THE SEC'S 2006 *SOFT DOLLAR GUIDANCE*: LAW AND ECONOMICS

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Abstract

After some two years of deliberations, in July 2006 the SEC released its long-awaited *Guidance* on the scope of the "soft dollar safe harbor." Passed as part of the Securities Acts Amendments in May, 1975, the safe harbor has protected fund advisers and other money managers for over 30 years from criminal actions and civil suits for breach of fiduciary duty when they use client assets to pay more than the lowest available brokerage commissions in exchange for "brokerage and research services." During this time the SEC has interpreted and re-interpreted the safe harbor's scope, largely owing to the public controversy soft dollars engender as a form of illicit "kickback" designed to subvert advisers' loyalty. The SEC's *2006 Guidance* attempts to dramatically narrow the permissible use of soft dollars by prescribing a laundry list of protected and unprotected services. Yet the SEC is now considering further interpretation, and its chairman has petitioned Congress for an outright repeal of the soft dollar safe harbor. This paper shows that soft dollars are an innovative and efficient form of economic organization that benefits fund investors. According to economic theory now well-established in antitrust law, the SEC's *Guidance* is hopelessly misguided. Were the *Guidance* to come under the scrutiny of a federal court, the SEC would very likely experience another in its recent string of embarrassing legal defeats.

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> *"[Soft dollars are] a witch's brew of hidden fees, conflicts of interest, and complexity . . . at odds with investors' best interests. . . . That's why I've asked Congress to consider legislation to repeal or at least substantially revise the 1975 law that provides a 'safe harbor' for soft dollars."* – SEC Chairman Christopher Cox[1]

I. INTRODUCTION

In the wake of the 2003 mutual fund scandals sparked by then New York Attorney General Eliot Spitzer,[2] the U.S. Securities and Exchange Commission (SEC) reexamined the regulation of conflicts of interest facing mutual fund advisers in their brokerage allocation decisions. Owing to periodic public allegations that it is a form of illicit kickback intended to subvert advisers' loyalty,[3] soft dollar brokerage ─ or simply *soft dollars* ─ quickly became a target of SEC regulatory reform. Completely banning soft dollars was not one of the SEC's options because the practice is covered by a statutory safe harbor. Passed as part of the Securities Acts Amendments in May, 1975,[4] for over 30 years Section 28(e)[5] of the Securities Exchange Act (1934)(SEA) has

[1] Speech by SEC Chairman: Address to the National Italian-American Foundation by Chairman Christopher Cox, U.S. Securities and Exchange Commission, New York City, May 31, 2007.
[2] *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.
[3] *See, e.g.*, *Speech by SEC Staff: Focus Areas in SEC Examinations of Investment Advisers*, TOP 10 States News Service, March 20, 2008; *Wall Street Roundup; 'Soft-dollar' deals draw SEC's ire*, Los Angeles Times, June 1, 2007, Home Edition, Part C, Pg. 6; *SEC OKs soft-dollar payment guidelines: Inflated commissions must relate to service*, Chicago Tribune, July 13, 2006, Final Edition, ZONE C, Pg. 3; David F. Swensen, *Invest at Your Own Risk*, The New York Times, October 19, 2005, Late Edition – Final, Section A, Column 1, Editorial Desk, Pg. 21.
[4] 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)).
[5] *15 U.S.C. section 78bb*(e) (1988) (as amended).

protected fund advisers, their portfolio managers, and other institutional money managers from criminal actions and civil suits for breach of fiduciary duty when they use client assets to pay more than the lowest available brokerage commission ─ to "pay up" ─ in exchange for "brokerage and research services." Barring an act of Congress, any regulatory reform by the SEC would have to come as a narrowing of its interpretation regarding which "brokerage and research services" qualify for safe harbor protection.[6]

Having re-interpreted Section 28(e) four times over the years, often in contradictory ways, in May 2004 the SEC's requested that the National Association of Securities Dealers (NASD) form a task force to advise it on how to "improve the transparency of mutual fund portfolio transaction costs and distribution arrangements," with special emphasis on soft dollars.[7] The NASD's *Report of the Mutual Fund Task Force, Soft Dollars and Portfolio Transaction Costs* appeared in November 2004, making various recommendations how Section 28(e)'s "brokerage and research services" might be interpreted more narrowly. After more than two years of investigation, in July 2006 the SEC issued its *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934.*[8] Owing to the intolerable conflicts of interest soft dollars are said to create, the *2006 Guidance* narrowed their permissible use. Since then, SEC Chairman Cox has called on Congress to completely repeal Section 28(e). Alternatively, the SEC staff has proposed to issue further interpretive guidance and to mandate more detailed disclosure of soft dollar practices by fund advisers and other portfolio managers.[9]

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[6] The SEC's interpretation of Section 28(e)'s scope has little legal force beyond providing market participants with notice about what activity the SEC believes falls outside the safe harbor. Simply because an activity falls outside the safe harbor does not mean it is subject to criminal or civil action. *See Interpretation Concerning the Scope of Section 28(e)*, Exchange Act Release No. 23,170, 51 Fed. Reg. 16,004 (Apr. 30, 1986) [hereinafter *1986 Interpretive Release*]

[7] (Nov. 11, 2004) [hereinafter *NASD Report*] (available at http://www.nasd.com/web/groups /rules-regs/documents /rules-regs/ nasdw-012356.pdf.)

[8] *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*, Securities Exchange Act Release No. 54165 (July 24, 2006) [hereinafter *2006 Guidance* or *Guidance*].

[9] See Sara Hansard, *Unforeseen Consequences of ADV Disclosures Cause Worry; Investors Could Wind up Swamped, they Say*, Investment News, February 18, 2008, p. 3; *Cox's Soft-Dollar Fight Becomes a Lonely Battle: SEC Sets it Sights Much Lower with Proposal for Added Guidance*, Investment News, February 25, 2008, p. 42.

The SEC's *2006 Guidance* is a laundry list of legally arbitrary and economically irrelevant formalisms bordering on the disingenuous.[10] Among other things, it stretches the plain meaning of language, directly contradicts the terms of the statute, ignores the SEC's own prior recitations of Congressional intent, and cites specific provisions of agency and trust law that purport to favor a narrow interpretation of "brokerage and research services" while disregarding other provisions that directly contradict such an interpretation. What is more, it completely ignores a substantial body of economic theory widely embraced by antitrust regulators and federal courts ─ primarily transaction cost economics ─ that strongly suggests paying up for "experience goods"[11] such as institutional portfolio brokerage is quite rational and, more likely than not, beneficial to investors. What emerges is the picture of a federal agency so desperate to appear vigilante after being trumped by Eliot Spitzer that it has abandoned any pretense of economic literacy. Were the *2006 Guidance* to come under the direct scrutiny of a federal court, the SEC would very likely experience another in its recent string of embarrassing legal defeats.[12]

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[10] In May, 2007, SEC Chairman Christopher Cox sent a pointed letter to Senate Banking Committee Chairman Christopher Dodd (D., Conn.) and House Financial Services Committee Chairman Barney Frank (D., Mass.) urging Congress to either ban soft dollar brokerage or regulate it to the vanishing point. See Judith Burns, *Cox Vows to Penetrate Soft-Dollar 'Fog'; SEC Chairman Urges Congress to Eliminate Fee-Research Bundling*, Wall Street Journal (Eastern edition), May 31, 2007, p. C.15. In late June, Chairman Frank's committee took Commissioner Cox's testimony in the presence of the other four SEC commissioners on this and other investor issues. *Testimony Concerning A Review of Investor Protection and Market Oversight with the Five Commissioners of the Securities and Exchange Commission.* Witness List: Christopher Cox, Chairman, Paul S. Atkins, Commissioner, Roel C. Campos, Commissioner, Annette L. Nazareth, Commissioner, Kathleen L. Casey, Commissioner, June 26, 2007: ". . . [T]he SEC has intensified its focus on "soft dollars" that brokers receive from mutual funds to pay for things other than executing brokerage transactions. Recently, the Commission acted unanimously to publish interpretive guidance that clarifies that money managers may only use soft dollars to pay for eligible brokerage and research services — and not for such extraneous expenses as membership dues, professional licensing fees, office rent, carpeting, and even entertainment and travel expenses. At the same time, we are examining the adequacy of current accounting and disclosure for soft dollars." See also Statement of Chairman Christopher Cox by Chairman Christopher Cox, U.S. Securities & Exchange Commission, before the U.S. Senate Committee on Banking, Housing and Urban Affairs, July 31, 2007: ". . . I have . . . called on Congress to consider the future of the so-called "soft dollars" that brokers receive from mutual funds to pay for things other than executing brokerage transactions."

[11] Philip Nelson, *Information and Consumer Behavior*, 78 J.P.E. 311 (1970). In contrast to experience goods, Nelson characterizes as "search" goods those that can be easily assessed at the point of sale. In fact, there probably are no pure search goods, though some goods no doubt require more experience to evaluate than others.

[12] See SEC v. Chamber of Commerce I, 412 F.3d 133 (2005) (SEC rule requiring investment companies boards to consist of 75% outside directors and an outside chairman as a condition for reliance on other

Relying largely on transaction cost economics,[13] this paper provides a careful analysis of the SEC's *2006 Guidance* to determine its likely effect on investor welfare.[14] There is little doubt soft dollars engender conflicts of interest, and that most mutual fund investors lack actual knowledge of these conflicts or ─ owing to the collective action problem they face ─ the wherewithal to directly monitor their managers and brokers.[15] Under the common law of agency, however, conflicts of interest reflect merely the potential for agent self-dealing. They are inevitable in a specialized intermediary economy and only rarely result in actual agent self-dealing or other forms of disloyalty.[16]

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exemptions found in violation of the Investment Company Act and the Administrative Procedures Act for failing to determine the costs of the two conditions and to address any proposed alternative to the independent chair condition); SEC v. Chamber of Commerce II, 443 F.3d 890 (2006) (SEC rule requiring investment companies boards to consist of 75% outside directors and an outside chairman as a condition for reliance on other exemptions found in violation of the Investment Company Act and the Administrative Procedures Act for "relying on materials not in the rulemaking record without affording an opportunity for public comment, to the prejudice of the Chamber"); 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 from the Investment Advisers Act brokers who receive special compensation for giving investment advice).

[13] 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. 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. See, e.g., Johnnie L. Roberts and Richard Gibson, *'Friction' Theorist Wins Economics Nobel*, Wall Street Journal, Oct. 16, 1991, Section B, page 1. R.H. Coase's The Problem of Social Costs, 3 J.L. & ECON. 1 (1960), is no doubt the most cited article in all of economics. Together with Coase's The Nature of the Firm, 4 Economica 386 (1937), the impact has been remarkable, as reflected in a virtual revolution in antitrust[13] and other areas of law. Most recently, see *Leegin Creative Leather Products v. PSKS, Inc*, 127 S. Ct. 2705 (2007), relying on Coase's work to reverse a near-100-year Sherman Act precedent treating minimum resale price maintenance as illegal *per se*. *See, generally*, Richard A. Posner, ECONOMIC ANALYSIS OF LAW (7th ed, 2007), as well as any issue of THE JOURNAL OF LAW & ECONOMICS.

[14] 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 JOURNAL OF POLITICAL ECONOMY 615 (1981). Based on a recent analysis of citations, these articles ranked third and 59th 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: http://ssrn.com/abstract=931371. Coase's seminal works antedated the database used for this study.

[15] This not to say investors collectively, as embodied in "the market," are incapable of effectively monitoring managers. See Eugene F. Fama and Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J. LAW & ECON. 327 (1983).

[16] Under agency law, a conflict of interest exists when the agent's interests are adverse to the principal, but a 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.

Despite the lofty pronouncements one hears from securities regulators and financial market commentators,[17] once transaction cost economics is considered the elimination of conflicts of interest is an impossible standard for protecting investors. In a competitive marketplace, innovative 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. Otherwise, the parties ─ brokers, advisers, *and* investors ─ would find it in their joint interest to eliminate them to the extent the cost of transacting allows. After all, the prospect of shared gains from trade is what brings the parties together to begin with.

It would be a mistake to summarily prohibit innovative business practices in the interest of investor protection simply because they give rise to conflicts of interest. The best that can be hoped for under such circumstances 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. Properly balancing conflicts of interest is a task best left to portfolio managers, fund advisers, and ultimately to fund directors subject to the requirement that truly material conflicts must be disclosed.

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[17] 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.").

With these thoughts in mind, this paper proceeds as follows. To lay a foundation, Part II briefly describes the organization of the mutual fund and institutional brokerage industries, paying special attention to existing principal-agent relations. Part III provides a history of soft dollar regulation, culminating with a detailed look at the SEC's *2006 Guidance*. Focusing on the economics of transaction costs, Part IV shows how soft dollars work to assure brokerage quality and efficiently subsidize investment research by fund advisers. Part V assesses the likely effect of the SEC's *2006 Guidance* on investor welfare in light of the economic theory set out in Part IV. Contrary to accepted wisdom, recent empirical work suggests soft dollars limit conflicts of interest by better aligning fund managers and their executing brokers' incentives to increase portfolio returns.[18] In this framework, the "net benefit test" determines which "brokerage and research services" should be covered by the safe harbor. Part VI provides concluding comments and makes a specific proposal for how the SEC might usefully reformulate its cost-benefit analysis for rulemaking under the `40 Act.

II. INDUSTRY ORGANIZATION

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 ready 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.[19] For this reason they are also known as *open-end funds*.[20] Much of Americans' savings are held by mutual funds and managed by advisory

[18] Stephen M. Horan and D. Bruce Johnsen, Can Third-Party Payments Benefit the Principal: The Case of Soft Dollar Brokerage, Intl. Rev. Law & Econ. (forthcoming, 2008).
[19] *Pricing of Redeemable Securities for Distribution, Redemption and Repurchase*, Investment Company Act Release No. 5519, 33 FR 16331 (1968), at 16.
[20] In contrast, closed-end funds issue shares once and do not offer shareholders a redemption option. To cash out, a shareholder must sell his or her shares to other investors in the market.

firms regulated under the Investment Company Act (ICA, 1940)[21] and the Investment Advisers Act (IAA, 1940)[22] (collectively known as "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 contract periodically approved by the fund's board of directors or a majority of fund shareholders.[23] 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(f) allows advisory firm owners to profit from a sale of control in the advisory firm that indirectly assigns the advisory contract. The relationship between the adviser and the fund therefore lies somewhere in an economic netherworld between vertical integration (an extended firm) and long-term contract (market exchange).[24]

Advisory services include record keeping, custody of shares, 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.[25] As an agent for the fund, an active manager'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 manager traditionally hires an institutional securities broker to "execute" it. In selecting between brokers, the manager has a fiduciary duty of "best execution" to the fund.

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[21] 15 U.S.C. Section 80a-1 through 80a-64 (1940) [hereinafter ICA].
[22] 15 U.S.C. Section 80b-1 through 80b-21 (1940) [hereinafter IAA].
[23] 15 U.S.C. Section 80a-15 (1940).
[24] 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).
[25] 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.

The executing broker is also an agent of the fund. Like the manager, he is subject to a fiduciary duty of best execution of portfolio trades. This requires him to search for willing sellers or buyers and to contract with them for the purchase or sale of the security on the best possible terms for the benefit of the fund.[26] In consideration, the broker typically receives a commission averaging five or six cents per share.[27] 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 importantly, anonymity. There is little doubt these specialized agents effectively reduce the total costs of transacting portfolio securities in the vast majority of agency trades.[28]

Because brokerage commissions are treated as capital items and included in the price basis of portfolio securities for tax reasons, fund shareholders implicitly pay them in the form of lower net returns.[29] Outsiders to the world of institutional securities brokerage are often shocked to hear brokers routinely provide fund advisory firms or their portfolio managers with benefits as a partial quid pro quo for their promise of premium commission payments on future portfolio trades. Soft dollars are the primary means by which brokers have provided such benefits.

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[26] For a statement of the adviser's duty of best execution *See 1986 Interpretive Release* at n. 35 *et seq*... 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).

[27] 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. *See 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 [hereinafter *Concept Release*]. There is no doubt commission rates have gradually declined over time and continue to do so.

[28] 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 *Concept Release* and discussion *infra*, at ?

[29] Brokerage commissions are added into the price basis of a portfolio security when it is purchased and netted out when it is sold. Gross investment returns are therefore net of commissions (and other transaction costs).

To understand how soft dollars work, Figure 1 illustrates relations between the parties. P represents the 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/manager, M, a fee consisting of a periodic share of the portfolio's net asset value, say 75 basis points per year.[30] In exchange the manager provides active management through an employee-manager, whose task is to provide effort identifying profitable trading opportunities. Having identified a profitable trade, the manager hires a broker, B, to execute it in exchange for commission payments on completion.

