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INTEGRATIVE SOCIAL CONTRACT THEORY AND INSTITUTIONAL BROKERAGE COMMISSION REBATES

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Abstract

This paper provides an Integrative Social Contract Theory analysis of the ethics of institutional brokerage commission rebates — soft dollars and directed brokerage — focused on transaction cost economics. Brokerage commission rebates are a form of vertical arrangement subject to the same economic analysis scholars and courts have used in the Antitrust setting to find that consumers often benefit from vertical arrangements. My analysis shows that institutional brokerage rebates, often condemned as kickbacks, payola, or commercial bribery, likely benefit mutual fund investors once the problem of brokerage quality assurance is recognized. According to Integrative Social Contract Theory they appear to be ethical forms of economic organization.

Introduction

Soft dollars and directed brokerage are two forms of institutional brokerage commission rebate that have persisted for years in the mutual fund industry both in the U.S. and across the globe, with total yearly volume in the billions of dollars. In the U.S., these practices have periodically come under attack from academics, financial market commentators, securities regulators, and politicians as examples of disloyalty and unjust enrichment by fund managers whose duty it is to serve investors. Yet a strong case can and has been made that they are efficient forms of economic organization that benefit investors. This chapter examines as well whether they are ethical according to *Integrative Social Contract Theory (ISCT)* as informed by transaction costs economics.

ISCT is primarily the creation of Dunfee and Donaldson (1999)(TD2), who developed it as a practical framework to help businessmen untrained in higher philosophy grapple with the ethical issues they are likely to face. *ISCT* is intellectually congruent with western philosophical discourse as reflected in its reliance on global ‘hypernorms’ and at the same time practical and approachable in its reliance on local ‘authentic community norms’ that allow for substantial ‘moral free space’.

The layered structure of *ISCT* is akin to the notion of competitive federalism in political and economic theory. It allows for local variation — “laboratories for experimentation” — minimally constrained from above to the extent necessary to mitigate inter-community spillovers. *ISCT* emphasizes the moral force of the informed individual’s options to exit from and exercise voice in local communities. These options ensure local norms are subject to evolutionary competitive forces. At the same time, *ISCT* is sufficiently empirical that it can evolve over time to gradually iterate toward a more useful structure applied to specific business settings. This chapter augments the TD2 conception of *ISCT* using transaction costs economics. Transaction cost economics suggests that law, ethics, and other evolved institutions serve, at least in part, to constrain socially inefficient behavior (Coase, 1937, 1960).

This chapter begins in the second section by briefly describing the U.S. mutual fund industry and soft dollars and directed brokerage, two forms of brokerage commission rebate that have been popular in the mutual fund industry but that have also been the target of repeated, and heated, criticism. Section three explains why these practices might be efficient and likely to benefit fund investors once the cost of transacting is considered. Section four briefly describes the basics of *ISCT* and integrates the insights from transaction costs economics to assess their ethical status. I conclude they are arguably ethical, though admittedly puzzling when viewed

from outside the local community of institutional brokers and money managers. Section five provides brief closing remarks.

The Mutual Fund Industry and Institutional Brokerage

The mutual fund industry relies heavily on agents to act on behalf of dispersed shareholders. In such a setting, conflicts of interest are inevitable but by no means crippling. To show how soft dollars and directed brokerage resolve conflicts of interest it is important to have a clear picture of how funds are organized and how soft dollars and directed brokerage actually work

The Organization and Regulation of Mutual Funds

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 securities (primarily corporate stocks and bonds, government debt, etc.) and cash to which shareholders have a pro rata claim. A unique feature of 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. For this reason they are also known as *open-end funds*.¹ Much of Americans' savings are held by mutual funds and managed by advisory firms regulated under the Investment Company Act (ICA, 1940) and the Investment Advisers Act (IAA, 1940) (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 contract periodically approved by the fund's board of directors or a majority of fund shareholders. 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 an extended firm and market exchange.²

Advisory services include record keeping, custody of shares, and other ministerial functions, but in an actively managed fund they consist most importantly of portfolio management, normally provided by an employee of the advisory firm.³ 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 to choose the broker that will provide 'best execution' for the fund.

