentive to improperly push participating funds over non-participating funds. The evidence from antitrust calls this conclusion into serious doubt.

Directed brokerage appears to be a form of vertical restraint designed to promote interbrand competition by suppressing intrabrand competition.[97] In the MSDW case, interbrand competition took the form, at least in part, of ensuring retail brokers had the information to help clients select knowledgably between a limited, though thorough, list of participating funds. It is important to understand that investors do not wake up one morning and automatically know what investments best serve their needs, and in any event those needs are constantly changing. Nor do retail brokers automatically know what funds are best for a given investor. For both parties, arriving at the proper suitability determination is a costly process that ordinarily involves intelligent search by a

---

[96] See Bork, Robert, THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF (1978); see, also, Goetz, Charles J and Fred S. McChesney, ANTITRUST LAW: INTERPRETATION AND IMPLEMENTATION (Foundation Press, 3rd ed., 2006), at 478-541.

[97] The U.S. Supreme Court caselaw recognizing the role vertical restraints play in promoting intrabrand competition by suppressing interbrand competition begins with Continental TV v. GTE Sylvania, 433 U.S. 36 (1977) and ends with the very recent decision in Leegin Leather Products v. PSKS, 127 S. Ct. 2705 (2007)

specialized agent between a universe of funds in hope of finding a reasonable match between the investor's needs and the fund's investment objectives and other important attributes.

The higher fees available to brokers for marketing participating funds (those brought within the MSDW brand umbrella, which included some 800 funds offered by 16 different advisory firms) under the MSDW Partners Program very likely served a function similar to garden-variety resale price maintenance. By preventing brokers from cutting price (their sales fee) the Program encouraged them to compete by providing special services, partly in the form of a more informed suitability determination than for the even broader selection of non-participating funds at hand. It compensated brokers for providing informed service and performed the dual function of relieving investors from having to engage in redundant search.

Although the U.S. Supreme Court began to recognize the potential efficiency of vertical non-price restraints as early as 1977, it only recently overturned the longstanding rule that resale price maintenance is illegal *per se* in *Leegin v. PSKS*. Resale price maintenance is now regarded under the rule of reason. Citing Coase, the extensive body of economic literature on resale price maintenance, and prior case law on vertical restraints, Justice Kennedy had this to say:

> The justifications for vertical price restraints are similar to those for other vertical restraints. . . . Minimum resale price maintenance can stimulate interbrand competition ─ the competition among manufacturers selling different brands of the same type of product ─ by reducing intrabrand competition ─ the competition among retailers selling the same brand. . . .
>
> Absent vertical price restraints, the retail services that enhance interbrand competition might be underprovided. This is because discounting retailers can free ride on retailers who furnish services and then capture some of the increased demand those services generate. . . . Consumers might learn, for example, about the benefits of a manufacturer's product from a retailer that invests in fine showrooms, offers product demonstrations, or hires and trains knowledgeable employees. . . . If the consumer can then buy the product from a retailer that discounts because it has not spent capital providing services or developing a quality reputation, the high-service retailer will lose sales to

> the discounter, forcing it to cut back its services to a level lower than consumers would otherwise prefer. Minimum resale price maintenance alleviates the problem because it prevents the discounter from undercutting the service provider. With price competition decreased, the manufacturer's retailers compete among themselves over services. . . .
>
> It may be difficult and inefficient for a manufacturer to make and enforce a contract with a retailer specifying the different services the retailer must perform. Offering the retailer a guaranteed margin and threatening termination if it does not live up to expectations may be the most efficient way to expand the manufacturer's market share by inducing the retailer's performance and allowing it to use its own initiative and experience in providing valuable services.[98]

Justice Kennedy quite rightly pointed out that resale price maintenance may also have anticompetitive effects under certain circumstances. This is why the practice is treated under the rule of reason rather than being legal *per se*. Under the rule of reason, courts hear all the factual evidence and expert testimony on the actual effects at hand. One important set of facts will be the defendant's share of market sales. If that market share is sufficiently low it raises a presumption that the defendants lacked the power to affect prices in a way that would injure consumers. Given the large number of brokerage firms that compete to sell fund shares, as well as the large number of different advisory firms selling myriad different funds, the suggestion that MSDW had sufficient market power to injure investors by its Partners Program lacks all plausibility.