In a typical soft dollar arrangement, the broker provides the manager with credits, oftentimes *up front*, to pay a specific dollar amount of his research bill with independent research vendors, V. In exchange, the manager agrees to send the broker future trades at premium commission rates. By way of example, the broker might provide the manager with $60,000 in research credits if the adviser agrees to send the broker enough trades over the coming months at seven cents per share to generate $140,000 in brokerage commissions, clearly more than necessary to cover the lowest available commission or the broker's marginal execution cost. In this sense the manager is said to "pay up" for research bundled into the brokerage commission. Historically, once having entered into this agreement the manager orders any of a large number of research products ─ fundamental analyses, hardware, software, subscriptions, databases, etc. ─ from independent, or *third-party*, vendors, who in turn receive payment from the broker.[31] If all goes as planned, the manager places the promised trades with the broker at the agreed premium commission rate. If not, he can terminate the broker at any time with no legal obligation to make the promised trades.

Courts and regulators have long regarded brokerage payments as assets of the fund,[32] so-called "client commissions."[33] Managers' use of client commissions for soft

[30] A basis point is one one-hundredth of a percentage point.
[31] This flow of third-party research is shown by the horizontal arrow from V to M in Figure 1, and the broker's payments to vendors are shown by the vertical arrow from B to V.
[32] 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, 17 CFR Part 270 (2004); and *2006 Guidance*.

dollars has been heavily criticized as a conflict of interest that may lead the manager to favor itself over fund investors, a situation the `40 Act was generally designed to prevent.[34] The prospect of unjust enrichment is said to malign advisors' incentives, leading them to engage in too much trading, to use too much research, and to select brokers to generate research credits rather than to enhance execution quality.[35] 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.

It bears emphasizing that none of these criticisms identify a conflict of interest unique to the manager's receipt of *independent* research through soft dollar arrangements. Instead, they identify a conflict inherent in bundling the costs of research and execution together into premium brokerage commissions. All institutional brokers do that.[36] Soft dollar brokerage constitutes only one form of bundling. Since time out of mind, full-service brokers have provided investment managers with proprietary in-house research and other brokerage services bundled together with execution as part of an informal, long-term relationship. Indeed, this practice predominates to this day, as illustrated by the diagonal arrow in Figure 1. The main difference between these two forms of institutional brokerage is that proprietary research is generated within the brokerage firm and is accounted for only informally during the long course of a trading relationship, while independent research is transacted in the market for a price and provided in arm's-length transactions by independent research vendors. That soft dollars foster

[33] *See 2006 Guidance*, at n. 3. Discussed *infra*.

[34] 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 (2005).

[35] See, e.g., D. Bruce Johnsen, *Property Rights to Investment Research: The Agency Costs of Soft Dollar Brokerage*, 11 YALE J. ON REG. 75 (1994); *See 2006 Guidance*.

[36] The exceptions consist of discount brokers and proprietary trading networks, which normally charge an "execution-only" brokerage commission and provide little in the way of bundled services, although that may be changing. Although proprietary networks are legally classified as brokers subject to registration under the Securities Exchange Act (1934), they operate through protocols that leave virtually all trading discretion to the manager. Instinet, LLC., is one example of a proprietary trading network. Institutional portfolio managers are said to trade only sporadically, if at all, through discount brokers, who tend to focus on retail clients.

specialization by separate, vertically disintegrated firms and formally meter research is hardly a reason to ban them or subject them to onerous regulation. Accordingly, the central policy question we address is whether the widespread practice of bundling the cost of research into premium commissions benefits or harms portfolio investors compared to a world in which managers are required to pay for all research out of their own pockets.

III. A BRIEF HISTORY OF SOFT DOLLAR REGULATION[37]

A. Vertical Dis-Integration of Investment Research and the 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 being felt to this day.[38] From its inception in 1792, the association of stockbrokers and dealers known until recently as the New York Stock Exchange (NYSE) (now NYSE Euronext) operated under a system of fixed minimum commissions that, according to many, bore conspicuous resemblance to a naked price fixing cartel.[39] 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.[40] With passage of the SEA and the creation of the SEC in 1934, this authority came by way

[37] To a large extent, the material in Sub-section A and Sub-part B1 of this section summarize portions of D. Bruce Johnsen, *Property Rights to Investment Research: The Agency Costs of Soft Dollar Brokerage*, 11 YALE J. ON REG. 75 (1994), *supra* n. ?. As this material merely provides background, I have chosen to keep citations to a minimum. Readers interested in detailed citations can find them in the original.

[38] 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 achieving this goal thirty years later. See Regulation NMS, Securities Act Release No. 51808, 17 CFR PARTS 200, 201, 230, 240, 242, 249, and 270 (2005).

[39] 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, (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 et al., Prices are Property: The Organization of Financial Exchanges from a Transaction Cost Perspective, 34 J.L. & Econ. 591, 596 (1991).

[40] See U.S. v. Chicago Board of Trade, 246 U.S. 231 (1918).

of then Section 19(b) of the Act.[41] Under what is now regarded as "the old fixed commission system," the small number of full-service brokerage houses that dominated the NYSE produced most of the investment research, largely in the form of proprietary conclusions as to mispriced securities ─ so called "stock picks" ─ and analyst reports best seen as outputs in the investment research process. They then bundled the costs of proprietary research together with execution of the associated securities trades into a single commission and allocated them to favored clients based, in part, on the amount of commission business the client did with the firm.

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. Between 1940 and 1975, total domestic mutual funds assets grew from approximately $450 million to approximately $46 billion.[42] Private and public pension funds and other institutional portfolios experienced similar growth. Moreover, the share of outstanding U.S. corporate common stock held by these institutions increased to over 33% in 1980.[43]

Emerging opportunities in investment research brought on by the ever accelerating "electronics revolution" helped make the growth of institutional portfolios possible. Fund advisers and other portfolio managers gradually developed the wherewithal to avoid the favoritism game played by full-service brokerage houses, allowing them to vertically dis-integrate investment research from securities trading. Instead of relying on these brokers' proprietary in-house stock picks, they 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.

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[41] 15 U.S.C. § 78s(b)(9) (repealed 1975)..

[42] Investment Company Institute, MUTUAL FUND FACT BOOK (2005), at 71 (available at http://www.ici.org/stats/mf/2006_factbook.pdf).

[43] Carolyn K. Brancato & Patrick A. Gaughan, *The Institutional Investor Project* (Sept. 1991) (unpublished working paper, on file with the Center for Law and Economic Studies, Columbia University School of Law) at Table 9.

Possibly owing to scale economies in securities trading, institutional portfolio managers 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 prevailing.[44] Large-block trading by institutions began to dominate the NYSE and other trading networks. As institutional managers 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, colorfully referred to as "give-ups" and "reciprocals." These rebates allowed managers to more or less "recapture," for the benefit of the portfolio, the excess portion of the commission above the broker's cost of execution. In this fitful regulatory environment, some methods of recapture proved fleeting, while others proved sustainable but fraught with conflicts of interest. Reciprocal commission recapture consisted primarily of in-house investment research provided by full-service brokers in exchange for future commission business. As time passed, managers continued to rely on full-service brokers for bundled-in research but increasingly turned to independent research from third-party vendors. As deregulation approached, research rebates accounted for roughly 60 percent of the commission on institutional-sized orders.[45]

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.[46] Commissions fell dramatically and trading volume surged.

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[44] Philip Maher, *Why Wall Street Can't Bank on Soft Dollars*, Investment Dealers' Dig., Oct. 23, 1989, at 19; see also Gregg A. Jarrell, *Change at the Exchange: The Causes and Effects of Deregulation*, 27 J.L. & ECON. 273, (1984), at 277.
[45] Jarrell, at 279.
[46] 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

B. The Rise of Soft Dollar Brokerage

With deregulation of fixed commissions many NYSE member firms suffered a sobering contraction. Commissions immediately declined to between five and ten cents per share.[47] In spite of a tremendous increase in trading volume, NYSE seat prices fell in value by roughly 50%.[48] Although, by any reasonable standard, industrial concentration remained fairly low, the brokerage industry experienced an alarming merger wave. Established full-service brokers began to diversify away from the trading of common stocks. Hardest hit were the medium-sized firms that had specialized in providing in-house research to institutional clients. Many of them left the industry. Helping to drive lower commissions were the many new entrants to the industry ─ so-called "execution-only" brokers ─ that had little or no in-house research capacity. Yet, curiously, freely-negotiated commissions failed to completely eliminate bundling. Though at much lower commission rates than before, most institutional brokers continued to bundle the cost of research — both proprietary and third-party — and portfolio trades into a single commission. The provision of third-party research in this way came to be known as soft dollar brokerage.

In contrast to the brokerage industry, the mutual fund industry flourished. Since then, with a minor exception in 2002, mutual fund assets have grown continuously to $8.9 trillion in 2005, a trend no doubt furthered by the advent of tax deferred retirement plans.[49] Along with the downward trend in commissions came a dramatic rise in portfolio turnover. The available evidence indicates that a sustained increase in soft dollar use accompanied the increase in turnover. Several commentators have estimated

section 6(e) and also prompted the SEC to adopt Rule 19b-3. Adoption of Rule 19b-3, Exchange Act Release 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. (1975), at 675.

[47] Maher, at 19; see also Jarrell, at 277.

[48] Jarrell, at 294-97.

[49] Investment Company Institute Factbook, available at http://www.icifactbook.org/fb_data.html#section1.

that by 1990 between 30% and 50% of all trades on the NYSE involved the provision of third-party research pursuant to some form of bundling arrangement,[50] with the annual soft dollar component of brokerage commissions thought to be in excess of $1 billion in 1989. Soft dollar use is now commonplace in financial markets throughout the developed world, whether by mutual fund advisers or other institutional portfolio managers. In the U.S., alone, they accounted for as much as half the $12.7 billion in brokerage commissions institutional portfolios paid in 2002.[51]

The growth in soft dollar use was apparently anticipated by Congress. 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, and more likely criminal sanctions under the ICA for the accepting outside compensation, would limit them to paying only the lowest available commissions for portfolio brokerage regardless of execution quality or the value of any research services they received.[52] 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

[50] Kevin G. Salwen, *Brokerage Firms Slam Wall Street's Soft Dollar Deals*, Wall St. J., June 22, 1990, at C1; see also Soft Commissions: Hard Nuts to Crack, Economist, Sept. 16, 1989, at 87.

[51] John Hechinger, *MFS Ends 'Soft Dollar' Payments on Concerns over Ethics*, Wall Street Journal, March 16, 2004, at C1. Hechinger cites Greenwich Associates, Inc., for this figure, while other sources relying on Greenwich report that soft dollars amounted to $1.24 billion in 2003 and accounted for 11 percent of total institutional commission payments. The discrepancy no doubt results from imprecision over how to define soft dollars. The former figure probably includes the value of all research and other services bundled into institutional commission payments, while the latter probably refers exclusively to research supplied by third-party research vendors. See discussion, *infra* at ?.

[52] *2006 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); discussed more fully *infra* at ?.

> 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. . . .
>
> (2) A person exercising investment discretion with respect to an account shall make such disclosure of his policies and practices with respect to commissions that will be paid for effecting securities transactions, at such times and in such manner, as the appropriate regulatory agency, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.
>
> (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;
> >
> > (B) furnishes analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts; 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 . . . .[53]

Although Congress intended Section 28(e) to provide broad protection to fund advisers or their managers 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 28(e)'s protection of brokerage and research services has evolved over the years with a number of SEC no-action letters, cases, and administrative proceedings.

[53] 15 U.S.C. section 78bb(e) (1988) (as amended).

1. The Era of Industry Capture, More or Less

During much of its first 63 years, mutual fund regulation under the `40 Act was largely an administered process. The SEC worked cooperatively with prominent members of the industry to address problems as they arose through various exemptions, no-action letters, interpretations, and rulemakings. This should come as no surprise given that the fund industry played a heavy role in drafting the `40 Act.[54] Standard capture by prominent advisory firms appears to have been at least a partial driver of the SEC's regulatory agenda under the `40 Act,[55] with large investment institutions (so-called "buy-side" firms) gradually wresting political power from broker-dealers (so-called "sell-side" firms) and other exchange interests in the march toward commission deregulation.[56]

A notable artifact of industry capture is the dearth of `40 Act cases litigated in federal court compared to, for example, the many civil and criminal antitrust cases brought under the Sherman and Clayton Acts. By giving the SEC blanket exemptive authority from any of its provisions,[57] the ICA has ensured that few disputes end up in litigation. The SEC is free to exempt from regulation those parties likely to succeed in court if the exemption were to be denied, while those with weak cases can be denied an exemption without fear of litigation.[58] The implicit bargain the industry cut may have been relief from the plaintiff's bar in exchange for detailed regulatory oversight from the SEC.

One of the SEC's first rulings under section 28(e) was a 1976 interpretive release finding that the safe harbor applies only to research products that are not "readily and

[54] See Mathew P. Fink, *The Revenue Act of 1936: The Most Important Event in the History of the Mutual Fund Industry*, Financial History (Fall 2005), at 16-19.
[55] George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J. LAW & ECON. 211 (1976): Gary Becker, A *Theory of Competition Among Pressure Groups for Political Influence*, 98 Q. J. ECON. 371 (1983)
[56] See Johnsen, Yale Jnl. On Regulation (1994).
[57] See ICA, Section 6(c), 15 U.S.C 80a-6.
[58] Very recently this state of affairs was revealed when Philip Goldstein, after successfully challenging the SEC's hedge fund registration rule, threatened the SEC with litigation if his fund was not given an exemption from portfolio disclosure under SEA 13(f). See Business Week, Sept. 12, 2006: at http://www.businessweek.com/investor/content/sep2006/pi20060913_356291.htm.

customarily available . . . to the general public on a commercial basis."[59] For many years this ruling nominally prohibited managers from receiving basic generic research inputs such as newspapers, magazines and periodicals, directories, computer facilities and software, government publications, electronic calculators, quotation equipment, office equipment including private direct telephone lines, airline tickets to conferences or to visit corporate managers, office furniture and business supplies, and other items helpful for effective portfolio management. By its terms, the interpretation favored the proprietary in-house research traditionally produced by full-service brokers in the form of stock picks and analyst reports.

In response, and no doubt with the help of evolving technology, market participants naturally begun packaging generic research inputs into more complex products and services to qualify for the not "readily and customarily available . . . to the general public" standard. Where there is value to be added, and hence money to be made ─ and shared ─ market participants are quite able to innovate while walking a legal tight-rope. In 1980, the SEC issued its *Report of Investigation in the Matter of Investment Information, Inc.* . . . condemning what appears to have been just such an arrangement.[60] Investment Information, Inc. (III) was a proprietary service offered to portfolio managers who agreed to send their commission business to any of a select group of "execution-only" brokers, as designated by III. Participating brokers retained half of their commission revenue and remitted the remainder to III. In turn, according to the SEC's later assessment, III took a fee for the "research" services it provided to money managers, "ostensibly for managing the client commission accounts."[61] III credited the remainder to the manager's account, either to be recaptured as cash by the portfolio or as third-party research services provided to the manager. The SEC found some of these research services ─ "such items as periodicals, newspapers, quotation equipment, and general computer services" ─ to have been generic in nature and therefore prohibited as

[59] *Interpretations of section 28(e): Use of Commission Payments by Fiduciaries*, Exchange Act Release No. 12,251, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) paragraph 80,407 (Mar. 24, 1976).
[60] Report of Investigation in the *Matter of Investment Information, Inc. Relating to the Activities of Certain Investment Advisers, Banks, and Broker-Dealers, Exchange Act Release No. 16679, 19 SEC Docket 926* (Mar. 19, 1980) [hereinafter *III Release*].
[61] *2006 Guidance*, at 41981.

readily and customarily available to the general public, even though the complete package III offered was proprietary.

These arrangements fell outside Section 28(e)'s safe harbor because, in the SEC words, participating brokers "in no significant sense provided the money managers with research services."[62] The brokers were unaware of the specific services the money managers acquired from the third-party vendors and did not directly pay the bills for these services. They merely executed the transactions and paid a portion of the commissions to III.[63] What is more, III was not a registered broker and performed no brokerage function in the securities transactions. As the SEC later summarized the *Report*, "[t]he Commission concluded that, although Section 28(e) does not require a broker-dealer to produce research services 'in-house,' the services must nevertheless be 'provided by' the broker-dealer."[64]

Later that same year the SEC clarified the meaning of the phrase "*provides* brokerage and research services" [emphasis added], finding that section 28(e)(3) requires only that the broker retain the "legal obligation to a third party producer to pay for the research . . . regardless of whether the research is then sent directly to the broker's fiduciary customer by the third party or instead is sent to the broker who then sends it to its customer."[65]

Amid growing unrest among institutional brokers and portfolio managers, in 1986 the SEC amended its 1976 "readily and customarily available" standard for the eligibility of safe harbor research. In response to the "changing array of research products and the impact of new technology on brokerage practices," and believing "that the issue is

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[62] *III Release*, at 931-32.
[63] Discuss infra whether III might have engaged in monitoring execution quality. By building a wall between managers and brokers, III may have been able to reduce brokers' opportunities for frontrunning. It may also have been able to put participating brokers into a tournament situation in which they knew their performance was being carefully assessed. Why should an arrangement that allows specialized monitoring that reduces conflicts be prescribed. Until the SEC figures out that the appearance of one conflict is very likely to ameliorate other, perhaps hidden, conflict, its approach to protecting investors is as likely to punish them as to protect them. Of course, according to Campos none of this bears any relation to investor returns.
[64] *2006 Guidance*, at 41981-82.
[65] *See National Association of Securities Dealers, Inc*., Exchange Act Release No. 17,371, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) paragraph 82,705 (Dec. 12, 1980).

ultimately one of good faith on the part of the money manager"[66] best addressed through disclosure, the SEC relaxed the definition of research to include anything that "provides lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities."[67] This standard begs the question of exactly what type of assistance is or is not lawful and appropriate, but the SEC lifted it straight from the *Congressional Record* and so it seems to have taken on a weight disproportionate to its utility.