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. In consideration, the broker typically receives a commission averaging five or six cents per share. Although the manager 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.⁴

Because brokerage commissions are treated as a capital expense and included in the price basis of portfolio securities for tax reasons, fund shareholders implicitly pay them in the form of lower net returns.⁵ Outsiders to the world of institutional securities brokerage are often shocked to learn 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 and directed brokerage are the primary means by which brokers have provided such benefits.

How Soft Dollars Work

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 manager, M, a fee consisting of a periodic share of the portfolio's net asset value, say 75 basis points per year.⁶ In exchange the manager provides active management by expending effort to identify profitable trading opportunities. Having identified a profitable trade, the manager hires an institutional broker, B, to execute it in exchange for commission payments on completion.

[Figure 1 about here]

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 manager 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. 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. 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, so-called 'client commissions'. Managers' use of client commissions to pay for research with soft dollars has been heavily criticized as an unethical conflict of interest that may lead the manager to favor itself over fund investors. The prospect of unjust enrichment is said to pervert 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.⁷ 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. Soft dollar brokerage constitutes only one form of bundling. Historically, 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 — in soft dollars — and provided in arm's-length transactions by independent research vendors. In either case, as part of the Securities Acts Amendments of 1975 Congress provided a safe harbor to fund managers who pay a premium commission for brokerage as long as they determine “in good faith that it was reasonable in relation to the value of the brokerage and research services provided.”⁸

How Directed Brokerage Works

Like soft dollars, directed brokerage occurs in the context of premium commission payments by the mutual fund in exchange for institutional brokerage, but rather than providing the manager with research the broker (or its underwriting affiliate) provides effort selling the fund's shares to the investing public. Figure 2 illustrates two ways fund shares can be marketed. Historically — but to a lesser extent today — the brokerage firm's retail brokers, RB, provided effort selling the fund's shares to the investing public, S, for an up-front load paid directly by the investor. The

investor would write a check for, say, \$100 to the RB, who would forward \$95 to the fund for the investor's account and retain the \$5 load fee as compensation for its selling effort.

[Figure 2 about here]

In a directed brokerage arrangement, the RB provided effort selling the fund's shares to the investing public in exchange for the adviser's commitment to send the brokerage firm future premium commission business on portfolio trades to be executed by the firm's institutional brokers.⁹ Until its prohibition by the SEC in 2004, directed brokerage was one of several 'no-load' methods an adviser could use to compensate brokers for their sales effort, often in the context of proprietary 'fund supermarkets' that feature funds from a variety of fund families managed by reputable advisory firms. In this context, directed brokerage can be seen as one form of 'payment for shelf space' similar to what occurs regularly in the retail grocery industry (Klein & Wright, 2007; Wright, 2007).

Examples of directed brokerage arrangements prior to the SEC's ban involved various 'partners programs' between a fund adviser and one or more retail brokers. In exchange for the expectation of having the adviser send trading commission business for its managed funds to the retail broker's institutional affiliate, the retail broker would agree to display the adviser's funds more prominently within its universe of fund listings when making recommendations to its client investors. Fund managers received greater access to the retail broker's sales system, including its branch system, access to individual point-of-sale brokers via training and customer seminars, inclusion in broker events, and invitations to participate in programs broadcast over the retail brokers' internal systems. In some cases the point-of-sale broker and his sales manager received

a larger fee for the sale of partner funds than non-partner funds, with this fee being paid out over time depending on how long the investor remained with the fund.