Owing to competition, vertical arrangements such as the MSDW Partners Program that sweep an entire industry of reputed firms are far more likely to be a form of organizational innovation that benefits consumers than a means of unjust enrichment. There is simply too much to be gained from eliminating the dissipation of value that attends such wealth transfers. Where, owing to transaction costs, all the dimensions of exchange are impossible to specify in a formal contract and vertical integration is too costly (in this setting it is prohibited), the parties to repeat transactions often rely on what is termed in the law and economics literature as "relational contracts."[99] As in a standard partnership, the threat of termination of ongoing beneficial trade rather than legal recourse for breach of contract is what keeps the parties focused on creating value.

[98] Leegin Creative Leather Products v. PSKS, 127 S. Ct. 2705, 1215-17 (2007).
[99] Charles E. Goetz and Robert J. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981).

Although noise is a problem in any distribution system, such relational contracts together with vigorous competition reduce the likelihood of systemic unjust enrichment to the vanishing point. As the Second Circuit Court of Appeals stated as early as 1996, "[i]f brokerage firms are slightly inflating the cost of their transaction fees, the remedy is competition among the firms in the labeling and pricing of their services, not resort to the securities fraud provisions."[100]

By preventing retail brokers from cutting fees on participating funds, and by maintaining those fees slightly above what brokers could earn on nonparticipating funds, the partner programs induced them to compete on service rather than on price. The most obvious attribute of service in this setting is knowledgeable advice regarding various funds' investment objectives and relative suitability. But ensuring brokers have the knowledge to make a proper suitability determination is only one attribute of service. According to quoted excerpts from the defendant's prospectus in one of the many civil cases following on the heals of the SEC administrative proceeding in MSDW and MFS, others include

> "granting access to a selling agent's registered representatives; providing assistance in training and educating the selling agent's registered representatives and furnishing marketing support and other related services[;] establishing and maintaining accounts and records; answering inquiries regarding purchases, exchanges and redemptions; processing and verifying purchase, redemption and exchange transactions; furnishing account statements and confirmations of transactions; processing and mailing monthly statements, prospectuses, shareholder reports and other SEC-required communications, and providing services that might typically be provided by a Funds' transfer agent."[101]

These and other dimensions of service are costly, and the broker must be compensated for providing them. Prior to the advent of 12b-1 fees, brokers were paid a standard front-end sales load of about five percent deducted from the gross price of the fund share. Front-end sales loads no doubt give brokers an adequate incentive to provide investors with point-of-sale services attendant to making the sale. But they may give the

[100] Feinman v. Dean Witter Reynolds, Inc., et al., 84 F.3d 539, 541 (1996).
[101] Siemers v. Wells Fargo & Co., et al., 2007 U.S. Dist Lexis 31287 (2007), at 34.

broker limited incentive to provide clients with ongoing service. Like it or not, investors value ongoing service. Compared to front-end loads, so-called no-load funds have increased in popularity. They charge annual 12b-1 distribution fees assessed against fund shareholders in common and, owing to NASD limitations on such fees and the prohibition on directed brokerage, may also rely on direct payments from the adviser ─ so-called revenue sharing arrangements ─ to compensate brokers for marketing fund shares. At the margin, no-load funds dramatically increase investor liquidity because investors are not required to pay a fee for selling shares in one fund and buying shares in another such fund. This allows investors to rebalance their investment portfolio periodically at low cost. In contrast, a standard front-end load deters such activity. More important, as already pointed out, under 12-1 plans, revenue sharing, and directed brokerage arrangements (prior to being prohibited), brokers can be paid trailing fees, so that any reduction by a broker in ongoing service raises the prospect he will be terminated and lose future income.

There is no doubt that beginning with the SEC's 1980 decision to allow 12b-1 plans, they have gradually displaced load-fee arrangements. At the same time, they appear to have engendered organizational innovation in the form of more articulate load-fee arrangements. At this time, most fund families offer investors a choice between various share classes in the same underlying fund that carry different combinations of front-end loads, back-end loads that decline or disappear with length of holding, and 12b-1 fees. Given the extremely competitive nature of the retail brokerage and mutual fund industries, this organizational innovation would be presumed beneficial to investors in any setting in which antitrust law and economics is taken seriously.