In the SEC's words, "[w]hat constitutes lawful and appropriate assistance in any particular case will depend on the nature of the relationships between the various parties involved and is not susceptible to hard and fast rules." The SEC made one other point clear from the *Congressional Record*, which is that "[t]he definition of brokerage and research services is intended to comprehend the subject matter in *the broadest* [emphasis added] terms."[68] This ruling clearly allowed generic research inputs to be included in the safe harbor and was followed by considerable expansion in soft dollar brokerage, largely at the expense of established full-service brokerage houses.

Perhaps the most puzzling early SEC proceeding under section 28(e) was a 1990 No-Action Letter ruling in response to an inquiry from the Department of Labor (DOL). Before taking enforcement action in several pending cases under the Employee Retirement Income Security Act (ERISA) (1974), which regulates the management of private pension funds, the DOL requested the SEC's opinion on whether the safe harbor applies to fixed income securities and over-the-counter (OTC) stocks, including those listed on the National Association of Securities Dealers Automatic Quotation System (NASDAQ), which are traded primarily by dealers on a principal basis rather than by brokers on an agency basis. In contrast to the commissions brokers receive for acting as agents, when trading for their own account as dealers they earn a mark-up or mark-down

[66] *1986 Interpretative Release*, at 13-14.
[67] *1986 Interpretative Release*, at 4. It seems plausible that the SEC's new interpretation was inspired, at least in part, with a view toward the London Stock Exchange's concurrent deregulation of fixed commissions, a development that no doubt threatened U.S. markets with a loss of trading volume.
[68] *1986 Interpretive Release*, at 3 and n. 9.

equal to the difference between the price at which they buy and the price at which they sell.

By its text, section 28(e) covers trades the manager sends to a "broker or dealer," but in reference to the trader's compensation it mentions only "commissions," not mark-ups or mark-downs. In the narrow sense of the term, only brokers earn commissions, while dealers, as principals, earn mark-ups and mark-downs. Since Congress passed section 28(e) to mitigate problems owing specifically to the unfixing of *commissions*, the No-Action Letter found that the safe harbor does not apply to dealer transactions. This decision brought the burgeoning use of soft dollars in fixed income and OTC equity transactions to a grinding halt.

Reportedly at the behest of Morgan Stanley and Goldman Sachs, leading full-service brokerage houses that had lost substantial business to soft dollar brokers,[69] in 1995 the SEC published a proposing release titled *Disclosure by Investment Advisers Regarding Soft Dollar Practices*. It called for public comment on a proposal to require investment advisers to provide clients with annual reports containing enhanced disclosure of the adviser's brokerage allocation practices. The release noted that current disclosure is sufficient to inform clients that their advisers engage in soft dollar arrangements, but in light of the associated conflicts of interest it may provide insufficient detail to allow them to negotiate specific limits on soft dollar use. Under then current rules, all advisers subject to the IAA (including advisers to mutual funds regulated under the ICA) were required to provide their clients annually with Part II of Form ADV, the so-called "brochure," which must disclose in general terms "the nature of the adviser's soft dollar practices, including: (i) the services that the adviser obtains through soft dollar arrangements; (ii) whether clients may pay higher commissions ('pay up') as a result of the arrangements; (iii) whether soft dollar services are used to benefit all client accounts or only those accounts the brokerage of which was used to purchase the services; and (iv) any procedures that the adviser uses to allocate brokerage."[70]

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[69] Jack Willoughby, *Goldman and Morgan Bow Under Client Pressure on Soft Dollars; Deluge of Client Complaints Softens Get-tough Provisions*, INVESTMENT DEALERS' DIGEST (August 21, 1995), at 3.
[70] *See Disclosure by Investment Advisers Regarding Soft Dollar Practices*, SEA Rel. No. 35375 (Feb. 14, 1995), 60 FR 9750, 9751 (Feb. 21, 1995) [*1995 Disclosure Proposal*], at 5 and n. 15.

The proposal outlined the conflicts of interest that arise from Section 28(e)'s modification of an adviser's strict fiduciary duty to act in the best interest of each client. First, soft dollar arrangements permit "an adviser to cause a client to pay higher commissions than otherwise are available to obtain research that may not be used exclusively for the benefit of the client or used to benefit the client at all." Second, they may "cause an adviser, in order to obtain soft dollar services, to violate its best execution obligations by directing client transactions to brokers who could not adequately execute the transactions." Third, they "may give advisers incentives to trade client securities inappropriately to generate credits for soft dollar services." Fourth, they may "diminish the ability of a client to evaluate the expenses it incurs in obtaining portfolio management services and may hinder the ability of the client to negotiate fee agreements, because the costs of soft dollar services are 'hidden' from investors in brokerage commissions." Fifth, by allowing "advisers to use their clients' transactions to pay for research services that they otherwise would have to purchase with 'hard dollars,' soft dollar arrangements permit advisers to charge fees that do not fully reflect the cost of portfolio management." Finally, "[a]dvisers that do not engage in soft dollar arrangements may be put at a competitive disadvantage if they pay for services with hard dollars and attempt to pass the cost of these services on to clients through higher fees."[71] The proposed annual report would have required advisers to provide enhanced disclose, on an aggregate basis across all of their client accounts for the most recent fiscal year, consisting of

> (1) the twenty brokers to which the adviser directed the largest amounts of commissions and certain other transaction-related payments (collectively, 'commissions'), (2) the three brokers substantially all of whose services for the adviser were execution services ('execution-only brokers') to which the adviser directed the largest amounts of commissions, (3) the aggregate amount of commissions directed by the adviser to each broker listed and the percentage of the adviser's total discretionary brokerage this amount represents, (4) the average commission rate paid to each broker listed, and (5) for each broker other than an execution-only broker, information concerning products or services obtained from the broker. The report would also disclose the percentages of the adviser's total

[71] *1995 Disclosure Proposal*, at 4-5.

> commissions that are directed to execution-only brokers, to other brokers, and at the request of clients.[72]

In the cost/benefit analysis the SEC routinely provides with such proposals, it concluded that enhanced disclosure "would impose some additional costs on advisers required to prepare the report and deliver it to clients. . . . [but] because the report would need to be prepared and delivered only annually, the costs of preparing and delivering [it] should be minimized. In short, the Commission believes that the costs of the proposals [sic] would be outweighed by the benefits to advisory clients in receiving more useful information about their advisers' direction of client brokerage."[73]

Members of the advisory and brokerage industry fiercely disagreed, seeing enhanced disclosure as a blunt attempt by established full-service sell-side firms, Morgan Stanley and Goldman Sachs, to hobble their smaller soft dollar rivals. As one industry trade publication put it, "[t]hough the tougher disclosure standards would put untold hardships on the small firms, they would mean nothing to the full service firm because their services [are] bundled together and, as such, [are] inseparable."[74] Members of the buy-side investment advisory community also protested, pressuring Morgan and Goldman to recapitulate. They ultimately did, favoring a watered-down system of enhanced disclosure to the SEC as an alternative. One important reason for advisory firms' protest was the prospect of having to reveal sensitive proprietary information allowing rivals to free ride on their strategic brokerage allocation practices. The SEC abandoned the proposal.

During the same year, the SEC created the Office of Compliance Inspections and Examinations (OCIE), consolidating inspection and examination programs authorized by the SEA and ICA and previously performed by the Divisions of Investment Management

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[72] *1995 Disclosure Proposal*, at 2.
[73] *1995 Disclosure Proposal*, at 18-19.
[74] Jack Willoughby, *Goldman and Morgan Bow Under Client Pressure on Soft Dollars; Deluge of Client Complaints Softens Get-tough Provisions*, Investment Dealers' Digest (August 21, 1995), at 3.

and Market Regulation.[75] OCIE's first major published report was its 1998 *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds*, in which it reviewed the results of an audit sweep of some 355 broker-dealers, advisers, and mutual funds. The *OCIE Report* described the range of products and services advisers were obtaining from their institutional brokers. Among other things, it raised concern about the products advisers were treating as research under 28(e), opining that many of them did not deserve safe harbor protection under the 1986 standard. It recommended that "the Commission provide further guidance on the scope of the safe harbor and require better recordkeeping and enhanced disclosure of client commission arrangements and transactions."[76]

In its abandoned *1995 Disclosure Proposal*, the SEC affirmed the 1990 No-Action Letter finding that principal transactions on fixed income and OTC equity securities fall outside Section 28(e)'s safe harbor. Given that this release was never approved its legal status is unclear, but in any event the SEC largely reversed itself in its 2001 interpretive release *Commission Guidance on the Scope of Section 28(e) of the Exchange Act*.[77] Noting that, to date, it had considered the term "commission" under the safe harbor to apply exclusively to transactions performed on an agency basis, the SEC conceded that reference to the term "dealer" in Section 28(e) "might suggest that the term 'commission' includes fees paid to a broker-dealer acting in other than an agency capacity."[78] To rationalize the ambiguity and at the same time to justify including certain dealer trades in its new interpretation, the SEC argued that "[t]he meaning of the term 'commission' in Section 28(e) is informed by the requirement that a money manager relying on the safe harbor must determine in good faith that the amount of 'commission' is reasonable in relation to the value of research and brokerage services received. This requirement presupposes that a 'commission' paid by the managed account is

[75] *Chairman Levitt Announces Two Initiatives to Improve Investor Protection: Creates Office of Compliance Inspections and Examinations to Coordinate SEC Inspection Programs; Creates Office of Municipal Securities*, SEC NEWS RELEASE 95-50, 1995 WL 119773 (S.E.C.), Mar. 22, 1995.
[76] Office of Compliance Inspections and Examination, U.S. Securities and Exchange Commission, *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds* 3 (Sept. 22, 1998), at 47-52 [*OCIE Report*] (available at http://www.sec.gov/news/studies/softdolr.htm).
[77] *SEC Interpretation: Commission Guidance on the Scope of Section 28(e) of the Exchange Act*, Exchange Act Release No. 45194 (Dec. 27, 2001), *67 FR 6* (Jan. 2, 2002) [*2001 Interpretive Release*].
[78] *2001 Interpretive Release*, at 7.

quantifiable in a verifiable way and is fully disclosed to the money manager."[79] At the time it issued its guidance in the 1995 release the spread cost on principal trades was neither quantifiable nor verifiable, precluding the manager from making the necessary reasonableness determination.

By 2001, changes in National Association of Securities Dealers (NASD) confirmation rules required so-called "riskless principal" transactions in OTC equity securities to be disclosed to the manager. In a riskless principal transaction, the manager informs the broker-dealer of his trading interest in advance. In a "buy" transaction, the dealer buys the security from another dealer for his own account and immediately re-sells it to the manager at a predetermined mark-up. With the mark-up formally reported, the manager is able to make the good faith reasonableness determination in relation to any research or other services he receives. Although this transparency rationale for Section 28(e) protection never appeared in the 1990 No-Action Letter or the 1995 Release, the SEC nevertheless used it to justify bringing riskless principal transactions in OTC equities within the safe harbor. Because fixed income markets had yet to develop sufficient transparency, dealer transactions in those securities continue to fall outside the safe harbor.

2. Regulatory Competition Emerges

In the wake of the widely-publicized *Global Settlement* by ten prominent members of the investment banking community for having allowed their research analysts to engage in conflicts of interest,[80] the mutual fund industry was widely touted as being scandal free. Speaking at an Investment Company Institute conference on securities law developments in December, 2002, SEC Commissioner Paul S. Atkins had this to say: "I believe that one reason why the mutual fund industry has avoided the scandals plaguing other industries stems from the simple, fundamental properties of fund management: (1) limitations on affiliated transactions, (2) daily market valuations, (3)

[79] *2001 Interpretive Release*, at 7.
[80] *See* http://www.sec.gov/news/press/2003-54.htm.

oversight of funds by independent boards to eliminate conflicts of interest and prevent abuses, and (4) no taxpayer guarantees like the banking industry has."[81]

This perception helps explain why the SEC took little action on the recommendations of the 1998 *OCIE Report* until New York State Attorney General Eliot Spitzer uncovered apparent trading improprieties in various mutual fund families beginning in September 2003.[82] What would quickly become known 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.[83] Facing intense regulatory competition from Spitzer, the SEC was

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[81] Speech by SEC Commissioner Paul S. Atkins: *Remarks Before the Investment Company Institute 2002 Securities Law Developments Conference*, December 9, 2002, at http://www.sec.gov/news/speech/spch120902psa.htm.

[82] 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.

[83] 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

compelled to do *something* to appear vigilante. The old administered equilibrium between the SEC and the fund industry was over. Although there was no evidence of significant or mounting improprieties in the soft dollars arena, they were an obvious target for further scrutiny and possible regulatory action, including SEC advice to Congress that it repeal the nettlesome Section 28(e) safe harbor.[84]

a. The SEC Considers Transaction Costs

In response to a number of then-recent academic studies showing low-return mutual funds tend to have high-expenses,[85] in December 2003 the SEC published its *Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs*.[86] The *Concept Release* solicited outside comments on whether, and to what extent, mutual funds should be required to report the cost of transacting

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> 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 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).

[84] WSJ on Cox Letter, *supra*, at n. ?. See *Testimony Concerning The Mutual Funds Integrity And Fee Transparency Act Of 2003*, H.R. 2420, Paul F. Roye, Director, Division of Investment Management, U.S. Securities & Exchange Commission, Before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services (June 18, 2003).

[85] *See, e.g.*, Mark Carhart, *On the Persistence in Mutual Fund Performance*, 52 J. FIN. 57 (1997); John C. Bogle, Re-Mutualizing the Mutual Fund Industry--the Alpha and the Omega, 45 B.C. L. REV 391 (2004). The results of these and other studies have since been called into question. *See, e.g.,* Russ Wermers, *Mutual Fund Performance: An Empirical Decomposition into Stock-Picking Talent, Style, Transaction Costs, and Expenses*, 50 J. FIN. 1655 (2000); Robert Kosowski, Allan Timmerman, Russ Wermers, and Hal White, *Can Mutual Fund "Stars" Really Pick Stocks? New Evidence from a Bootstrap Analysis*, 61 J. FIN. 2551 (2006).

[86] *Concept Release*, at 74820-21.

portfolio securities.[87] As of that time, funds were already required to report various fees, expense ratios, annual portfolio turnover, and annual brokerage commissions for the most recent three years. In the introduction to the *Concept Release* the SEC correctly points out that brokerage commissions are only one component of the costs of transacting securities. In addition, executing portfolio trades gives rise to implicit and difficult-to-measure transaction costs, including spread costs, "price" or "market" impact, and the opportunity cost of delay, which together can easily overwhelm brokerage commissions.

Specialists, who make markets on the floor of the NYSE and other exchanges, and market-makers on the NASDAQ and other OTC markets, occupy the crossroads ─ whether real or virtual ─ where securities traders meet to execute their clients' trades. These dealers post the bid and ask prices at which they stand ready to buy or sell an identified number of shares of a given security for their own account. Their public charge is to provide liquidity by making an orderly market. They would not be in business for long unless they made enough money buying and selling to compensate them for their forgone opportunities. At any moment, therefore, the posted price the market maker "asks" to sell the security will always be slightly greater than the price he "bids" to buy it. The difference is known as the "spread." A hypothetical trader who buys and immediately resells a small block of stock, as in a riskless principal transaction, would pay an easily calculated spread ─ in addition to any brokerage commission paid to an agent or mark-up or mark-down paid to in intermediate dealer to search for the most advantageous opportunity to trade. But because many round-trip trades are completed over the course of time it is normally impossible to know the exact spread cost.

The real problem is that it is extremely difficult to distinguish adverse changes in bid and ask prices owing to noise from those that result from an informed trader's presence in the market. Market-makers, specialists, and other market participants are ever watchful for evidence that privately-informed traders ─ those who seek to trade mispriced securities ─ have entered the market to trade a particular security. So-called

[87] Both the *Concept Release* and the great majority of finance scholars use the term "transaction costs" to refer to the costs of trading securities, rather than the cost of economic organization more generally. The former is a subset of the latter. Harold Demsetz, a prominent practitioner of transaction cost economics, was the first to analyze the cost of trading securities. Harold Demsetz, *The Cost of Transacting*, 82 Q.J.E. 33 (1968).