According to the SEC's release *In re Massachusetts Financial Services Company*,¹⁰ MFS, a prominent fund adviser, negotiated for preferential access to its partners' sales staffs and 'heightened visibility' for its fund offerings within their distribution systems. In exchange, MFS paid the retail broker between fifteen and twenty-five basis points for the sale of its fund shares and three to twenty basis points per year in trailing fees for fund shares held by its partners' clients more than one year. In some cases MFS paid partners in cash from its own account, but in others it paid with directed brokerage, and there was apparently some evidence to suggest it preferred this method. In any event, MFS made clear to the employees on its trading desk that they could consider partners' sales of fund shares only as "a factor" in allocating portfolio brokerage and that best execution was not to be compromised. MFS cautioned its personnel not to enter into legally binding agreements with partners to promise a specific amount of commission business nor to refer to their arrangements with partners as binding. Nevertheless, some MFS employees casually labeled commission allocations to partners as 'obligations,' 'commitments,' or amounts 'owed'. What is more, from time to time MFS requested that its trading desk increase trading with specific partners to satisfy the commission targets.

MFS informed its fund boards that, subject to best execution, it considered the sale of fund shares as a factor in allocating its funds' portfolio brokerage. It also showed them the exact amount of commission business allocated to every broker-dealer for which consideration of fund sales was a factor. In substance, the SEC found that MFS had entered into bilateral arrangements in which it agreed to allocate specific amounts of fund brokerage commissions, subject to best execution, to broker-dealers for 'shelf space' or heightened visibility within their distribution

systems. The MFS disclosures to the fund boards were therefore inadequate because they failed to specifically state that the amounts were “used to satisfy bilateral arrangements under the [partners programs].” What is more, the SEC found that MFS avoided using its own assets in consideration for its partners programs by financing the sale of fund shares with directed brokerage. It therefore failed to communicate adequately its reliance on directed brokerage to its funds’ boards. Although the SEC release makes no mention of an actual injury to any MFS client, it found MFS had violated various securities laws, assessed it \$50 million in disgorgement and penalties, censured it, and imposed various remedial and compliance undertakings.

A Transaction Cost Analysis of Institutional Brokerage

Any serious transaction cost analysis of business practice must take seriously the proposition that the parties to a transaction, in this case fund advisers, institutional brokers, and fund investors, share a common interest in increasing the gains from trade. They will adopt new forms of organization that help them do this. Transaction costs stand in their way. Transaction costs are real costs, and so it does not pay the parties to resolve all conflicts of interest or seek the first-best allocation of resources. Nevertheless, cooperation subject to the constraint imposed by transaction costs is a powerful beacon to understand economic organization.

The Role of Prices in Transaction Cost Analysis

Prices as an economic phenomena are not just about who gets the income from a commercial activity, they are also about providing informative signals to otherwise ignorant market participants — the ‘man on the spot’ (Hayek, 1945) — about how best to allocate scarce resources. By relying on prices to allocate resources, both parties to a transaction are encouraged

to adjust the good's attributes to maximize the gains from trade. If, compared to payment on delivery, widget buyers are willing to pay an extra 20 gizmos per widget for credit terms that cost the seller only 15 gizmos, sellers will happily bundle credit terms into the transaction for an increase in price of somewhere between 15 and 20 gizmos. Similarly, if widget buyers are willing to pay an extra 20 gizmos per widget to assure their quality rather than spending the equivalent of 30 gizmos on careful inspection, sellers will happily provide a warranty or some other form of quality assurance as long as the cost of doing so is less than 20 gizmos.

But transfer for a price accomplishes more than efficient bundling. One party's claim that his widget is worth 30 gizmos is more credible when that party is willing to accept 30 gizmos for the widget, and vice-versa for the other party; that is, when the parties "put their money where their mouth is," so-called 'smart money.' The transfer has two components: a simple trade of one good for another and reliable information about the value of the respective goods, all bundled attributes considered. However distributed,¹¹ the parties' gains from trade are a private benefit, but the information itself is a nonrivalrous public good that reliably signals what they consider efficient resource allocation. Only if (and to the extent that) there are substantial spillovers from the transaction — costs or benefits that fall on outsiders — is the informational role of prices undermined (though not entirely eliminated).