V. INVESTOR WELFARE

The preceding section made several important points relevant to assessing the effect of directed brokerage on investor welfare. First, the temporal pattern of flows between the parties appears to assure the quality of portfolio brokerage and, in essence, the retail broker's suitability determination. Second, directed brokerage is in the category

of vertical restraints that likely benefits investors by giving brokers high-powered incentives to provide point-of-sale and ongoing services. As a general matter, careful consideration must be given to the transaction costs market participants face in choosing between alternative forms of organization, each with its own vector of conflicts. Rather than summary condemnation of any particular conflict, sound investor protection requires a careful balancing of countervailing conflicts and a careful investigation of the conflicts that plague the next best form for organization. Seen in this light, the following statement by then SEC Commissioner Roel C. Campos before the *2007 Mutual Fund Directors Forum* completely misses the mark:

> "It is incredible to me that I still hear this argument. Let me clarify — the SEC is not is *not* in the business of improving [investment] performance. We are not an agency of investment analysts or professionals. Moreover, no other rule or regulation that I know of has ever been characterized as deficient from an investor protection standpoint because it does not improve performance or returns on investment. Again, the purpose [of the mutual fund governance rules] is not to improve performance, but to eliminate a glaring conflict of interest."[102]

Simply to declare a conflict of interest, even a "glaring conflict," is insufficient justification for prohibiting the activity in question. It makes little sense to protect investors from agent self-dealing that would cost them only fifty cents if it reduces expected investment performance by a dollar. Such inefficient outcomes cannot be what Congress intended when it passed the ICA and IAA.

In antitrust law a consensus has emerged that alternative legal rules must be judged by their likely effect on consumer welfare.[103] Similarly, the inevitable trade-offs between alternative SEC rules regarding conflicts of interest can be judged only by their effect on investor welfare. Where judicial (and regulatory) administration is costly, and therefore imperfect, any legal rule has the potential for both Type I and Type II errors.[104] The same is true in the realm of mutual fund regulation. With errors possible in either

[102] Coral Gables, Florida: February 28, 2007) at http://www.sec.gov/news/speech/2007/spch022807rcc.htm.
[103] Bork.
[104] See Frank H. Easterbrook, The Limits of Antitrust, 63 TEX. L. REV. 1, 2 (1984); Brooke Group Ltd v. Brown & Williamson Tobacco, 509 U.S. 209 (1993).

direction, a rule that protects investors from the potential harms of a particular business practice also denies them the opportunity to enjoy any associated benefits. Prudence in protecting investors demands Type I and Type II errors be properly balanced, not that one or the other type be totally eliminated.

There can be little doubt risk-adjusted "performance" net of transaction costs, including any residual losses from agent self-dealing, is ultimately what investors want. To promote investor welfare, the SEC must learn to address regulatory trade-offs in light of established economic theory and to eschew the kind of facile rhetoric Commissioner Campos apparently considered appropriate. In no sense does this require the SEC to be "an agency of investment analysts." It simply requires a serious assessment of the likely economic effect of alternative rules, something antitrust regulators and courts have been doing for decades according to a well-developed body of scholarship and case law that is readily accessible to the SEC.

As yet, no systematic empirical work has been done to determine the actual effects on investor welfare of directed brokerage or its prohibition. An empirical study of soft dollar brokerage ─ a practice related to directed brokerage in which the adviser pays premium brokerage commissions on portfolio trades in exchange for broker-provided investment research ─ finds that the more a portfolio adviser pays in premium brokerage commissions the higher the portfolio returns. This finding is consistent with the hypothesis that paying up for brokerage bonds the quality of the broker's executions while improving the adviser's incentive to act in investors' best interests.[105] A recent empirical study of "slotting contracts" ─ the name given to shelf-space arrangements in the retail grocery industry ─ based on a large scanner database shows no indication the practice harms consumers.[106]

The main evidence in defense of directed brokerage and other shelf-space arrangements comes from the many civil cases that followed the SEC's administrative actions against MSDW and MFS. These cases included claims based on various forms of

[105] Horan, Stephen F. and D. Bruce Johnsen, *Can Third-Party Payments Benefit the Principal: The Case of Soft Dollar Brokerage*, ITL. REV. OF LAW & ECON (forthcoming, 2008).
[106] Wright, Joshua D., *Slotting Contracts and Consumer Welfare,* 74(2) ANTITRUST L.J. 439 (2007); see also Wright, Joshua D. and Benjamin Klein, 50 J. Law & Econ __ (2007).

securities fraud, in part for failure to properly disclose material information, as well as claims for excessive fees under Section 36(b) of the ICA, other violations of the ICA, and various state law claims. *Benzon v. Morgan Stanley* was the first civil case involving improper fee disclosure to be heard on appeal following the SEC's prohibition on directed brokerage.[107] The plaintiffs appealed from the federal district court's dismissal in a plaintiffs' class action against Morgan Stanley Dean Witter and various affiliates. Although the case did not specifically address directed brokerage, the plaintiffs alleged among other things that the defendants violated Section 10(b) of the SEA (1934) and *Rule 10b-5(b)* thereunder "by failing to disclose a broker compensation scheme which . . . works a conflict of interest."[108] Specifically, they alleged that by way of differential loads and 12b-1 fees "Morgan Stanley brokers receive[d] higher commissions from the sale of Morgan Stanley funds than from the sale of mutual funds sold by companies not affiliated with Morgan Stanley."[109]