"frontrunners" will try to trade ahead of informed traders. They will buy the security in advance of informed buyers, who, by definition, know the current price is too low, and sell ─ or sell short if they do not already own the security ─ in advance of informed sellers. One category of such frontrunners are disloyal brokers, who either trade for their own account in advance of their informed clients' trades or tip associates as to the pending opportunity for a near-riskless profit. Another category consists of traders who wait patiently for careless brokers to signal their informed clients' presence in the market and then trade ahead of the broker.

Market-makers and specialists versed in the art of trading will be on guard to adjust their bid and ask prices to avoid being taken advantage of by informed traders and frontrunners. Any trader who shows undue haste to have an order executed, including those who seek to trade in relatively large blocks, is likely to cause the market-maker or specialist to adjust the bid or ask price in an adverse direction. The same is true of any significant or sustained order imbalance from seemingly disparate sources. When the price of a security changes as a result of the effort to purchase or sell it, the result is price impact. The Concept Release recognizes price impact as a large component of implicit transaction costs and one the portfolio manager can influence through careful trading.

Among other methods, a manager can reduce price impact by breaking a trade into smaller orders and stretching their execution out over time. At some point delaying the completion of a trade will lead to an offsetting cost. Imagine, for example, a manager who has concluded that Security X, which he holds in his portfolio, is overpriced and that Security Y is underpriced. He decides to sell a large block of X and then buy Y with the proceeds. He can reduce price impact on X by delaying, but he risks the possibility that Y will increase before he has the capital from the sale of X to buy it. This represents a forgone opportunity from delay. A prudent manager will optimize over price impact and the opportunity cost of delay. Indeed, he will optimize over explicit and implicit transaction costs, neither minimizing nor maximizing either.

The *Concept Release* seeks comment on whether, and how, implicit transaction costs might be disclosed to fund shareholders. It concedes that completely accurate disclosure is impossible, among other reasons because it is too costly to disentangle price

changes owing to noise from those owing to price impact. As the SEC quotes one commentator, "transaction cost measurement is as much an art as a science. It's very difficult to accurately measure implicit trading costs. Not all companies use the same methodology, and there's no commonly accepted standards [sic] as to how to measure price impact."[88] To its credit, the SEC has thus far declined to take any action requiring fund advisers to disclose implicit transaction costs.

b. The Safe Harbor Reconsidered

Amid the gathering political storm inspired by Spitzer's fund scandals, Congress held hearings to further consider regulation of fund advisers and their institutional brokerage arrangements. Two emergent bills were the *Mutual Fund Transparency Act of 2003*, aimed at improving disclosure of fees and brokerage commissions,[89] and the *Mutual Fund Transparency Act of 2004*, among other things aimed at prohibiting soft dollar brokerage.[90] In the words of then Senator Fitzgerald (R-Illinois), a prominent critic of soft dollar brokerage and co-sponsor of the 2004 Bill, "a mutual fund will cut a deal with a broker that will allow the brokerage to charge higher-than-market commissions on trades – soft-dollar commissions – in return for the brokerage firm buying, for example, computer terminals or research for the fund company. These costs are passed on to the fund company's customers without ever showing up in the expense ratio. It's wrong."[91]

In this charged political environment, the SEC's requested the National Association of Securities Dealers (NASD) to form a task force to provide it with guidance on how to "improve the transparency of mutual fund portfolio transaction costs and distribution arrangements." Composed of senior executives from the NASD, prominent advisory firms, broker-dealers, and representatives of the legal and academic

[88] *Concept Release*, n. 23.
[89] S. 1822, 108th Cong. (2003).
[90] H.R. 4505, 108th Cong. (2004).
[91] Jon Birger, *Mr. Fitzgerald Leaves Washington*, MONEY, Dec., 2004, at 80A. The costs of soft dollar research show up in the portfolio's net returns, which will necessarily be lower than otherwise, all else being equal.

communities, in November 2004 the Task Force issued its *Report*.[92] Among other things, it found that "the safe harbor for soft dollar practices set forth in Section 28(e) is an important element in the current system for providing research and remains valid . . . [But that the] advantages of [soft dollar research] must be balanced against the need to address the potential conflicts of interest and disclosure issues as they raise."[93] Noting that the SEC's 1998 *Inspection Report* had found that relatively small advisory firms were relatively heavy users of third-party research, the Task Force emphasized that investors will be best served if proprietary and third-party research are treated equally under 28(e), so that research is readily available to all portfolio managers.

The *NASD Report* went on to recommend that the scope of research services be narrowed to exclude services that principally benefit the adviser. Specifically, it suggested that safe harbor protection be limited to "brokerage services as described in Section 28(e)(3) and the 'intellectual content' of research," which it defined as "any investment formula, idea, analysis or strategy that is communicated in writing, orally or electronically and that has been developed, authored, provided or applied by the broker-dealer or third-party research provider."[94] Excluded from protection should be the means by which intellectual content is provided, such as publications in general circulation, computer hardware, online news services, phone lines, data transmission lines, portfolio accounting services, proxy voting services unrelated to research, and travel expenses to meet with corporate managers.[95]

Almost a year later the SEC put forth its proposing release *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*,[96] which it adopted largely intact in July 2006.[97] Occupying 17 pages of the

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[92] NASD, (Nov. 11, 2004) [*NASD Report*] (available at http://www.nasd.com/web/groups /rules-regs/documents /rules-regs/ nasdw-012356.pdf.).
[93] *NASD Report*, at 4.
[94] NASD Report at 6-7.
[95] *NASD Report*, at 7.
[96] Exchange Act Release No. 52635 (Oct. 19, 2005), *70 FR 61700* (Oct. 25, 2005).
[97] *2006 Guidance*, supra n. ?

The SEC adopted this release with an eye to recent developments in the United Kingdom. In July 2005, the U.K.'s Financial Services Authority (FSA) adopted final client commission rules that describe "execution" and "research" services and products eligible to be paid for by client commissions. It also specified a number of "non-permitted" services that must be paid for with hard dollars, such as "computer hardware, telephone lines, and portfolio performance measurement, and valuation services,"

Federal Register, the release begins by noting that the term "soft dollars" has become increasingly ambiguous. It originally referred to the explicit bundling of third-party research into premium brokerage commissions. Eventually one scholar, and then regulators, came to recognize that whatever conflicts arise with soft dollars are actually the result of bundling and not the provision of third-party research, *per se*.[98] The implicit bundling of in-house proprietary research into premium brokerage commissions, as illustrated by the diagonal arrow in Figure 1, is subject to the exact same alleged conflicts of interest. It increases managers' incentive to trade, to use research, and to show increased loyalty to participating brokers.[99] To ensure equal treatment of third-party and in-house research, the release notes that the SEC now uses the phrase "client commissions" to refer to any situation in which the manager receives bundled brokerage and research services protected under the Section 28(e) safe harbor.[100]

Citing Section 216 of the *Restatement (Second) of Trusts*, the release emphasizes that fiduciary principles require "the adviser to act in the best interest of his client [and preclude] the adviser from using client assets for the adviser's own benefit or the benefit of other clients, at least without client consent."[101] According to the SEC's reasoning, client commissions are assets of the client. A manager who uses client commissions to pay for brokerage and research services he or she would otherwise have paid out of pocket receives a personal benefit. Ergo, a manager who receives brokerage or research services ineligible for safe harbor protection under 28(e) faces a conflict of interest that may constitute a breach of fiduciary duty. A manager's receipt of benefits falling outside of 28(e) may also constitute a criminal violation of ICA Section 17(e), which prohibits

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acknowledging that some products and services may be permitted or non-permitted depending on how they are used by the money manager. In the SEC's words, "we have taken the FSA's work into account in developing our position in this release, while recognizing the significant differences in our governing law and rules, such as the fact that the United Kingdom does not have a statutory provision similar to Section 28(e)." *2006 Guidance*, at 41983.

[98] D. Bruce Johnsen, *Property Rights to Investment Research, supra* n. ?, at 109-10. To the best of my knowledge, this was the first scholarly article to recognize that the popular criticisms of soft dollars apply equally to proprietary in-house research. The first indication that the SEC recognized the equivalence appears in its 1995 disclosure release, where it first uses the more even-handed phrase "client commissions" to describe bundled-in research.

[99] See supra, at ?, citing *1995 Disclosure Proposal*.

[100] *2006 Guidance*, at 41978.

[101] *2006 Guidance*, at 41978.

agents, other than brokers, from accepting outside compensation when buying or selling property for a registered investment company.

The release explains that in light of various market developments the SEC is revising its 1986 interpretation of the scope of "brokerage and research services" under the safe harbor, even though it will continue to rely on the "lawful and appropriate standard" more generally. The resulting framework for analysis requires the manager to make three determinations. First, "whether the product or service falls within the specific statutory limits of Section 28(e)(3) (*i.e.*, whether it is eligible 'research' under Section 28(e)(3)(A) or (B) or eligible 'brokerage' under Section 28(e)(3)(C))." Second, "whether the eligible product or service actually provides lawful and appropriate assistance in the performance of [the manager's] investment decision-making responsibilities," with mixed-use products and services requiring "a reasonable allocation of the costs of the product according to its use." Third, tracking the language of 28(e), whether the manager believes in "good faith [that] the amount of client commissions paid is reasonable in light of the value of products or services provided by the broker-dealer."[102]

Much of the release discusses how to determine the eligibility of specific types of brokerage and research services. Foremost in the discussion is the SEC's finding that, to qualify as eligible *research*, "advice, analyses, and reports" must reflect an "expression of reasoning or knowledge." This includes "order management systems," "pre- and post-trade analytic software," and "other products that depend on market information to generate market research, including research on optimal execution venues and trading strategies."[103] Products or services that reflect no expression of reasoning or knowledge, with the sole exception of market data services, fall outside the safe harbor. Eligible research includes "reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts," as specifically mentioned in the safe harbor. It also subsumes other topics such as "political factors" that can influence any of the enumerated subjects.[104]

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[102] *2006 Guidance*, at 41985.
[103] *2006 Guidance*, at 41987.
[104] *2006 Guidance*, at 41985.

Mass marketed publications, inherently tangible items such as computer terminals, telephone lines, and office furniture, and travel to seminars and meetings with corporate executives reflect no expression of reasoning or knowledge and are more properly considered overhead than advice, analyses, or reports. As such, they are ineligible for safe harbor protection as research services. The sole exception, according to the SEC, may be for certain market and other data services that are "lawful and appropriate," such as stock quotes, last sale prices, trading volumes, economic data, and company financial data, that contain "substantive content." In the SEC's words,

> "this approach will promote innovation by money managers who use raw data to create their own research analytics, thereby leveling the playing field with those money managers who buy finished research, which incorporates raw data, from others. Additionally, we believe that excluding market data from the safe harbor could become meaningless if it encouraged purveyors of this information to simply add some minimal or inconsequential functionality to the data to bring it within the safe harbor."[105]

In defining eligible *brokerage* services, the release notes that Section 28(e)(3)(C) protects any person who "effects securities transactions." It goes on to observe that the "technological explosion" has led to a proliferation of state-of-the-art computer and communications systems to facilitate the execution of trades. The use of client commissions to pay for such tangible items may present advisers with difficulty distinguishing between eligible brokerage services and ineligible overhead. To help advisers distinguish between the two, the SEC points out that the "execution of transactions is a process." From this, the release identifies what it characterizes as a "temporal standard" for defining eligible brokerage services, according to which "brokerage begins when the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution and ends when funds or securities are

[105] *2006 Guidance*, at 41987-88.

delivered or credited to the advised account or the account holder's agent."[106] This standard excludes activity on the front-end and back-end of an order, as well as overhead.

In addition to protecting those who effect securities transactions, Section 28(e)(3)(C) protects functions incidental thereto, such as "clearance, settlement, and custody," or that are required "in connection therewith by rules of the Commission or a self-regulatory organization." Whereas connectivity services that transmit *research* are separable and therefore excluded from safe harbor protection, the transmission of orders to brokers has always been "considered a core part" of brokerage services and is therefore eligible under the safe harbor. The release identifies the following laundry list of incidental functions eligible as brokerage services under the temporal standard: "connectivity service [such as] dedicated lines between the broker-dealer and the money manager's order management system, . . . dedicated lines providing direct dial-up service between the money manager and the trading desk at the broker-dealer[,] message services used to transmit orders to broker-dealers for execution, . . . trading software used to route orders to market centers, software that provides algorithmic trading strategies, and software used to transmit orders to direct market access ("DMA") systems . . . ."[107] Telephones, computer terminals, including those used in connection with order management systems, and software used for quantitative analytics, recordkeeping, administration, and portfolio modeling are ineligible because they are insufficiently related to order execution and fall outside the temporal standard. They therefore constitute ineligible overhead.

Also falling outside the category of eligible brokerage services are those allowing managers to meet their compliance and reporting responsibilities. Compliance tests that analyze the quality of brokerage executions over time for the purpose of assessing best execution or portfolio turnover are excluded, as are assessments of the comparative performance of similarly managed accounts to detect favoritism, misallocation of investment opportunities, or other breaches of fiduciary duty.

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[106] *2006 Guidance*, at 41989.
[107] *2006 Guidance*, at 41989.

So-called "mixed-use" items confront managers with special problems. An example of a mixed use item is a computer or other hardware that performs eligible brokerage services and ineligible research services. Even with regard to software, for example, if the manager uses "account performance analyses for both marketing purposes and investment decision-making, [he] may use client commissions only for the allocable portion of the item attributable to use of investment decision-making . . . ."[108] The manager must perform a "good faith, fact-based analysis" of how the product or service is used to determine how its cost should be allocated between eligible and ineligible uses. In doing so, he or she may rely on such factors as "the amount of time the product or service is used for eligible purposes versus non-eligible purposes, the relative utility (measured by objective metrics) to the firm of the eligible versus non-eligible uses, and the extent to which the product is redundant with other products employed by the firm for the same purpose."

Relying on a 1975 House Report on Section 28(e) finding that a manager who receives brokerage and research would "of course . . . stand ready and be required to demonstrate that such expenditures were *bona fide*,"[109] the release concludes that the burden of proving good faith rests with the manager. The manager must therefore maintain sufficient books and records documenting its allocations to be able to make the required good faith showing.[110]

The *Guidance* correctly observes that "specialization and innovation in the financial industry have resulted in the functional separation of execution and research"[111] — what economists call *vertical dis-integration*. In many though by no means all cases, managers now receive research, largely in the form of inputs, from third-party vendors they select largely outside the purview of the executing broker. This raises the ongoing issue of the relationship between Section 28(e)'s requirements that the broker "*provides* brokerage and research" and "*effects* securities transactions" [emphasis added]. According to the SEC, in the new era of specialization a manager may rely on the safe

[108] *2006 Guidance*, at 41990, n. 133.
[109] *2006 Guidance*, at 41991.
[110] *2006 Guidance*, at 41991.
[111] *2006 Guidance*, at 41993.

harbor only if the broker "effecting" the trade performs at least one of four functions and takes steps to ensure the other functions have been "reasonably allocated" to one of the other brokers in the arrangement in a way fully consistent with their obligations under existing rules. The four functions are: "(1) [t]aking financial responsibility for all customer trades until the clearing broker-dealer has received payment (or securities), *i.e.*, one of the broker-dealers in the arrangement must be at risk for the customer's failure to pay; (2) making and/or maintaining records relating to customer trades required by Commission and SRO rules, including blotters and memoranda of orders; (3) monitoring and responding to customer comments concerning the trading process; and (4) generally monitoring trades and settlements."[112]

Finally, the release announces that the SEC is modifying its interpretation of "provided by" from its *1986 Release*. On one hand, the SEC understands the benefits of specialization and the attendant pressure to separate brokerage and research. On the other hand, it expresses concern that money managers might use the associated arrangements to "conceal the payment of client commissions to intermediaries (including broker-dealers) that provide benefits only to the money manager." Accordingly, it finds the safe harbor is available to the manager only if the broker "pays the research preparer directly" and actively engages in monitoring "to assure itself [that any client commissions] the manager directs it to use to pay for such services are used only for eligible brokerage and research."[113]

IV. A TRANSACTION COST ANALYSIS OF INSTITUTIONAL 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

[112] *2006 Guidance*, at 41994.
[113] *2006 Guidance*, at 41994-95. This requirement would seem to impose on the broker the duty to render a legal conclusion regarding the SEC's likely interpretation of 28(e) with respect to specific research services. Brokers do not have the wherewithal to render such judgments. Indeed, the SEC's wherewithal is doubtful. It has now re-interpreted the Section 28(e) safe harbor at least four times, abandoned a major soft dollar disclosure proposal, and abandoned its suggestion with the *Concept Release* that implicit transaction costs might be disclosed.

quality is easily evaluated at the moment trade occurs.[114] 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, *i.e.*, all goods are "search" goods. 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 on any significant scale, because the parties have strong incentives to avoid it. In 1976, Jensen & Meckling published the seminal work on principal-agent conflicts.[115] 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. These are the residual losses. As long as residual losses persist, the parties have an

[114] Johnnie L. Roberts and Richard Gibson, *'Friction' Theorist Wins Economics Nobel*, Wall Street Journal, Oct. 16, 1991, Section B, page 1, supra at ?.
[115] Michael C. Jensen and William H. Meckling, *supra* n. ?, 3 J. FIN. ECON. 305 (1976). For other notable works see Stephan Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 10 BELL J. ECON. 55 (1979); Sanford J. Grossman and Oliver D. Hart, *An Analysis of the Principal-Agent Problem*, 51 ECONOMETRICA 1 (1983); Yoram Barzel, *The Entrepreneur's Reward for Self-Policing*, 25 ECON. INQ. 103 (1987).