The common criticism of this and, indeed, all methods of price allocation is that it gives the rich an advantage over the poor. True, being rich, or well-capitalized, provides one with more opportunities than being poor. In a market system, those of relatively modest means often succeed in outbidding their richer rivals when they are able to generate greater value-added as a result. Value-added, not riches, is what gives market participants pricing power because capital tends to flow to more profitable uses.

One point worth noting about the important role prices play in an economic system is that as informative as prices may be they are also costly to use (Coase, 1937). Where we see prices emerging for goods, or attributes of goods, that have otherwise been unpriced or bundled with other goods for a single price, it suggests that the informational benefit a new price generates exceeds the transaction cost to the parties involved.

At a very basic level, soft dollars and directed brokerage payments are nothing more or less than garden-variety prices targeted to the agents of fund investors. These practices unquestionably involve real conflicts of interest, but at the same time they appear superior to the available alternatives once subjected to the scrutiny of transaction cost economics (Johnsen, 1994; Horan and Johnsen, 2008; Johnsen, 2009). Where transacting is costly, perfection is an irrelevant benchmark.

Agency Costs

Agency law tolerates conflicts of interest as long as they are disclosed or, if not disclosed, as long as the agent can demonstrate after the fact that any self dealing was fair. This is sensible and, I should point out, the empirically evolved common law approach. The phrase ‘conflict of interest’ identifies the set of activities in which agent self-dealing *might* occur. Agency law is, and in this chapter I argue *ISCT* can be, far more parsimonious than to condemn soft dollars and directed brokerage as unethical *per se*.

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.¹² 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 what economists characterize as ‘search’ goods. Once transaction costs are introduced, 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, ethical norms, or various other forms of economic organization that rely on specialized agents who are 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.

This does not mean unjust enrichment occurs on any significant scale because the parties can profit by avoiding it. In 1976, Jensen & Meckling published the seminal work on principal-agent conflicts.¹³ 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 such as shirking by the agent. In some settings 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. In addition, it is inevitable that some beneficial trade does not occur that would have occurred absent agency costs. These forgone benefits are the ‘residual losses.’ As long as residual losses persist, the parties have an interest in innovating new forms of organization to increase the gains from trade. The cost of transacting inhibits this process.

Understanding economic organization, including ethical norms, is largely about how the parties adjust the rules to increase the gains from trade.

Institutional Brokerage as an Experience Good

It would be difficult to find an industry that departs more fundamentally from the neoclassical model than institutional securities brokerage. 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 quality will become apparent only in time or with repeated use. For certain experience goods, the receipt of unexpectedly low quality can impose substantial transaction costs on the buyer in the specific form of search costs. The quality of an institutional broker’s execution is costly for a portfolio manager to evaluate owing to the inherent noisiness of securities prices. Excessive price impact on large block trades can easily overwhelm brokerage commissions and create a substantial drag on investor returns.¹⁴ Price impact is an artifact of the high transaction costs managers face achieving best execution.

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.

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. If the cost of legally verifying the quality of broker executions were 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 example¹⁵ — 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.

Execution Quality Assurance

A well-known transaction cost model of how sellers assure the quality of experience goods (Klein & Leffler, 1981) shows why, under plausible assumptions, investors would suffer if fund managers paid the lowest available brokerage commission, and why they are better served if managers instead pay up for brokerage in exchange for soft dollar research and other beneficial inputs.