The Court's response to this allegation was clear, succinct, and directly at odds with the SEC's findings of disclosure violations in its MSDW and MFS administrative proceedings, as well as in its release prohibiting directed brokerage: "Current SEC regulations [impose no] disclosure obligation with respect to broker compensation[, nor do they impose a duty] to disclose that brokers received greater compensation for the sale of Morgan Stanley mutual funds than for the sale of funds offered by other companies."[110] What is more, taking the position that investors should be required to protect themselves to some extent, the Court observed that the defendant's prospectus "put prospective investors on notice that there was a possibility that brokers were being compensated more highly for the sale of certain class shares than others, such that investors could pursue that line of inquiry with their financial advisors if they were concerned about broker incentives."[111]

---

[107] 420 F.3d 598 (6th Cir., 2005).
[108] *Id*., at 602.
[109] *Id*., at 611.
[110] *Id*., at 611-12.
[111] *Id*., at 612.

A large number of civil cases have since addressed directed brokerage and revenue sharing arrangements. All but two have been dismissed on the pleadings.[112] Specifically reviewing the MSDW Partners Program, the district court in *In Re Morgan Stanley and Van Kampen Mutual Fund Securities Litigation* rebuked the plaintiffs for asserting the MSDW settlement agreement as binding precedent. According to the court, "statements made by the SEC and NASD in the settlement documents are not law; they are rather untested assertions made by litigants. . . . [T]he position articulated in the SEC settlement agreement is not binding on this Court."[113] (citations omitted) Somewhat pointedly, and inconsistent the SEC's finding against MSDW and MFS with respect to disclosure requirements, the court also emphasized that at the time of the alleged wrongdoing "neither the SEC nor NASD . . . required registered representatives of broker/dealers to disclose their own compensation in a securities transaction, although both have been fully aware that registered representatives often received special incentives beyond the normal compensation to sell a particular product."[114] Citing *Benzon*, it went on to find that that the primary disclosure document for mutual funds under federal law, Form N-1A, "requires the disclosure of the total fees paid by the investor in connection with a securities purchase, as well as total commissions paid by the fund, but it does not require disclosure of how differential compensation is allocated."[115] (citations omitted) In any event, the court found that the differential

[112] See, e.g., In re Merrill Lynch Investment Management Funds, 434 F. Supp. 2d 233 (2006) (all claims for failure to disclose shelf-space payments and for excessive fees dismissed); Strigliabotti v. Franklin Resources, 398 F. Sup 2d 1094 (2005) (ICA 36(b) claims for excessive fees based on shelf-space dismissed; State law fraud claims for shelf space not dismissed): Bellikof v. Eaton Vance, 481 F.3d 110 (2007) (claim under ICA 36(b) dismissed for failure to allege excessive fees); Alexander v. Allianz Dresdner, 2007 U.S. Dist. LEXIS 68476 (2007)(Claim for failure to disclose shelf-space payments dismissed.); Boyce v. AIM Management, 2006 U.S. Dist. LEXIS 71062 (2006)(excessive fee claims dismissed); In re Evergreen Mutual Funds Fee Litigation, 423 F. Supp. 2d 249 (ICA Section 36(b) excessive fee claims for shelf-space dismissed); In re AIG Advisor Group Securities Litigation, 2007 U.S. Dist. Lexis 69396 (2007) (Rule 10b-5 claim for inadequate disclosure of shelf-space payments dismissed); In re Blackrock Mutual Funds Fee Litigation, 2006 U.S. Dist. LEXIS 13846 (2006)(claims for excessive fees and fraud dismissed for failure to make demand). But see Forsythe v. Sun Life, 417 F. Supp. 2d 100 (2006)(claims for shelf space, directed brokerage, conflicts of interest, dismissed for failure to make demand; ICA 36(b) claim survives motion to dismiss but drastically narrowed); Siemers v. Wells Fargo et al., 2007 U.S. Dist. Lexis 31287 (2007) (claims for excessive fees and failure to disclose shelf-space arrangements not dismissed).
[113] 2006 U.S. Dist. Lexis 20758 (2006), at 19-20.
[114] *Id*., at 30.
[115] *Id*., at 32.

compensation in the MSDW Partners Program involved mere fractions of a percentage point that were far too small to be material.