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.

A. 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. In contrast to search goods, 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 in time or with repeated use. For certain experience goods, moreover, the receipt of unexpectedly low quality can impose substantial indirect costs on the buyer. By focusing on difficult-to-measure price impact and other implicit transaction costs, the SEC's own *Concept Release* implicitly views institutional brokerage as an experience good, even if it does not explicitly say so. Not only is the quality of a broker's execution costly for a portfolio manager 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.[116] Price impact is an artifact of the high transaction costs managers face enforcing the portfolio's exclusive property rights to profitable trading opportunities.[117]

Despite the SEC's willingness to acknowledge transaction costs in the narrow realm of trade execution, it has yet to consider how transaction costs in the sense of market frictions influence market participants' choice of economic organization more generally. Ronald Coase's pathbreaking work shows that the cost of transacting is the essential to understanding economic organization, including the intricacies of principal-

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[116] From the *Concept Release*: Footnote 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 learned that transaction costs can be a significant drag on performance, and they have begun managing them as intently as they research stocks." See, also, Schack, *supra* note 10, at 32; and See, e.g., Stephen A. Berkowitz et al., The Total Cost of Transactions on the NYSE, 43 J. Fin. 97, 98 (1988).
[117] D. Bruce Johnsen, Property Rights to Investment Research, *supra* n. ?.

agent relations.[118] His work, and indeed the entire field of transaction costs economics, is now widely integrated into the existing corpus of antitrust law, where it has been used to justify treating many vertical arrangements under the Rule of Reason rather than as illegal per se. Under the Rule of Reason, many puzzling business practices that were once summarily condemned as illegal per se are now judged by their actual or likely effect on consumer welfare following a fact-based inquiry guided by established economic theory.

Precisely because transacting is costly, the parties to many transactions must balance myriad countervailing conflicts; it simply does not pay them to incur a dollar's worth of transaction costs to eliminate a particular conflict of interest that might cost investors only fifty cents. A foremost example is managers' decision, almost invariably, to use brokers to execute difficult trades rather than trading directly for their own accounts. Managers benefit from the expertise of specialized agents and at the same time gain an important measure of anonymity. Anonymity reduces price impact, but it comes at the cost of insinuating a self-interested broker into the equation.

A conflict of interest arises from the manager'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 manager by doing a careless job that leads to excessive price impact. The broker would earn a high commission and save on execution costs. Before the manager could discover the breach his investors would have suffered diminished portfolio returns.

Despite this possibility, there is little doubt the reduction in transaction costs from using brokers leaves portfolio investors substantially better off on average. This is probably why, by long-standing industry custom, institutional portfolios bear the cost of brokerage commissions. The quick point is that economic organization can mitigate conflicts of interest but it can seldom eliminate them altogether. Conflicts of interest are an inescapable artifact of specialization, and it is therefore a mistake to prohibit business

[118] *See, especially*, Ronald H. Coase, Payola in Radio and Television Broadcasting, 22 Journal of Law & Economics 269 (1979).

practices merely because they give rise to conflicts of interest. The cure is likely to be worse than the disease.

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. 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, managers could enter into binding 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[119] ─ it is impossible for a manager 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. The best the manager can do to protect the portfolio is to terminate brokers whose execution quality proves to be sub-par over an extended series of trades.

B. Adverse Selection 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.[120] 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

[119] 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.
[120] *See, e.g.*, Klein & Leffler, *supra* n. ?; Charles J. Goetz and Robert E. Scott, Principles of Relational Contracts, 67 VA. L. REV. 1089 (1981); Oliver E. Williamson, Credible Commitments: Using Hostages to Support Exchange, 73 (4) Am. Econ. Rev. 519 (1983); George Baker, Robert Gibbons, Kevin J. Murphy, Relational Contracts and the Theory of the Firm (forthcoming Q.J.E.).

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 who buy generic aspirin for themselves tend to favor branded aspirin over generic for their children, where quality assurance is considered particularly important.[121]

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 others' behalf should do the same. Those who condemn fund managers for using investors' money to pay premium commissions for trades claim identical execution can be found for as little a penny per share. The inference is that any excess commission payment above this amount provides no compensating benefit to investors, serving merely to unjustly enrich managers. 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 manager was required to pay the lowest available brokerage commission and why they are better served if he instead pays up for brokerage in exchange for soft dollar research and other beneficial inputs.[122]

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, but the adviser cannot tell the two apart. He knows the HQ broker must charge at least four cents per share to cover his execution

[121] See K&L, 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 http://www.econlib.org/Library/Enc/BrandNames.html.
[122] 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.

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 per share.[123] 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 the solicitation of an 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 (or is compelled by regulation to set the lowest available commission) 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 gains. 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

[123] 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 would occur on HQ brokerage.

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 total trading gain of $120,000.

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 in excess of his execution costs 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.[124] Total transaction costs with Outcome 2 are $200,000.

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 in cash to the portfolio at the start of the first quarter. Were the manager to select the LQ broker, he would 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.

[124] 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.

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 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. 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.

Assuming for the moment that the manager recaptures the bond in the form of cash (recall *III*), investors earn a trading gain of at least $30,000 per quarter for a total of $60,000 and also enjoy the benefit of $60,000 in cash paid to the portfolio, for a total of $120,000.[125] The portfolio is clearly better off paying up for a quality-assuring performance bond. This mechanism is a reflection of *reciprocity*, a characteristic of human interaction so fundamental that for years it went unrecognized until economists, cognitive psychologists, and others identified its power and importance in all manner of trading relationships.[126]

C. Soft Dollars as a Quality-Assuring Performance Bond and Efficient Research Subsidy

The use of a quality-assuring performance bond is subject to three competitive conditions that soft dollar brokerage clearly meets.[127] First, the bond must be large enough relative to expected commissions that the HQ broker earns no surplus and merely covers his forgone opportunities. Second, the bond must be nonsalvageable in the sense that the broker cannot recover it once he has paid it. Finally, the bond must take the form that provides the greatest possible value to the portfolio. With soft dollars the first condition is met because, holding the brokerage commission constant, brokers compete

[125] Cash commission recapture appears to occur in most cases only after the associated trades when the manager has failed to exhaust the performance bond in the form of brokerage and research services.
[126] D. Bruce Johnsen, The Formation and Protection of Property Rights Among the Southern Kwakiutl Indians, 15 JOURNAL OF LEGAL STUDIES 41 (1986); Elizabeth Hoffman et al., Behavioral Foundations of Reciprocity: Experimental Economics and Evolutionary Psychology, 36 ECON. INQUIRY 335, 338 (1998); D. Bruce Johnsen, Customary Law, Scientific Knowledge, and Fisheries Management among Northwest Coast Tribes, 10 N.Y.U. ENVIRONMENTAL LAW JOURNAL 1 (2001); Yoram Barzel, Michel A. Habib, and D. Bruce Johnsen, *Prevention is Better Than Cure: The Role of IPO Syndicates in Precluding Information Acquisition* (forthcoming, J. BUS. 2008).
[127] Klein & Leffler.

vigorously for managers' business by offering larger soft dollar research payments. The second condition is met because the manager can insist the broker provide soft dollars up front[128] — whether in the form of third-party or in-house research — and any "commitment" he makes to use a particular broker's services is legally unenforceable as contrary to his fiduciary duty of best execution. A broker who is terminated for poor execution quality will lose its up-front bond. The remaining question is whether soft dollar research provides the greatest possible value to the portfolio. The answer is that investors benefit *more* if the bond takes the form of soft dollar research provided to the manager rather than an equivalent amount of cash paid into the portfolio.

To see this it is important to identify the main conflict of interest the manager faces. The extensive literature on the economics of agency uniformly recognizes that agents whose compensation is based on a fractional share of benefits to the principal have too little incentive to produce gains for the principal if they are required to pay the entire expense out of their own account. It is therefore in the principal's interest to subsidize inputs that complement the agent's labor effort in producing gains. Few corporate managers or other agents pay for their own business travel, office space and furniture, computers, telephone calls, copies, etc., because these and other inputs enhance their productivity. An alternative might be to increase their compensation by the expected cost of such inputs and to require them to bear the input expense directly. But unless the board can directly monitor their expenditures this would very likely lead them to be inefficiently frugal, to the detriment of corporate shareholders. Following this logic, in mutual funds investors' concern is not that managers will over-use brokerage and research services but that they will under-use them if required to pay the entire expense out of their own account.[129]

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[128] "The traditional soft dollar arrangement works on a simple formula: The soft dollar house provides research or other services to a trader in exchange for a certain amount of trading business *in the future*. The arrangement is normally defined by a ratio: say two dollars' worth of trading commissions for every dollar's worth of research." Jack Willoughby, *Autranet Angers Rivals Again with Soft Dollar Proposal; Suggests SEC Ban Commission Commitments*, Investment Dealers' Digest (February 20, 1995), at 5

[129] Even an individual principal will decline to spend a dollar monitoring his agent if the benefits from improved agent decision making are less than a dollar, but the situation becomes especially acute where the principal consists of a securities portfolio whose investors are numerous and dispersed.

Contrary to prevailing wisdom, the critical conflict of interest for fund managers is that they will tend to spend too little on raw research, devote too little labor effort to identifying mispriced securities, and do too few profitable trades.[130] If spending a dollar out of his own pocket on research yields a two-dollar increase in portfolio wealth but the manager receives only fifteen cents as his fractional share, he may decline to spend the dollar. The limiting case is known as "closet indexing," in which the manager collects a hefty fee for active management but instead indexes the entire portfolio, saving the cost of researching mispriced securities. This kind of underinvestment is generally known in the agency literature as the "shirking" problem.[131]

The efficiency of the soft dollar research subsidy in overcoming the manager's tendency to shirk is illustrated in Figure 2. MC shows the marginal cost of active management inputs, consisting of the optimal combination of raw research inputs, manager labor effort to identify mispriced securities, and broker executions. As the manager increases management inputs, marginal cost rises while the increment to portfolio wealth declines, shown by ΔNAV. As a conflict-free benchmark, if the manager owns the entire portfolio and pays all the costs of generating profitable trades he continues providing management up to M^*, where MC = ΔNAV, and total portfolio wealth is maximized. But because he receives only a small fractional share, θ, of ΔNAV he instead provides management inputs only up to M°,[132] where MC equals θΔNAV. This outcome fails to maximize the parties' joint wealth. Transaction costs to portfolio investors from monitoring the manager to ensure he refrains from shirking are prohibitive.

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[130] They may also engage in sub-optimal monitoring of execution quality, but the use of a quality-assuring performance bond reduces this problem.

[131] See Jensen & Meckling, *supra* n. ?.

[132] It is important to note that managers' share of the portfolio residual is substantially larger than their periodic management fee for at least two reasons. First, they receive a recurring fee so that any permanent increase in portfolio wealth provides them with an increase in compensation equal to the present value of the increase in future fees. Second, several studies indicate that flows into funds (which increase total fees) are positively related to past performance Richard A. Ippolito, *Market Solutions to Low Quality Producers: Evidence from the Mutual Fund Industry*, 35 J. LAW & ECON. 45 (1992); Erik R. Sirri and Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. FIN. 1589 (1998); and Judith Chevalier and Glen Ellison, *Risk Taking by Mutual Funds as a Response to Incentives*, 105 J.P.E. 1167 (1997)); Wermers (2001). As a result, managers tend to receive future benefits from performing well, but in any case, they are likely to underinvest in research if they are required to pay all research costs even after considering the effects of fund flows.

It is unsurprising that the beneficiaries of managed portfolios ─ whether fund investors, trust beneficiaries, or pension plan sponsors ─ routinely subsidize their managers' use of brokerage and allow them to bundle the cost of research and other services into the brokerage commission through some form of soft dollar arrangement. By paying brokerage commissions covering pure execution costs, the portfolio causes the manager's cost of inputs to fall, say, to MC-E, in which case he increases management to $M^{\dagger}$. By also allowing the manager to bundle the cost of research into the brokerage commission, the portfolio further reduces his management costs, say to MC-E-R. This encourages him to increase management inputs, perhaps all the way to M^{*}. With increased management, including research, the manager is likely to identify more profitable trading opportunities and to have good reason to order more portfolio trades.[133]

Managers earn no expected surplus as a result of the research subsidy because competition bids down their fees so they just cover their opportunity cost. The important point regarding incentive alignment is that, at the margin, bundling adjusts relative prices to encourage managers to do more research and more trading for the benefit of portfolio investors,[134] and, at least where the manager receives the research up front, bundling specifically reduces the manager's cost of monitoring execution quality by raising the penalty the broker suffers from cheating.

It is entirely plausible soft dollars constitute a self-enforcing bond to assure high-quality brokerage execution and efficiently subsidize manager research. Given the subsidy, the possibility remains, of course, that managers use too much research and execution, perhaps going beyond M^{*} in Figure 2. Where the manager receives third-party research in the form of generic inputs he has little to gain from overuse, however, because generic research has no intrinsic value unless he provides his own labor effort to transform it into conclusions regarding mispriced securities. Indeed, it may be that managers overuse full service brokers' in-house research, which often comes in the form

[133] See Tae-Young Paik and Pradyot K. Sen, *Project Evaluation and Control in Decentralized Firms: Is Capital Rationing always Optimal?*, 41 MGMT. SCI. 1404 (1995), whose results suggest that if research inputs, labor effort, and broker executions are complementary and normal inputs in portfolio management, subsidizing any single input will encourage managers to use more of all inputs.

[134] This form of organization is known as a "two-part tariff in the economics literature. Walter Y. Oi, A Disney Land Dilemma: Two-Part Tariffs for a Mickey Mouse Monopoly, 85 Q.J. Econ. 77 (1971); Richard Schmalense, Monopolistic Two-Part Pricing Arrangements, 12 Bell J. Econ. 445 (1981).

of conclusions about which securities to buy or sell. Here, the *broker* provides the labor effort to identify mispriced securities, thereby allowing the manager to conserve his own resources. This suggests yet another conflict of interest managers may face, though it does not necessarily result in actual bad conduct or unjust enrichment. Conflicts of interest abound.

As reflected in the *Concept Release*, the SEC focus has been on fund expenses. It has steadfastly resisted any notion that shareholders' can assess manager performance and discipline bad behavior by redeeming their shares and taking their money elsewhere. That fund shareholders can do so was first proposed by Fama & Jensen, who saw the redemption option as akin to a partial "takeover" of fund capital.[135] Theoretical and empirical work since then has uniformly demonstrated that fund flows are extremely sensitive to performance, that advisers and their managers actively compete on the basis of fees and other expenses, and that organizational innovation in the fund industry is alive and well.[136] That few many fund shareholders have little actual knowledge of their manager's brokerage allocation decisions, or the total cost of transacting, is virtually irrelevant.

V. INVESTOR WELFARE

The preceding section on the unassailable assumption that institutional securities brokerage is not a standardized commodity whose attributes can be easily evaluated at the point of sale and whose price can be expected to equal marginal production cost. Rather, it is in an experience good. Transactions involving experience goods ordinarily require some measure of trust between the parties to a long-term relationship in which the temporal flow of reciprocal benefits is carefully designed to provide high-powered incentives. The price of an experience good must exceed marginal production cost to provide a premium sufficient to induce the seller to fulfill its implicit promise to provide

[135] Fama & Jensen, *supra* n. ?
[136] See articles cited *supra* n. ?, as well as 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) and D. Bruce Johnsen, A Closer Look at Mutual Fund Advisory Fees (GMU School of Law Working paper).

high quality. As Judge Posner explicitly recognized in *Wsol v. FMA* (2001),[137] cutting commissions to the execution-only rate is not an option available to the parties.