Given the problem of price impact, institutional brokerage is an experience good. What is more, the cost to the broker of avoiding price impact increases the greater care he takes in executing trades. Suppose the manager offers to pay a broker, say, four cents per share for high-quality execution, which is exactly equal to the broker's execution cost. The broker can cheat by secretly providing low-quality execution that costs, say, two cents per share. In noisy securities markets it takes time even for a diligent manager to discover the excessive price impact from low-quality execution and to terminate the broker. In the meantime, the broker earns a short-term profit of two cents per share. Absent brokers' ability to bond themselves against this moral hazard, managers will refuse to pay for high-quality execution, low-quality execution will

dominate the market, and investors will suffer excessive price impact that reduces their returns (Akerlof, 1970).

Suppose, instead, that the manager offers to pay a broker a premium commission of seven cents per share for high-quality execution. Brokers will welcome this opportunity because it allows them to earn a surplus, or ‘economic rent’, on each trade of three cents per share, presumably over an indefinite time horizon assuming he refrains from cheating. If he were to cheat he could earn a surplus of five cents per share, but only until the manager discovered his trades create excessive price impact. The Klein/Leffler model shows that there is some commission premium on high-quality trades sufficiently high that the long-term gain to the broker from providing high-quality execution exceeds the short-term gain from cheating. If offered a sufficient commission premium, a wealth maximizing broker will never cheat.

The harder it is and the longer it takes for the manager to detect excessive price impact — as where the noisiness of securities prices increases — and the higher the broker’s discount rate, the higher the commission premium must be to assure high-quality execution. What is more, the manager must presume any broker offering to trade for a low commission is likely to perform poorly and generate excessive price impact. Shopping between brokers for lower commissions is futile where execution quality is unobservable *ex ante*.¹⁶

In general, quality assurance requires the buyer to pay a premium price for honoring his commitment. This should come as no surprise. The average consumer routinely buys hundreds of experience goods for which he happily pays a premium price to assure quality — gasoline, golf balls, fine perfume, and even garden-variety aspirin are just a few such goods. Aspirin buyers often pay a premium price for branded tablets, for example, although the generic equivalent is far cheaper and said to be chemically identical. 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.¹⁷ For the producers of high-quality goods, cutting price is simply not an option because it signals to consumers a likely reduction in quality.

If people acting on their own behalf often pay a premium price — they ‘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 or two 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. Unjust enrichment is a normative claim that has little or no foundation in positive economic theory.

Soft Dollars and Directed Brokerage as Performance Bonds

The Klein/Leffler model has one additional feature. Brokers competing for institutional trades stand to earn a surplus equal to the difference between the premium commission they receive on each trade and their cost of executing high quality trades. In the above example this was three cents per share. Standard economic theory tells us that abnormal profits cannot persist in a competitive environment. For normal search goods, competition takes the form of price reductions, but for experience goods a price reduction signals low quality. Consequently, brokers cannot cut their commissions. Instead, they compete by offering to post an up-front performance bond equal to the discounted present value of the quality-assuring premium over the expected time horizon and trading volume.

The use of a quality-assuring performance bond is subject to three competitive conditions. First, the bond must be large enough relative to expected commissions that the broker earns no surplus and merely covers his forgone opportunities. The performance bond capitalizes the broker's expected commission premiums, ensuring he earns only a competitive profit. Second, the bond must be non-salvageable in the sense that the broker cannot recover it once he has paid or incurred it. Finally, the bond must take the form that provides the greatest possible benefit to the portfolio. With soft dollars the first condition is met because brokers compete vigorously for managers' business by offering larger soft dollar research payments. The second condition is met because the manager can insist that the broker provide soft dollars up-front¹⁸ — whether in the form of third-party or in-house research — and any 'commitment' the manager 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. Following this logic, if managers were required to pay the entire expense out of their own account, mutual fund investors' concern would not be that they will over-use brokerage and research services but that they will under-use them.

Contrary to prevailing wisdom, the critical conflict of interest for fund managers is that they will tend to spend too little of their own money on raw research, devote too little labor effort to identifying mispriced securities, and do too few profitable trades. If spending a dollar out of his or her 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.