One of the issues that invariably arises in Rule 10b-5 litigation is "loss causation." Plaintiffs must allege that they relied on the defendant's material misstatement or omission and that the disclosure failure proximately caused them a cognizable loss.[116] On this issue, the *In re Morgan Stanley* court found that mutual fund shares are essentially different from ordinary stock in a publicly-traded operating company. "Unlike an ordinary share of stock traded on the open market" it explained, "the value of a mutual fund share is calculated according to a statutory formula. Share price is a function of 'Net Asset Value', the pro-rata share of assets under management, minus liabilities such as fees. Plaintiffs explain no mechanism by which a mutual fund share's price could differ from its objective 'value'."[117] The imbedded assumption in the court's explanation, quite correctly, is that no broker or investor can predict *future* fund performance. With shares of all funds offered by a broker priced at Net Asset Value, there is no way a broker can distort the merits of any particular fund, and any misstatements or omissions regarding fee allocations to brokers could not have caused investors a loss.

In addressing the materiality standard for federal securities disclosure, the Supreme Court long ago divined the problem of Type I and Type II errors, observing that:

> "[s]ome information is of such dubious significance that insistence on its disclosure may accomplish more harm than good. The potential liability for a Rule 14a-9 violation can be great indeed, and if the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to bury the shareholder in an avalanche of trivial information - a result that is hardly conducive to informed decision-making. . . . What the [materiality] standard does contemplate is a

[116] To plead proximate causation, plaintiffs must allege that the target misstatements or omissions were "the cause of the transaction's turning out to be a losing one." *Id.*, at 35-36 (quoting Bastian v. Petren Resources Corp., 892 F.2d 680, 684 (7th Cir.1990)).
[117] *Id.*, at 35-36.

> showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available"[118]

Relying on *TSC*, in *Feinman v. Dean Witter* Chief Judge Newman stated that "reasonable minds could not find that an individual investing in the stock market would be affected in a decision to purchase or sell a security by knowledge that the broker was pocketing a dollar or two of the fee charged for the transaction."[119] As the *Benzon* court had suggested, to avoid overloading investors with too much detail it is sufficient that disclosure provides them the wherewithal to make the necessary inquiries.

The negative effects of mandatory disclosure can go beyond merely burying investors in an avalanche of trivial information. Under some circumstances, mandatory disclosure risks revealing proprietary information. An excellent example under current ICA regulation is ICA Rule 30b1-5, which requires fund advisers to disclose the contents of their portfolios every quarter with a 60-day lag.[120] Ostensibly, the reason for this is to allow investors to verify the adviser's adherence to its reported investment style (*e.g.*, large-cap, growth, value, tech sector, etc.). But careful empirical analysis by several well-known economists shows that so-called copycat funds can rely on these disclosures to free ride on the investment adviser's stock selection,[121] ultimately diverting investment returns away from the underlying fund. This cannot be in the best interest of investors. Although the possibility remains that the benefits to investors from being able to quickly verify their adviser's conformity with reported investment style outweigh the harm from

---

[118] TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 448-49 (1976) (plaintiffs complaint also alleged violation of Rule 10b-5.
[119] Feinman v. Dean Witter Reynolds, Inc., et al., 84 F.3d 539, 541 (1996).
[120] Citation.
[121] Mary Margaret Frank, James M. Poterba, Douglas A. Shackelford, and John B. Shoven *Copycat Funds: Information Disclosure Regulation and the Returns to Active Management in the Mutual Fund Industry*, 47 J. LAW & ECON. 515 (2004).

lost returns, there is no evidence the SEC considered this trade-off in arriving at it disclosure policy.

In the context of fund share marketing it is fairly clear that substantial organizational innovation has occurred over time. Starting from a standard front-end load the industry developed directed brokerage arrangements designed in part to recapture portfolio brokerage commissions during the era of fixed commissions, 12b-1 fees, back-end and contingent loads, revenue sharing, and eventually fund supermarkets. This kind of organizational innovation is costly to advisers and brokers, and the available evidence suggests that it has benefited investors by building high-powered incentives into the adviser-broker-investor relationship that reduce, rather than increase, conflicts of interest and the prospect of unjust enrichment. If so, it may fall into the category of proprietary business information. To the extent the parties must reveal through mandatory disclosure any innovation that allows them an advantage over their competitors, the expected return from innovating declines and their incentive to invest in developing better marking programs declines along with it.

In a competitive business environment it should come as no surprise to investors that their agents are engaged in organizational innovation; in fact, it is very likely they expect it. Forcing advisers and brokerage firms to disclose such innovation can by no means be presumed to benefit investors. This is not to say that such innovation should enjoy intellectual property protection, only that if the parties are unable to engage in private contracting to protect it investor welfare may be diminished.