Statements by former Senator Fitzgerald (R-Illinois), the SEC, and others arguing that portfolio managers could realistically pay the lowest available brokerage commissions with no loss to investors are based on a naïve and out-dated economic model of exchange of standardized commodities in which the cost of transacting is assumed to be zero. The SEC's repeated expression of hope that the execution of institutional securities trades can be completely unbundled from research and other services is similarly misguided.[138] It fails to recognize that the parties to institutional securities brokerage have every incentive to eliminate bundling if it fails to maximize the gains from trade, net of transaction costs. That they routinely decline to do so in such an intensely competitive industry suggests they are constrained by significant transaction costs.

Once the cost of transacting is considered, soft dollars appear to provide managers and brokers with high-powered incentives to properly act on investors' behalf. The arrangements can be structured in a way that forces brokers to assure execution quality by posting an up-front performance bond whose payback is conditional on manager satisfaction. A soft dollar research bond appears likely to benefit investors by efficiently subsidizing managers to research profitable portfolio trades and to efficiently execute those trades. Conditional on the broker providing an up-front bond, investor welfare is served as long as the manager spends each soft dollar on items that, in his good faith

[137] Wsol v. Fiduciary Management Associates, Inc., and East West Institutional Services, Inc., 266 F.3d 654 (Seventh Circuit, 2001) ("In either case, FMA, which is to say the fund, would have paid 6 cents a share per trade; that is the standard fee and there is no proof that FMA could have obtained comparable trading services for less").

[138] There is no doubt market participants are attempting to move to unbundling. Massachusetts Financial Services, Fidelity Management and Research, American Century Funds, and several other large advisory firms have stated their intent to pay an execution-only rate for brokerage and to bear the entire cost of portfolio research out of their own account. See John Hechinger, *MFS Ends 'Soft Dollar' Payments on Concerns over Ethics*, Wall Street Journal, March 16, 2004, at C1, *supra* n. ? Gregg Greenberg, Fidelity Continues Unbundling, The Street.com, December 20, 2005, at http://www.thestreet.com/_yahoopi/funds/funds/10258409.html?cm_ven=QUIGO&cm_cat=FREE&cm_ite=NA. But there is also no doubt their success at doing so relies heavily on their refined ability to accurately assess execution quality using various proprietary methods. These methods are unavailable to many smaller advisory firms. Regulation that artificially mandates unbundling will put these firms at a competitive disadvantage and very likely injure investors.

belief, yield more than a dollar in expected benefits to investors. Investor welfare is served if cash commission recapture occurs only after all such beneficial opportunities have been exhausted. Certain brokerage and research services clearly qualify for this "net benefit" test. This is no doubt why Congress saw fit to provide managers with a statutory safe harbor where the increased commission they pay is "reasonable in relation to the value of the brokerage and research services" they receive. It is probable, however, that products and services falling outside the interpretation set out in the *Guidance* also meet the net benefit test. If Section 28(e) is truly a safe harbor, such items are not necessarily illegal or civilly actionable.

The effect of soft dollars and other forms of research bundling on investor welfare is ultimately an empirical question, on which only limited published work has been done. One study purports to measure the difference in transaction costs between soft dollar brokers and other kinds of institutional brokers.[139] They find the total transaction costs for soft dollar brokers ─ including explicit brokerage fees, price impact, and the opportunity cost of delayed execution ─ are generally higher than for other institutional brokers after adjusting for trade difficulty (order size) and other factors. Absent evidence regarding the relative benefits of the research managers and investors receive from each of these forms of bundled brokerage, they are unwilling to conclude soft dollar brokerage harms investors on net balance. More to the point, their database only crudely differentiates soft dollar brokerage from these other forms of brokerage because all institutional brokers do a substantial amount of their business pursuant to soft dollar arrangements and in any event routinely bundle in-house research into a single premium brokerage commission.[140] At best their analysis addresses the merits of third-party research relative to in-house research. It simply fails to address the critical question, which is whether or not bundling research into brokerage commissions harms investors.

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[139] Jennifer. S. Conrad, Kevin M. Johnson, and Sunil S. Wahal, S., Institutional Trading and Soft Dollars, 56 J. Fin. 397 (2001).

[140] At best, their results suggest that vertically disintegrating the production of private information from the brokerage house to the management firm (supported by third-party research products) leads to an increase in the transaction costs of securities trading. But no one has criticized soft dollars because they result in vertical disintegration, only because soft dollar bundling maligns managers' incentives. These results completely fail to address the effects of bundling, *per se*, on transaction costs or investor welfare.

More recently, Horan & Johnsen examine the effect of paying up for brokerage on a sample of private money managers' portfolio returns.[141] After adjusting for various factors likely to affect execution costs and returns, they find that managers who pay higher premium commissions per dollar under management generate higher portfolio returns. They also find that management fees do not decline as a manager's use of premium commissions increases, contrary to the concern the SEC expressed in its *1996 Disclosure Proposal*.[142] If soft dollars allow managers to unjustly enrich themselves, consistent with the SEC's concern in its *1995 Disclosure Proposal*,[143] the associated rents would be competed away in the managerial labor market, leading to lower fees. Both of these empirical findings are consistent with the hypothesis that bundling benefits investors by assuring the quality of brokerage executions and efficiently subsidizing manager research. They are inconsistent with the hypothesis that bundling harms investors by allowing managers to unjustly enrich themselves.

The policy favored by a chorus of soft dollar critics, including SEC Chairman Cox, would be to eliminate the Section 28(e) safe harbor entirely. This would very likely raise at least two countervailing conflicts of interests. First, it would lead portfolio managers either to shift toward low-quality brokerage that increases price impact more than the reduction in brokerage commissions or to spend added time and attention monitoring brokers at the risk of missing trading opportunities. Second, it would lead to an increase in advisory fees to compensate managers for their higher out-of-pocket research costs but would weaken their marginal incentives to identify profitable trades for the benefit of investors. If, as the analysis in this paper suggests, soft dollar bundling is an efficient research subsidy the increase in fees would exceed the expected cost of bundled-in research. Both sacrifice investment performance.

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[141] Stephen M. Horan and D. Bruce Johnsen, *Can Third-Party Payments Benefit the Principal: The Case of Soft Dollar Brokerage*, INTL. REV. LAW & ECON. (forthcoming, 2008). Private money managers consist primarily of pension fund managers, but also include the managers of private trusts, hedge funds, private equity funds, etc.
[142] *See supra* at ?
[143] "Advisers that do not engage in soft dollar arrangements may be put at a competitive disadvantage if they pay for services with hard dollars and attempt to pass the cost of these services on to clients through higher fees."

A. The 2006 Guidance: Salient Points, Economic Irrelevance

The SEC's long awaited *2006 Guidance* helps credit it with having done *something* in response to the Spitzer-inspired mutual fund scandals, but as a laundry list of formalistic rules unsupported by economic analysis it provides little in the way of demonstrable benefits to investors. On many issues it flatly contradicts itself, the statute, existing common law, and the SEC's prior findings of Congressional intent in passing 28(e). Perhaps more important, by requiring managers to document their good faith in allocating brokerage it completely negates the safe harbor's primary purpose, which is to raise a presumption that managers have acted properly and to impose the burden of proof on those who might claim otherwise. Though by no means exhaustive, this subsection reviews several of the *Guidance's* more salient deficiencies in light of the economic analysis from Section IV.

1. The Common Law Antecedents of 28(e)?

Recall the SEC's *1986 Interpretive Release* expanding the scope of the safe harbor. It observed that the looming abolition of fixed commissions in May, 1975, led money managers and institutional brokers to express concern to Congress that they would be exposed to suits for breach of fiduciary duty if managers continued to pay brokers more than the lowest available commission. In the SEC words,

> "[t]his concern was based on the traditional fiduciary principle that a fiduciary cannot use trust assets to benefit himself. The purchase of research with the commission dollars of a beneficiary or a client, even if used for the benefit of the beneficiary or the client, could be viewed as also benefiting the money manager in that he was being relieved of the obligation to produce the research himself or to purchase it with his own money."[144]

[144] *1986 Interpretive Release,* at around nn. 3-4, *supra* n. ?.

To justify narrowing the safe harbor in its *2006 Guidance*, the SEC went one step further, finding that money managers who pay up for brokerage face significant conflicts of interest prohibited under the common law of trusts. Citing Section 170 of the *Restatement, Second, of Trusts* for the proposition that trustees must act "solely in the interest of the beneficiaries,"[145] the *Guidance* concludes that "[t]he fundamental obligation of the adviser to act in the best interest of his client . . . generally precludes the adviser from using client assets for the adviser's own benefit or the benefit of other clients, at least without client consent."[146] It concludes that soft dollar bundling would violate trust law absent safe harbor protection.

This conclusion is baffling for its failure to mention other relevant passages from the *Restatement*, as well as other sources of relevant law. The comments following Section 170 make clear that the nature of the precluded "benefits" to which it refers involves situations in which the trustee "profit[s] at the expense of the beneficiary [or] . . . enter[s] into competition with him." A representative example includes sale by the trustee of trust property to himself, either directly or indirectly. Even ignoring the likely benefits investors enjoy from soft dollars as a result of the economic incentives they provide, it is implausible to suggest they ordinarily allow managers to "profit" at investors' expense in the sense covered by Section 170.

This is obvious from the language of Section 244, which the SEC fails to acknowledge. It states that "[t]he trustee is entitled to indemnity out of the trust estate for expenses properly incurred by him in the administration of the trust." Comment b to Section 244 goes on to explain that

> "[i]f the trustee properly incurs a liability in the administration of the trust, he is entitled to indemnity out of the trust estate either by way of exoneration, that is by using trust property in discharging the liability so that he will not be compelled to use his individual property in discharging it, or by way of reimbursement, that is if he has used his individual

[145] Section 170 reads "Duty of Loyalty [as Revised]: (1) The trustee is under a duty to administer the trust solely in the interest of the beneficiaries. (2) The trustee in dealing with a beneficiary on the trustee's own account is under a duty to deal fairly and to communicate to the beneficiary all material facts the trustee knows or should know in connection with the transaction." *Restatement (Second) of Trusts* (1959).
[146] Citing *Restatement (Second) of Trusts* (1959), *2006 Guidance*, at n. 3 (FR 41978)

> property in discharging the liability, by repaying himself out of trust property."[147]

Bundled-in research provides managers with a benefit only to the extent it relieves them of the burden of paying for the same research out of their own pockets. Section 244 squarely contradicts the SEC's claim that receipt of such benefits is contrary to trust law. Unless managers receive benefits to the *exclusion* of investors, as where the broker provides the managers with personal benefits that have no *bona fide* business purpose, no self dealing has occurred and no suit for fiduciary breach is warranted under the common law of trusts. The SEC and others have identified instances in which soft dollars were used for such self dealing.[148] This doubtless happens from time to time, but there is no evidence in the public record to suggest it presents a systemic problem sufficient to require either a narrowing of the safe harbor or its total elimination. In any organization, self seeking people press the limits and step over the line of propriety from time to time. Some even steal. But these actions are normally punished internally, and in any event the SEC's *2006 Guidance* does not even attempt to target such conduct. It targets conduct otherwise considered "lawful and appropriate."

The rules requiring trust beneficiaries to indemnify trustees out of trust assets is by no means peculiar, having a close parallel in the common law of agency. Section 428 of the *Restatement, Second, of Agency* observes that

> "(1) A principal is under a duty to indemnify the agent in accordance with the terms of the agreement with him; (2) In the absence of terms to the contrary in the agreement of employment, the principal has a duty to indemnify the agent where the agent, (a) makes a payment authorized or made necessary in executing the principal's affairs or, unless he is officious, *one beneficial to the principal* [emphasis added], or, (b) suffers a loss which, because of their relation, it is fair that the principal should bear."

Comment b to this section, titled "*Reimbursement, exoneration, and subrogation*," continues on to find that

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[147] *Restatement (Second) of Trusts* (1959)
[148] See *1998 OCIE Report*; WSJ article on Cox letter, *supra*; Kara Scannell, Susanne Craig, and Jennifer Levitz, *'Gifts' Case Nabs a Star*, WALL STREET JOURNAL, Thursday, March 6, 2008, at C1..

> "[t]he agent's right of indemnity always includes a right to reimbursement for amounts properly paid or losses suffered without his fault in transactions authorized by the principal. This right arises at the time when the agent makes an authorized payment, or suffers a loss, without his fault. In some cases, he has only a right of reimbursement, as where he specially agrees to use his own assets to pay claims arising against himself or the principal, or where such an agreement can be inferred by the *customs of business* [emphasis added] or prior dealings between the parties. . . ."

General corporate law principals, which derive from the common law of agency, are thought to provide fiduciaries with greater leeway than trust law, and they are a more appropriate guide for assessing active portfolio managers' fiduciary duty to generate profitable securities trades and to otherwise manage portfolio assets. Trustees' primary charge is to preserve the corpus of the trust by taking care with investor assets, while both the managers of operating corporations and active portfolio managers are expected to increase the corpus by making risky investments.[149] With risky investments, there is always a substantial chance a bad state of the world will come to pass and the investment will fail.

To avoid hindsight bias in suits for breach of fiduciary duty, state common law provides corporate managers with protection under the business judgment rule. It raises a rebuttable presumption managers made their decisions in good faith, acted with due care,

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[149] As Chancellor Allen aptly put it,

> "[i]n general, the duties of a trustee to trust beneficiaries, such as loyalty, good faith, and due care, while broadly similar to those of a corporate director to his corporation, are different in significant respects. Corporate directors are responsible for often complex and demanding decisions relating to the operations of business institutions. The nature of business competition insures that these directors will often be required to take risks with the assets they manage. Indeed, an unwillingness to take risks prudently is inconsistent with the role of a diligent director. The trustee's role is quite different. The role of the trustee is prudently to manage assets placed in trust, within the parameters set down in the trust instrument. The classic trusteeship is not essentially a risk taking enterprise, but a caretaking one."

Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134 (1994). Being called on to perform investment research and make risky investment decisions, managers should not be held to the same strict standard as a trustee. Given that the Restatement of Trusts explicitly allows a trustee to deduct expenses from the trust by way of either exoneration or reimbursement, the same should apply to investment managers absent specific agreement to the contrary, especially where doing so is consistent with established business custom or the parties' prior dealings.

had no interest in the subject matter of the decision, were informed to the extent they reasonably believed appropriate under the circumstances, and rationally believed the decision to have been in the best interest of the corporation.[150] It is up to the party challenging the fiduciary's conduct to rebut any one or all of these business judgment rule presumptions. Nowhere in the common law does the fiduciary have any burden of proof *ab initio*. And in any event once an adverse party rebuts any of the business judgment rule presumptions the fiduciary has the ability to avoid liability by proving entire fairness.[151]

Needless to say, the managers of operating corporations are free to charge virtually all the expenses of management to the firm, either by way of exoneration or reimbursement. Doing so in no way removes business judgment rule presumptions. There is no doubt a fund adviser (and the fund manager) is a fiduciary under the ICA, and nothing in the Act suggests the business judgment rule is in any way superseded. Notwithstanding the ICA's statutorily imposed fiction the advisory firm is legally separate from the mutual fund, it is difficult to see how a portfolio manager who pays up in exchange for broker-provided benefits he sincerely believes will improve portfolio performance would violate a fiduciary duty, especially if he acts within policies established by the fund's board. This conclusion holds even in the absence of Section 28(e)'s safe harbor and irrespective of the SEC's interpretation of its scope.

Ordinarily, whether the manager's receipt of benefits violates a fiduciary duty depends on what the advisory contract or board policy explicitly authorizes. To the extent the advisory contract and board policy are silent on the subject, established business custom and the prior dealings of the parties are normally used to determine the legitimacy of managers' conduct. It is beyond question that paying up for research and other benefits was a longstanding business custom well before the deregulation of fixed commissions, very likely dating back to the dawn of securities trading. That the broker's provision of research can be used to bond the quality of his executions while encouraging the manager to spend more than otherwise on investment research strongly reinforces the

[150] Charles R.T. O'Kelley and Robert B. Thompson, *Corporations and Other Business Associations*: *Cases and Materials* (Aspen, 5th Ed., 2006: New York), at 236.
[151] *See*., e.g., Cede & Co. v. Technicolor, Inc., 884 A.2d 26 (Del. S. Ct., 2005)

conclusion that there is nothing actionable under the common law about paying up for broker-provided items reasonably expected to benefit the fund.

Rather than a detailed list of specific contractual rules, the fiduciary duty constitutes a broad standard of conduct that economizes on transaction costs by filling gaps resulting from the prohibitive cost of complete contracting.[152] The economic function of the fiduciary duty is to relieve the parties, both principal and agent, from the burden of having to contract over every detail of their ongoing relationship. Possible breaches are assessed ex post only when a bad outcome finds the agent and principal in an adversarial setting. It makes little sense to hold fund advisers to a fiduciary duty if the SEC is going to prescribe every detail of the adviser-fund-investor relationship. Contracting with and monitoring the advisor is the function of the fund's board of directors, at least 40% of which must be independent of the advisory firm under Section 10(a) of the ICA.[153] That investors quickly move their money out of poorly performing funds suggests that competitive forces will favor funds whose boards engage in efficient contracting and monitoring and punish those that do not.