VI. CONCLUDING REMARKS

With intense competition at work in the brokerage and mutual fund industries, it is difficult to understand what the SEC considers improper about directed brokerage. One of the MSDW Program's obvious goals was to improve brokers' access to information about these funds and to provide valuable point-of-sale services. By way of trailing fees, it also provided brokers with the incentive to provide investors with valuable ongoing services. The only reasonable conclusion from the SEC's position is that it

simply does not approve of mutual fund marketing, presumably because marketing somehow induces investors to buy things that are not good for them while unjustly enriching brokers. Apparently, either investors should be left to fend for themselves when selecting among a vast universe of mutual funds or retail brokers should be deputized as employees of the regulatory state who provide only "objective" advice. The positive value to consumers of subjective retail marketing in a competitive marketplace is an issue that has long ago be asked and answered in economics and in antitrust.

By itself, the transaction cost analysis provided here should give the SEC pause enough to systematically investigate the potential benefits to investors from directed brokerage and similar shelf-space practices. But the alarming string of federal court dismissals of civil claims relying on the reasoning from the SEC's release prohibiting directed brokerage should stop it dead in its tracks. The great weight of federal court decisions on shelf-space arrangements flatly contradict the SEC's conclusion that directed brokerage creates intolerable conflicts of interest. Most of these decisions do not even attempt to address the possible benefits to investors from directed brokerage, as it was not an issue at the pleading stage. That the *In re Morgan Stanley* court made a point of emphasizing that SEC statements in settlement documents do not bind federal courts suggests that the issue of possible benefits to investors from directed brokerage may yet be prove ripe.

The SEC has recently suffered a troubling string of defeats in federal court on other matters that suggests its prohibition on directed brokerage could plausibly be challenged.[122] Most relevant for this paper are two related District of Columbia Circuit Court's decisions in *Chamber of Commerce v. SEC I*[123] and *Chamber of Commerce v. SEC II*.[124] Along with its prohibition on directed brokerage, in 2004 the SEC adopted a rule requiring mutual funds that rely on various exemptive rules to adopt specific governance practices, among them that a fund must have a board with no less than 75%

[122] Goldstein v. SEC, 451 F.3d 873 (2006) (SEC's hedge fund registration rule is arbitrary, vacated and remanded) and Financial Planning Associations v. SEC, 482 F.3d 481 (2007) (SEC exceeded its authority when it exempted brokers from the IAA who receive special compensation for giving investment advice).
[123] 412 F.3d 133 (2005).
[124] 443 F.3d 890 (2006).

independent directors and an independent chair.[125] The rule was necessary, according to the SEC, to give fund boards greater independence in light of inherent conflicts of interest stemming from recent enforcement actions following the Spitzer-inspired fund scandals. In *Chamber I*, the Court found that the SEC had the authority under the ICA to adopt the rule and to condition its prior exemptions on fund compliance, but that it violated the Administrative Procedures Act (APA) when it failed to determine the costs of the two conditions and to address any proposed alternative to the independent chair condition, as required by Section 2(c) of the ICA. This provision mandates that when the SEC engages in rulemaking it is required "to consider or determine whether an action is consistent with the public interest, [it] shall . . . consider . . . whether the action will promote efficiency, competition, and capital formation."[126]

In a hurried response on the eve of then Chairman Donaldson's departure, the SEC reconsidered the rule's costs and independent chair alternatives and readopted the rule without amendment. The Chamber of Commerce again petitioned for review, and in *Chamber II* the D.C. Circuit Court found that the SEC had again failed to comply with the APA, this time "by relying on materials not in the rulemaking record without affording an opportunity for public comment, to the prejudice of the Chamber."[127] The Court vacated both the 75% outside directors condition and the independent chair condition, allowing the SEC 90 days to reopen the record to allow the Chamber of Commerce an opportunity to comment on the costs of the two conditions.

At a time when burgeoning compliance requirements are widely believed to be are burying the financial industry in paperwork and imposing a huge tax on investors, it seems reasonable that the SEC should be required to justify added compliance requirements with more than the one-sentence conclusion "we do not anticipate that drafting or implementing these policies and procedures will be costly." Along the same lines, not only have the SEC's conclusions regarding the materiality of directed brokerage and other shelf-space arrangements been consistently contradicted by federal courts, but its release prohibiting directed brokerage consists of a series of summary

[125] Investment Company Governance, Release No. 26,520, 69 Fed. Reg. 46,378, 46,381 (Aug. 2, 2004).
[126] 15 U.S.C. § 80a-2(c).
[127] 443 F.3d 890, 894 (2006).

conclusions regarding the threat directed brokerage poses to investors unsupported by any kind of substantial evidence. Instead, these conclusions are supported by economically incorrect inferences about the maligned incentives directed brokerage provides advisers and institutional and retail brokers.

That directed brokerage is no longer the "benign" practice it once was, even if true, can cut in two directions. It might either actively improve or malign the parties' incentives. Reasonable inferences from established transaction costs economics suggest directed brokerage improves incentives, directly contradicting the SEC's conclusions. Rather than distorting advisers' decisions about which broker will execute portfolio trades, as the SEC concluded, bundling the cost of fund sales effort into institutional brokerage commissions allows them to maintain smaller cash balances, bond the quality of broker executions, and reduce the associated cost of monitoring brokers. That advisory fees are paid out over time reinforces this conclusion. Rather than inducing retail brokers to push unsuitable funds, directed brokerage gives them the wherewithal and incentive to provide suitable investment recommendations and other valuable services. As with advisers, that brokers were paid trailing fees reinforces this conclusion.

In its assessment of the effect of its directed brokerage prohibition on competition, efficiency, and capital formation, the SEC expressed hope that by reducing institutional brokerage commission rates its ruling would lead to the unbundling of distribution from portfolio execution and allow fund advisers to obtain other services more beneficial to fund shareholders. The model of quality assurance put forth in Part IV suggests that, as long as institutional brokerage remains an experience good, advisers must continue paying premium commissions to bond execution quality. Only if institutional brokerage evolves into an easily assessed commodity will brokerage commissions begin to approximate the marginal of executing portfolio trades. At this point, paying up for brokerage will naturally vanish owing to competitive forces. In the meantime, the SEC's hopes for unbundling will, and should, remain unmet.

Recall that Section 28(e) of the SEA specifically protects investment advisers from suits for breach of fiduciary duty when they pay premium brokerage commissions for bundled-in brokerage and research services. The primary focus of Section 28(e) over

the years has been as a safe harbor for the provision of investment research. Although the issue has apparently never been raised, by its plain meaning Section 28(e) appears to cover directed brokerage arrangements as well. Sub-section (3) says that a "person provides brokerage and research services insofar as he . . . (A) furnishes advice . . . as to the value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of securities or purchasers or sellers of securities; or . . . (C) effects securities transactions."[128] Under the MSDW Partners Program retail brokers furnished advice and its institutional brokers effected securities transactions, all within a single firm. Simply as a matter of legal interpretation, it seems likely that a federal court would find directed brokerage to be protected under Section 28(e). The benefits directed brokerage provides investors by reducing transaction costs make this possibility all the more likely.

Nothing in the SEC's analysis or the weight of subsequent federal court decisions suggest that MSDW-like directed brokerage programs were anything but models of organizational innovation, and the SEC's reports make no mention of evidence of an injury to any investors or any sacrifice of best execution. This is not to suggest agents never engage in self-dealing or that there is no way regulators, courts, or lawmakers can improve the contracting environment. Instead, it suggests that any truly workable solution must specifically account for the transaction costs the parties face in balancing myriad, subtle, and invariably countervailing conflicts.

For the long-term health of U.S. financial markets and the bona fide protection of investors, the SEC must begin to incorporate transaction cost economics into its decision making process. The Federal Trade Commission, the Antitrust Division of the Department of Justice, and federal courts have been doing this for over 30 years. Surely the SEC can be expected to do the same. It must. Writing in 1968, Oliver Williamson's observations regarding the importance of transaction cost economics to antitrust enforcement is uncanny for its relevance to the SEC's current regulation of conflicts of interest in financial markets. In his words, "if neither the courts nor the enforcement agencies are sensitive to [transaction cost] considerations, the system fails to meet a basic

[128] 15 U.S.C. section 78bb(e) (1988) (as amended).

test of economic rationality. And without this the whole enforcement system lacks defensible standards and becomes suspect."[129]

[129] Oliver E. Williamson, *Economics as an Antitrust Defense: The Welfare Tradeoffs*, 58 AM. ECON. REV. 18 (1968).