2. Research Services: Outputs versus Inputs

The *Guidance* expresses the intent to treat proprietary in-house research and research supplied by independent third-party venders equally under the safe harbor. Yet it goes on to find, with only one exception, that protected "research services" are limited to "advice," "analyses," and "reports" reflecting the expression of "reasoning or knowledge." This interpretation comprehends the phrase "brokerage and research services" in the narrowest possible terms rather than in the "broadest possible terms," which plainly contradicts the SEC's recitation of Congressional intent in its *1986 Interpreting Release*. Advice, analyses, and reports are in the nature of *outputs* resulting from the combination of raw research *inputs* and the *broker's* labor effort, traditionally produced and supplied as in-house research. Research inputs, on the other hand, are

[152] *See* Frank H. Easterbrook and Daniel R. Fischel, The Economic Structure of Corporate Law (Harvard University Press: London, Cambridge, 1991).
[153] 15 U.S.C. § 80a-10(a)

disproportionately produced by independent third-party research vendors and supplied to fund managers by full-service and soft dollar brokers alike. The *Guidance* explicitly excludes from safe harbor protection a host of generic but potentially useful research inputs such as subscriptions to mass marketed publications, travel to conferences and to visit corporate offices, and inherently tangible products or services such as computer hardware and dedicated telephone lines used exclusively to transmit research.

Research that reflects the expression of reasoning and knowledge falls on a continuum, with exclusive access to a full-service broker's in-house stock picks at one extreme and generic research inputs such as mass marketed publications at the other.[154] A parallel continuum is one involving the manager's labor effort. A manager who gains exclusive access to a full-service broker's stock picks need not put much of his own labor effort into the investment decision making process to generate adequate portfolio returns. This could be regarded as a countervailing conflict of interest to the extent the manager pays up for research to avoid the labor effort necessary to arrive at profitable stock picks.[155] At the other end of the continuum, a manager who relies exclusively on generic inputs must put forth a great deal of his own labor effort in the investment decision making process to generate the same returns. He has nothing to gain by ordering generic research inputs if he has no intention of contributing his own labor effort, unless of course the research has value to him apart from the investment decision making process. In that case the manager would risk running afoul of agency law, trust law, and any of the SEC's past or present interpretations of Section 28(e)'s scope. The pressing concern is that the *Guidance* screens out too much, forcing managers to leave money on the table and depriving investors of the associated benefits.

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[154] In theory, it is possible that third-party vendors will try to sell stock picks. The problem is that the buyer never knows where he stands on the vendor's priority list. Did he receive the first call from the vendor or the last call? What is called the "favoritism problem" reflects a fundamental conflict of interest in transacting conclusory investment research in the spot market. Even if the research is potentially profitable the manager must make the associated trades without too much price impact, for which the research vendor would appear to have no responsibility. By seeking research in the form of stock picks from full-service brokers who will also execute the associated trades, the manager better aligns the brokers' incentives to generate profitable trades net of transaction costs.

[155] In extreme cases, such shirking may be civilly actionable under state law. "Sloth could certainly be an appropriate addition to that incomplete list if it constitutes a systematic or sustained shirking of duty." In re the Walt Disney Company Derivative Litigation, 907 A.2d 693 (2005). The problem with such claims is that judicial measurement costs may be overwhelming.

The single exception to the generic input exclusion is for "market data" provided through tangible media such as Quotron machines or Bloomberg terminals (descendants of the original "ticker-tape" machine). The *Guidance* claims this exception levels the playing field between managers who use raw data to generate their own stock picks and those who receive stock picks through full-service brokers' in-house research. While it is true that this exception moves in the direction of leveling the playing field, the SEC gives no explanation why this is the appropriate stopping point. Why not other kinds of useful computer hardware? Why not subscriptions to mass-marketed publications that contain stock price quotes and other relevant news? Why not travel to meet with operating company managers or to conferences? Any suggestion that market data terminals are unique because they have been historically supplied by brokers is economically irrelevant, especially in light of the SEC's view that innovation in the field of research provision will, and presumably should, occur. It also fails to acknowledge that in the vast majority of principal-agent relations, principals subsidize their agents' use of such inputs. Indeed, this is the default rule under the common law of agency and trusts, as we have already seen.

If the *protected* brokerage and research services a manager receives fail to exhaust the broker's performance bond, the manager should be encouraged to spend the remaining soft dollars on any inputs that provide investors with net benefits. Only if he has exhausted such opportunities is it in investors' interest for him to recapture the bond in the form of cash. This conclusion holds regardless of whether the inputs in question can be characterized as "overhead" expenses for accounting purposes or whether the advisor is a legally separate firm. Note that to the extent investors subsidize such inputs, over the long run advisory fees will adjust downward to ensure managers earn only a competitive wage. But to the extent managers would otherwise underinvest in such inputs (*i.e.*, a subsidy is efficient) the reduction in brokerage commissions will fall short of the increase in management fees.

The distinction between research inputs that constitute overhead and those that do not is economically misguided, especially given the SEC's acknowledgement that the form in which brokerage and research services are delivered is more or less malleable,

what biologists and some economists refer to as "plasticity."[156] Recall the arrangement in *Investors Information Incorporated*, for example, in which, as a third-party vendor, III packaged brokerage selection services with various generic research inputs excluded from safe harbor protection under the then-current "readily and customarily available . . . to the general public on a commercial basis" standard. Early on, this demonstrated market participants' remarkable ingenuity at designing products and services around an existing legal standard. Recall, also, the SEC's finding that excluding market data from safe harbor protection might encourage "purveyors of this information to simply add some minimal or inconsequential functionality to the data to bring it within the safe harbor."

Abstracting from questions regarding the scope of safe harbor protection, managers are generally indifferent to the form in which they receive research services; their concern is with the underlying substance. Market participants have tremendous latitude in selecting the form, especially over the long run. In economics, one such choice is whether to generate a given level of output by incurring large up-front fixed costs (so-called "overhead") and low ongoing variable costs or, instead, to incur low fixed costs and high variable costs. By excluding overhead from safe harbor protection, the *Guidance* encourages advisers to make socially inefficient substitution decisions when contemplating the trade-off between fixed and variable costs.[157] Nothing in the *Guidance* suggests the SEC is even aware of this conflict of interest, let alone that it adequately considered it when arriving at its interpretation.

Suppose a manager has the opportunity to invest $10 on equipment the *Guidance* would exclude as overhead. The manager would have to pay this expense out of his own pocket. Suppose, also, that this investment would reduce by $100 the discounted present value of the broker-provided research services protected under the *Guidance*. At the margin, the *Guidance* tips the manager in favor of substituting low-overheard-high-variable-cost research for more efficient high-overhead-low-variable-cost research.

[156] See, e.g., Jack Hirshleifer, *Economics from a Biological Viewpoint*, 20 J. LAW & ECON. 1 (1977).
[157] It is well-settled in economics that holding real income constant people consumers (producers) will substitute away from goods (productive inputs) whose relative price increases.

Investors suffer.[158] There is no way to escape economic substitution and no way to hold the manager responsible for failing to make an investment that he never formally considered or even bothered to identify because it was not in his interest to do so. Because of the inability of either boards of directors or the SEC to identify alternative actions not taken, managers must be given a zone of discretion to optimize on shareholders' behalf. This is exactly what the safe harbor (and the business judgment rule) was designed to protect.

Having the SEC prescribe the details of managers' decisions in a dynamic business environment can hardly be conducive to investor welfare. At some point, the SEC must recognize and rely on the market's ability to punish indiscrete manager actions with poor performance and shareholder redemptions.[159]

3. Brokerage Services

The *Guidance* establishes what it describes as a "temporal standard" for determining the eligibility of "brokerage services" for safe harbor protection. According to this standard, "brokerage begins when the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution and ends when funds or securities are delivered or credited to the advised account or the account holder's agent."[160] This standard is contradicts the statue and is economically irrelevant. First, it fails to recognize the underlying reality of managers' trading strategies, which often involve breaking information-based trades of a given size into smaller orders. To

[158] The substitution problem applies to virtually the entire laundry list of brokerage and research services excluded under the *Guidance*. Travel to meet with the operating corporation executives is a powerful case on point. Under some circumstances, "face time" with corporate executives can be one of the most beneficial investments a portfolio manager can make on behalf of his fund. Yet many people view travel as personally tiring, tedious, distracting, and even scary — *i.e.*, it comes at a high personal cost to the manager. By excluding travel expenses from safe harbor protection the *Guidance* will cause managers to adjust marginally away from it. This cannot possibly benefit fund shareholders.

[159] The same applies to the SEC's finding in its *2001 Interpretive Release* that only transactions in which the dealer spread is quantifiable are eligible for safe harbor protection. There is no doubt that over the course of repeated transactions with a broker a prudent manager can assess the reasonableness of any excess spread in relation to the value of the brokerage and research services he receives even if he is unable to quantify the exact spread in any given trade. Managers who fail in this regard will suffer poor fund performance and shareholder redemptions compared to those who succeed.

[160] *2006 Guidance*, at 41989.

disguise his intentions, a prudent manager will often parse these orders out to different brokers over a span of days or even weeks. Any suggestion that his receipt of services in connection with each separate order must meet the temporal standard contradicts Section 28(e), which protects a manager's brokerage allocation decision in "either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion." The plain meaning of "overall responsibilities" surely contemplates both multiple accounts under the manager's control and the manager's intertemporal strategic brokerage allocation decisions with respect to each account.

Second, the temporal standard fails to recognize the importance of the manager-broker relationship, what economists and others have characterized as "relational contracts."[161] By definition, a relational contract is no contract at all because the parties' mutual obligations are too difficult to verify to a court of law. Instead, the parties' perform their obligations sequentially. Trade in experience goods is facilitated by a long course of repeat interactions in which the flow of reciprocal benefits cannot be uniquely attributed to any specific transaction or time period. Rather than assessing price impact on each order executed by a given broker, prudence requires the manager to trust his brokers and instead assess their performance over an extended trading relationship. The up-front bond inherent in soft dollars facilitates such a strategy.

When transacting experience goods through relational contracts, the parties must expect a reciprocal flow of economic rents that gives them something to lose from termination, that ensures they will refrain from cheating by delivering deceptively low quality, and that, in general, they will cooperate on a host of difficult-to-specify dimensions of their long-term relationship. The economic reality under such circumstances is that managers must have a zone of discretion within which their conduct cannot be second-guessed. And yet the SEC appears intent on adhering to the misguided belief that institutional brokerage is a standardized commodity ─ a *search* good ─ whose dimensions can be easily assessed at the point of sale and that investors uniformly benefit from detailed regulatory prescriptions. The parallel assumption is that any long-term

[161] Charles J. Goetz and Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981); George Baker, Robert Gibbons, Kevin J. Murphy, *Relational Contracts and the Theory of the Firm* (forthcoming Q.J.E.).

trust, loyalty, or reciprocity between the parties necessarily comes at investors' expense. Nothing could be further from the truth.

Finally, the temporal standard ignores the pervasive substitution problem. While it is true, as the *Guidance* asserts, that specialization has led to functional separation between brokerage and research in many settings ─ as with in-house and third-party research ─ in many settings the two are impossible to separate. The assumption implicit in the *Guidance* is that identifying mispriced securities is the singular goal of investment research. As the SEC's *Concept Release* makes clear, however, any potentially profitable trade (which will normally involve a large block of securities) is likely to suffer some measure of price impact. As the model in Part IV shows, paying up for brokerage can limit the problem. Both investment research and brokerage contribute to portfolio returns.[162] They are complementary inputs subject to economic substitution, and it is therefore risky to treat them as distinct in all settings. Nothing in the *Guidance* suggests the SEC is aware of this risk in prescribing a formalistic laundry list of included and excluded brokerage and research services.

Two categories of services excluded under the temporal standard as "overhead" are compliance and error correction trades. The *Guidance* states that

> "managers may not use client commissions under the safe harbor to meet their compliance responsibilities, such as: (i) Performing compliance tests that analyze . . . the quality of brokerage executions (for the purpose of evaluating the manager's fulfillment of its duty of best execution), an analysis of the portfolio turnover rate, or an analysis of the comparative performance of similarly managed accounts (to detect favoritism, misallocation of investment opportunities, or other breaches of fiduciary responsibilities)"[163]

[162] "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." . . . ". . . [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 learned that transaction costs can be a significant drag on performance, and they have begun managing them as intently as they research stocks." *Concept Release*, *supra* n. ?, at n. 32.
[163] *2006 Guidance*, at 41990.

Having to pay the expenses associated with compliance out of their own pocket is likely to cause managers to inefficiently substitute away from such activity. More concretely, the conclusion that compliance expenditures are excluded from the safe harbor directly contradicts its clear terms. Section 28(3)(C) states that "brokerage and research services" include "functions incidental thereto . . . or *required in connection therewith by rules of the Commission*" [emphasis added]. The irony is worth noting; the *Guidance* compounds managers' compliance burden with respect to brokerage allocation and at the same time, contrary to the language of the statute, removes safe harbor protection for compliance expenditures.

It is unsurprising to hear that over the course of hundreds or even thousands of trades, a fund manager and an executing broker will miscommunicate about some attribute of a trade now and then, even if both exercise due professional care. The broker may trade a security for the manager that the manager did not intend to trade or fail to trade one the manager intended to trade. In the fast-paced institutional trading world, mistakes happen that cannot be attributed to anyone's *fault*. Given the extended trading relationship soft dollar brokerage entails, one way for the parties to address this situation is for the broker to swallow the cost as an expression of reciprocity. He can do this by correcting the original trade at a price that is favorable to the portfolio at the time of the correction. This is likely to be costly for the broker, and in the past managers and brokers have agreed to charge some or all of the cost against the manager's soft dollar balance.

According to the *Guidance*, the cost of such error correction trades is excluded from Section 28(e)(3)(C) because they are "separate transactions to correct the manager's error, not to benefit the advised account, and thus . . . are properly characterized as "overhead," *i.e.*, part of the manager's cost of doing business."[164] Not only does this ruling explicitly contradict the common law of trusts quoted above ("[i]f the trustee properly incurs a liability in the administration of the trust, he is entitled to indemnity out of the trust estate"), but it ignores the substitution problem and neglects the important role of long-term relations. Recall the SEC's *Concept Release*, which formally states that the "opportunity cost of delay" is one of the implicit transaction costs that can drag down

[164] *2006 Guidance*, at 41990.

portfolio performance. The last thing shareholders want is for their active portfolio manager to exercise too much administrative caution trading securities when there are better ways to handle trading errors such as relational trust. Excess caution by a manager will lead to missed opportunities to generate trading profits. In the limit, the manager might avoid all trading errors by never trading. Shareholders may therefore want to subsidize the correction of trading errors as long as the manager will not otherwise exhaust his soft dollar performance bond on other brokerage and research services. It is entirely plausible error correction meets the net benefit test. Managers who use error correction trades efficiently will generate higher portfolio returns than those who do not, and investors will favor them by subscribing to their funds.

4. Mixed Use Items and Good Faith

The *Guidance* states that managers who want to avail themselves of the safe harbor must "make a good faith determination that the commissions paid are reasonable in relation to the value of the brokerage and research services received. . . [T]he burden of proof in demonstrating this determination rests on the money manager."[165] In reaching the conclusion that safe harbor protection requires the manager to prove his good faith determination, the *Guidance* cites a 1975 House Report stating that "[i]t is, of course, expected that money managers . . . would stand ready and be required to demonstrate that such expenditures were *bona fide*."[166] Nothing in the language of the statute remotely suggests that the manager has the burden of proving his own good faith. Section 28(e)(2) gives the SEC discretion only to require that the manager disclose his "policies and practices." It is virtually impossible to affirmatively prove one's subjective state of mind. This interpretation of *bona fide* is completely contrary to the purpose of the safe harbor, which is to raise a presumption the manager acted in the best interest of investors as long as various objective criteria are met, such as that the services he receives are reasonably viewed as brokerage and research. A far more natural

[165] *2006 Guidance*, at 41991.
[166] *2006 Guidance*, at 41991.

interpretation of the term "*bona fide*" in the House Report is that a reasonable man would conclude the services in question provide a plausible net benefit to the portfolio, that is, they are not an obvious sham intended to benefit the manager at shareholders' expense.[167]

The *Guidance* requires that the manager make a good faith reasonable allocation of the cost of mixed use items as well. Where the adviser uses analyses of account performance for both investment decision-making and for the purpose of marketing fund shares to investors, for example, he may use client commissions to pay only for the investment decision-making aspect and must pay for the marketing component out of his own account. The *Guidance* repeats this good faith allocation requirement throughout its laundry-list of mixed-use items. Yet, in economics there is no proper way to allocate costs between jointly produced outputs ─ in this case the analysis of account performance (the input) for investment decision-making (an output) as opposed to the marketing of fund shares (also an output).