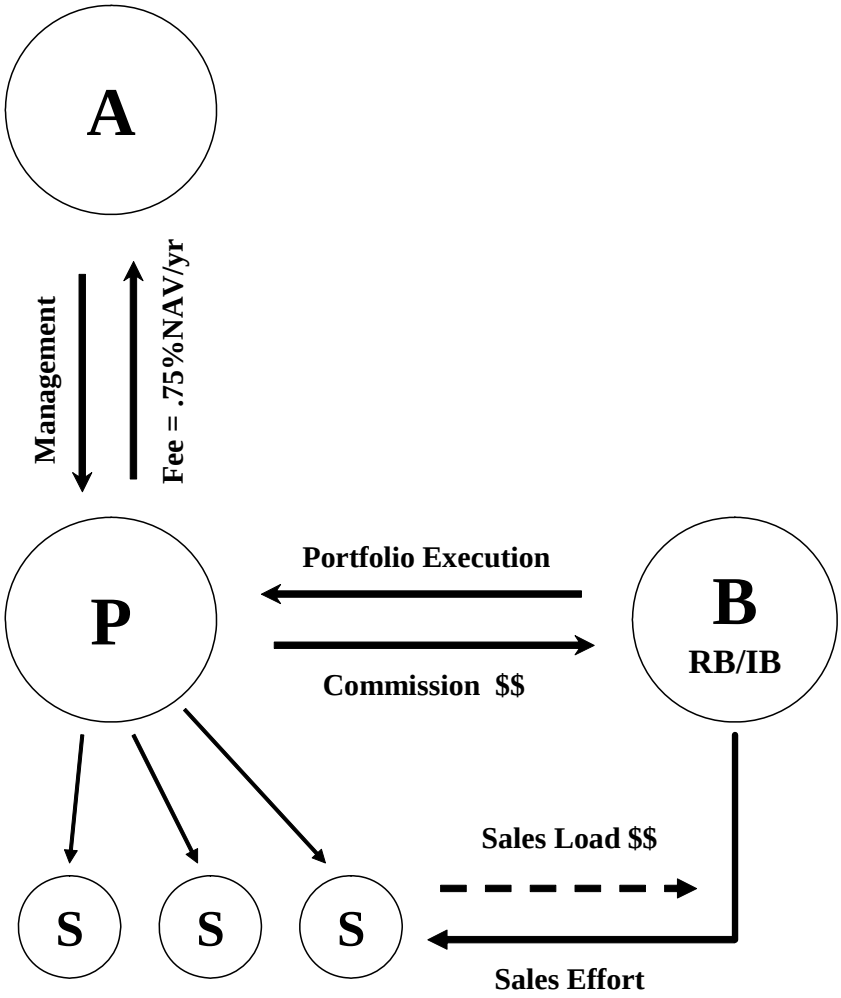

Figure 1
Relations Between the Parties

TABLE I

ALTERNATIVE BROKERAGE ARRANGEMENTS

Transaction Data	Quarter 1	Quarter 2	Quarters 1 + 2
Gross Gain Per Share @ 10¢/sh	$100,000	$100,000	$200,000
Panel A: Adviser Pays Two Cents Per Share			
Total Commissions @ 2¢/sh	$20,000	$20,000	$40,000
	LQ Broker	LQ Broker	
Broker Cost	$20,000	$20,000	$40,000
Broker Surplus	0	0	0
Price Impact	$120,000	$120,000	$240,000
Total Transaction Cost	$140,000	$140,000	$280,000
Trading Gain/(Loss)	($40,000)	($40,000)	($80,000)
Panel B: Adviser Pays Four Cents Per Share			
Total Commissions @ 4¢/sh	$40,000	$40,000	$80,000
Outcome 1	HQ Broker	HQ Broker	
Broker Cost	$40,000	$40,000	$80,000
Broker Profit	0	0	0
Price Impact	0	0	0
Total Transaction Cost	$40,000	$40,000	$80,000
Trading Gain	$60,000	$60,000	$120,000
Outcome 2	LQ Broker	HQ Broker	
Broker Cost	$20,000	$40,000	$40,000
Broker Surplus	$20,000	0	0
Price Impact	$120,000	0	$120,000
Total Transaction Cost	$160,000	$40,000	$200,000
Trading Gain	($60,000)	$60,000	0
Expected Outcome			
Expected Transaction Cost			$140,000
Expected Trading Gain/(Loss)			+$60,000
Panel C: Adviser Pays Seven Cents Per Share, Accepts $60,000 Up-front Bond			
Total Commissions @ 7¢/sh	$70,000	$70,000	$140,000
	HQ Broker	HQ Broker	
Broker Cost	$40,000	$40,000	$80,000
Broker Surplus	$30,000	$30,000	$60,000
Price Impact	0	0	0
Total Transaction Cost	$70,000	$70,000	$140,000
Trading Gain	$30,000	$30,000	$60,000
HQ Broker Bond	+$60,000		+$60,000
Total Gain			+$120,000