A manager may be able to state in good faith that "but for" his use of the analysis of account performance for investment decision-making he would not have ordered it. If so, its after-the-fact or incidental use for marketing purposes is nonrivalrous and involves a zero marginal cost ─ it is, essentially, a free good with respect to the marketing of fund shares, costing investors nothing.[168] Making any such allocation in an economically meaningful way is as much art as science. This, again, is exactly why managers must be given a zone of discretion in making such decisions, quite possibly according to policies determined in advance and policed by the board of directors. The SEC neither has the practical business experience nor the resources to properly prescribe such decisions in a dynamic marketplace.

B. Legal Status of the Guidance

It may be, as the SEC observed in its *1986 Interpretive Release* and reiterated in the *2006 Guidance*, that support from advisers and brokers for the safe harbor arose out

[167] Female escorts and bags of illegal drugs are a recent case in point. See Kara Scannell, Susanne Craig, and Jennifer Levitz, '*Gifts' Case Nabs a Star*, WALL STREET JOURNAL, Thursday, March 6, 2008, at C1.
[168] This conclusion is consistent with the SEC's reasoning in its *1995 Disclosure Proposal*, at n. 46.

of an excess of caution given uncertainty regarding the contours of managers' fiduciary duty when freely negotiated commissions loomed in 1975.[169] Perhaps market participants were legitimately concerned that paying up for research would be considered by courts to constitute an exclusive benefit that would negate their business judgment rule presumption of good faith. Perhaps the safe harbor was designed as a redundant check on strike suits hoping to overcome business judgment rule presumptions. Far more likely as a cause for concern is the onerous specter of criminal sanctions under Section 17(e) of the ICA. Addressing conflicts of interest in agency transactions, it reads in relevant part:

> "It shall be unlawful for . . . any affiliated person . . . acting as an agent, to accept from any source any compensation (other than a regular salary or wages from such registered investment company) for the purchase or sale of any property to or for such registered investment company or any controlled company thereof, except in the course of such person's business as an underwriter or broker . . ."[170]

As one federal judge noted early on, "Section 17(e) is far from a model of clarity."[171] According to the analysis presented here, anything managers receive from brokers that provides plausible net benefits to the fund should not be treated as "compensation" under 17(e), but the issue has yet to be tested. The prospect of criminal liability together with the legal uncertainty this provision raises was very likely an important driver of market participants' desire for safe harbor protection.

Because Section 28(e) is merely a safe harbor, however, a manager that accepts benefits falling outside its protection does not necessarily violate agency or trust law The SEC recognizes that some such conduct risks criminal sanctions under Section 17(e),[172] but in its many interpretations of the scope of the safe harbor, including its *Guidance*, it has never given detailed attention to the scope of Section 28(e) *vis-à-vis* Section 17(e). Is it the SEC's position that all conduct falling outside the safe harbor automatically violates

[169] *1986 Interpretive Release* quoted in text, *supra* at ?
[170] 15 U.S.C. §§ 80a-17(e) (1964).
[171] U.S. v. Deutsch, 451 F.2d 98 (1971).
[172] See *2006 Guidance*, at 41981.

Section 17(e)? Or is there a range of conduct involving paying up for benefits that falls outside the safe harbor but short of violating Section 17(e)?

The extent to which Sections 28(e) and 17(e) dovetail is a critical issue, and one that may be ripe for legal challenge. Given that the SEC has changed its interpretation of Section 28(e)'s scope over the years, it would be hard pressed to suggest that the two provisions exactly dovetail. Though the SEC clearly has authority to state its interpretation of the safe harbor as a forecast of conduct it intends to challenge, it has no authority to expand or retract the reach of 17(e) in the process. This suggests there is a range of conduct that falls outside the *Guidance* but short of violating 17(e). To avoid judicial condemnation such conduct must plausibly provide net benefits to investors even though it fails under the SEC's interpretation. This view is in keeping with trust and agency law. Were the SEC to challenge such conduct, one can only speculate about how a federal court would resolve the issue. The reduced deference federal courts have recently shown to the SEC's rulemaking suggests the *Guidance's* questionable legal and economic analysis would fare poorly.[173]

VI. CONCLUDING REMARKS

Most generally, this paper makes the point that it is impossible to fairly judge conflicts of interest in an economic vacuum. Careful consideration must be given to the transaction costs market participants face in choosing between alternative forms of economic 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. The following statement by then SEC

[173] The SEC has recently suffered a troubling string of defeats in federal court on other matters that suggests the *Guidance* could plausibly be challenged. Chamber of Commerce v. SEC I, 412 F.3d 133 (2005) (SEC failed to adequately determine the cost of two exemptive conditions regarding mutual fund board composition); Chamber of Commerce v. SEC II, 443 F.3d 890 (2006) (SEC improperly relied on materials not in the rulemaking record by failing to afford an opportunity for public comment, to the prejudice of the Chamber); Goldstein v. SEC, 451 F.3d 873 (2006) (SEC's hedge fund registration rule found 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). See footnote ?, *supra*.

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."[174]

The SEC cannot eliminate all conflicts of interest. Simply to declare a conflict of interest, even a "glaring conflict," is insufficient justification for prohibiting the activity in question. Even assuming a given conflict of interest will result in agent self-dealing, which is normally unlikely, it makes little sense to protect investors from self-dealing that would cost them only fifty cents if it reduces expected investment performance by a dollar. Just as in antitrust law, where a consensus has emerged that alternative legal rules can be judged only by their likely effect on consumer welfare,[175] the inevitable trade-offs between alternative SEC rules can be judged only by their effect on investor welfare. And there is no doubt risk-adjusted "performance" net of any residual losses from agent self-dealing is ultimately what investors believe determines their welfare.

The SEC must learn to address these trade-offs in light of established economic theory and eschew the kind of imperious rhetoric ─ what might be termed "condemnation by characterization" ─ 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 effect of alternative legal rules on the cost of transacting, something antitrust courts have been doing for decades.

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

[174] Coral Gables, Fla: February 28, 2007, at http://www.sec.gov/news/speech/2007/spch022807rcc.htm.
[175] Robert H. Bork, The Antitrust Paradox: A Policy at War with Itself (1978). See, e.g., Leegin Creative Leather Products v. Kay's Shoes, 127 S. Ct. 2705 (2007).

neither the courts nor the enforcement agencies are sensitive to [transaction cost] considerations, the system fails to meet a basic test of economic rationality. And without this the whole enforcement system lacks defensible standards and becomes suspect."[176]

It has long been recognized in antitrust that legal rules are subject to error.[177] Rules that try too hard to protect investors will also screen out activity that benefits them. Where a particular market activity is subject to competitive pressures and yet is pervasive, it necessarily provides investors with some measure of benefits. The proper regulatory objective is not to minimize the possibility of injury to investors from conflicts of interest, but to optimize over both the potential harm and the potential benefit. A middle course between completely ignoring conflicts and completely prohibiting them is to use transaction costs analysis to provide a more articulate understanding of when specific conflicts benefit or harm investors on net balance. This is the equivalent of the Rule of Reason from antitrust law, under which novel business arrangements are treated by their actual or likely effect on consumer welfare following a fact-based inquiry guided by established economic theory. That the Section 28(e) safe harbor establishes a reasonableness standard for the manager's receipt of services suggests such treatment is appropriate in assessing its scope.

The economic theory relied on here ─ primarily transaction cost economics ─ is standard fare in antitrust law, well understood and rigorously applied by antitrust regulators and federal courts. Because the *Guidance* is an interpretation, rather than a rule, the SEC was not required to do any kind of cost-benefit analysis or to assess the likely effect on competition, efficiency, and capital formation. A striking example of the SEC's failure to take economic theory seriously in its cost-benefit analysis comes from its abandoned *1995 Disclosure Proposal*, which sought to require fund managers to provide detailed disclosure in annual reports regarding their brokerage allocation decisions. In the SEC's facile words, enhanced disclosure "would impose some

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

[177] *See* Frank H. Easterbrook, *The Limits of Antitrust* , 63 TEXAS L. REV. 1, 3, 10, 15 (1984). See, also, Charles J. Goetz and Fred S. McChesney, ANTITRUST LAW: INTERPRETATION AND IMPLEMENTATION (Foundation Press, 3rd ed., 2006), at 66-68 (Type I errors involve screening out actions that benefit investors, while Type II errors involve failing to screen out actions that harm investors).

additional costs on advisers required to prepare the report and deliver it to clients. . . . [but] because the report would need to be prepared and delivered only annually, the costs of preparing and delivering [it] should be minimized. In short, the Commission believes that the costs of the proposals [sic] would be outweighed by the benefits to advisory clients in receiving more useful information about their advisers' direction of client brokerage."[178]

All but a few prominent members of the industry protest that this disclosure would have required them to reveal sensitive proprietary information. Economic costs include far more than the out-of-pocket expenses an adviser incurs in preparing and delivery an annual report to shareholders. These expenses are trivial in comparison to two important opportunity costs. First, as virtually everyone including the SEC recognizes, more detail in the annual report is likely to overload investors and end up being *less* informative.[179] More important, being forced to reveal proprietary information regarding brokerage allocation could easily force managers to share hard-found innovative trading strategies with competitors, much to the detriment of investors. Indeed, serious consideration must be given to the possibility that in many settings investors do not want managers to disclose material proprietary information, even if it means they must forgo the information themselves. The resulting reduction in the resources managers and advisers would devote to organizational innovation could have a devastating negative effect on their fund's performance and, over time, on the market itself. The value of this forgone opportunity is a substantial cost that must weigh heavily in any cost-benefit analysis. That the SEC failed even to mention this cost in its *1995 Disclosure Proposal* is alarming.

Admittedly, sound cost-benefit analysis is very difficult to do. Many economists hesitate to undertake the hazy work of quantifying costs and benefits. Their tendency is to emphasize marginal analysis — so-called "comparative statics" — in which they compare two alternative states of the world (either hypothetical, across time, or across

[178] *1995 Rule Proposal*, at 18-19.
[179] *See, e.g.*, TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 448-49 (1976).

settings at a given moment in time), in which all relevant conditions are roughly identical except the activity or event in question.

Where the parties regularly interact in a functioning market, transaction cost economics suggests a workable alternative to standard cost-benefit analysis. As a positive body of theory, transaction cost economics makes the following abstract prediction: in the face of so-called "market failures" that reduce the parties' joint wealth (*i.e.*, "social efficiency"), they will adopt the form of organization that minimizes the associated wealth losses.[180] The literature on transaction cost economics is filled with analyses showing how parties overcome market failure through organizational innovation. This process is constrained only by the cost of transacting, and it applies, by definition, to all affected parties.[181] A formulation of cost-benefit analysis consistent with this theory begins by identifying the relevant market failure ─ whether a free rider problem, a collective action problem, an agency problem, a moral hazard or adverse selection problem, etc. ─ and the nature of the transaction costs that inhibit the parties from overcoming it. The next question is whether and how the proposed regulation reduces the relevant cost of transacting, thereby assisting the parties in overcoming the market failure as part of their natural maximizing behavior. Compared to standard cost-benefit analysis, this methodology reduces the information burden on regulators. It requires information only about marginal differences in one particular category of costs ─ transaction costs ─ between alternative legal rules. What is more, because it harnesses market participants' admittedly self-serving cooperative behavior it does not require detailed information about benefits or a host of other costs. Balancing and influencing these benefits and costs is left to market participants to resolve.

The inexorable tendency in U.S. financial markets is toward *pareto*-improving organization in which all parties are made better off compared to the alternative form of organization. Turning this proposition on its head, the observation of persistent conflicts of interest in institutional securities brokerage probably demonstrates the remarkable

[180] "Wealth" is defined as the discounted present value of future net benefits. See D. Bruce Johnsen, *Wealth is Value*, 15 J. LEG. STUD. 263 (1986)
[181] If some parties' preferences are not taken into account, it is because transaction costs inhibit them from being communicated.

effectiveness of economic organization at averting disloyalty by highly specialized agents while maintaining high-powered incentives, rather than widespread market failure or rampant agent self-dealing.[182] This is not to suggest agents never engage in self-dealing or that there is no way regulators, courts, or lawmakers can improve the legal environment. Rather, 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. It also suggests agents must be allowed to share in the gains from *pareto*-improving organizational innovation that reduces the cost of transacting.[183]

Candid recognition by the SEC that transacting in the market entails frictions and that suspect business practices can be evaluated only relative to the next best alternative form of organization would go a long way toward improving its regulatory oversight of institutional brokerage. If the Federal Trade Commission, the Antitrust Division of the Department of Justice, and federal courts can do this, surely the SEC can be expected to do so as well.

[182] The large number of investors who place their money in mutual funds no doubt feel substantially more comfortable with the many conflicts of interest fund managers face than with the conflicts inherent in retail brokerage accounts or the systematic discounts from net asset value characteristic of closed-end funds.

[183] Any number of state law cases have recognized the right of corporate fiduciaries to benefit disproportionately from implementing *pareto* improving organizational innovation. See Wilkes v. Springdale Nursing Homes, Inc., 353 N.E.2d 657 (Massachusetts, 1976); Toner v. Baltimore Envelope Co., 498 A.2d 642, 652 (Maryland, 1985); and Nixon v. Blackwell, 626 A.2d 1366, 1376 (Delaware 1993).

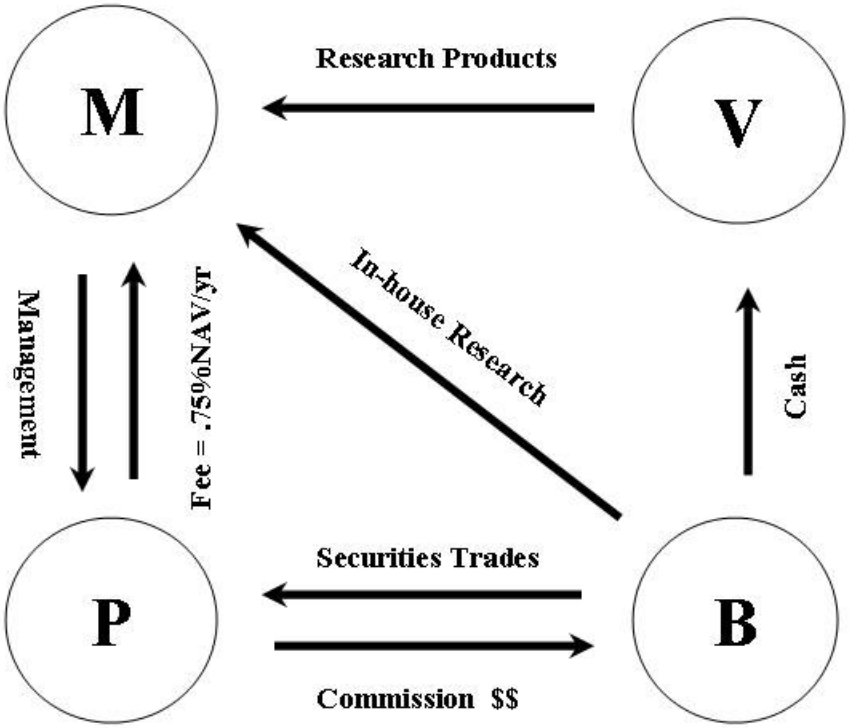

Figure 1
Relations Between the Parties

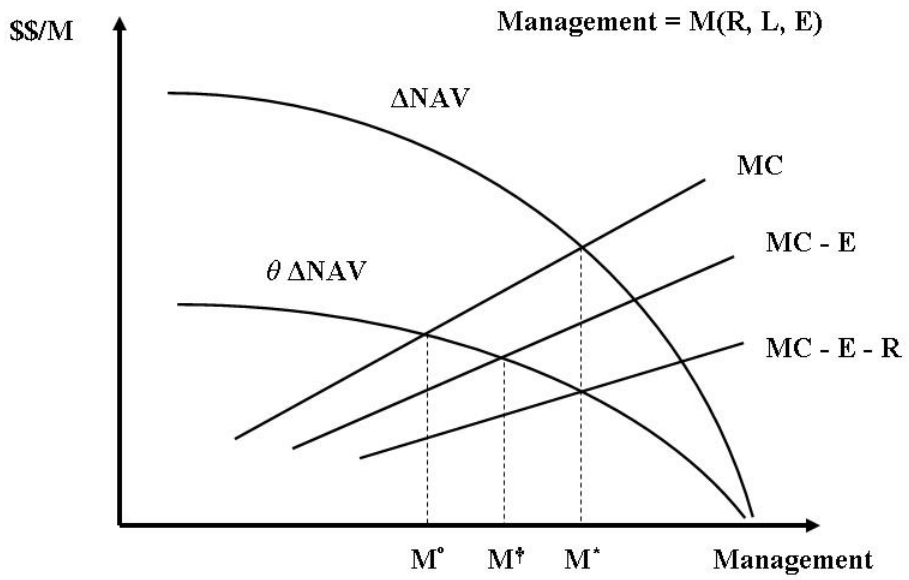

Figure 2

The Agency Problem in Delegated Portfolio Management

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