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. Because raw research is a complement to the manager’s labor effort in identifying profitable trading opportunities, by subsidizing research the fund increases the manager’s effort. With increased effort the manager is likely to identify more profitable trading opportunities and to have good reason to order more trades.

Empirical work suggests soft dollars constitute a self-enforcing bond to assure high-quality brokerage execution and efficiently subsidize manager research (Horan and Johnsen, 2008). But what about directed brokerage? Prior to the SEC’s complete prohibition on directed brokerage it appears to have met the necessary competitive conditions. First, there is little doubt brokerage firms competed intensely for fund advisers’ trading business by offering to sell shares issued by their funds to the investing public. As with soft dollars, the size of the ‘sales effort’ bond should have approximated the discounted present value of the expected stream of premium

brokerage commissions. Second, retail brokers' sale of fund shares to the investing public came in advance, with the manager following up by directing portfolio trades to the firm's institutional brokers based on their *past* success selling fund shares. Owing to the manager's fiduciary duty of best execution, he or she was free to terminate the broker with the balance of the directed brokerage trading account unpaid. A broker's costly effort selling fund shares was therefore non-salvageable in the sense that the adviser could terminate the broker with the balance of the trading 'obligations' unfulfilled if the adviser discovered low-quality execution.

The final question is whether a dollar's worth of extra trading commissions used to compensate brokers for their sales effort might have been worth more than a dollar paid to the portfolio in cash. In the absence of concerted sales effort most equity mutual funds would experience net redemptions approaching 18 percent per year.¹⁹ Perhaps more important, uncertainty over near-term redemptions requires a fund to hold higher cash balances than otherwise. Relative to risky securities, cash yields a low expected return. By spending fund resources to sell fund shares to the investing public a manager can control its net redemptions to reduce cash balances and increase investor returns. Because managers' fees provide them with only a fraction of the investment returns they generate, they would otherwise have too little incentive to spend their own resources selling fund shares. By subsidizing fund share sales, investors reduce the associated conflict of interest.

A widespread but misguided criticism of allowing managers to use fund assets to promote the sale of fund shares is that it gives the adviser a perverse incentive to increase fund assets through share sales, to which its compensation is tied, rather than to increase fund assets through investment performance. These outcomes are not mutually exclusive. By allowing the manager to reduce cash balances, fund sales effort can be an efficient form of performance bond

that benefits investors more than dollar-for-dollar. More important, when the manager sells new shares his or her added fees consist of a percentage fee based on the larger asset holdings in the current period *and* additional fees for each subsequent period in which the larger asset holdings persist. The manager's compensation is 'back-end loaded' and contingent on continuing investor satisfaction. Making an unsuitable share sale to a new investor does little to increase the manager's long-run compensation (i.e., wealth) because the investor is likely to become dissatisfied with an unsuitable fund and withdraw sooner rather than later.

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

Finally, the partner programs targeted by the SEC provided point-of-sale brokers with back-end loaded compensation. Brokers who sold fund shares retained by investors for more than one year received trailing fees of three or more basis points per year as long as the investor held the shares.²⁰ In many cases these fees were paid by way of ongoing directed brokerage arrangements. The point-of-sale brokers' compensation therefore increased the longer fund investors held their shares. Holding a broker's sales effort constant, the more suitable the sale to a particular client-investor the longer the client would have held on to the shares and the higher the discounted present value of the broker's total compensation. The broker's willingness to

accept trailing fees bonds the credibility of his promise to provide an appropriate suitability determination.

As long as a dollar's worth of sales effort provided the fund with benefits exceeding a dollar in cash, directed brokerage cost fund investors nothing compared to the alternative and in fact provided it with net benefits. Recall that the size of the performance bond is set by competition, and that the brokerage commission therefore cannot be reduced without suffering a loss of execution quality. As a loyal economic agent, the manager's charge is to spend the competitively-determined performance bond on any of a long list of items according to the benefits they provide to the fund. Some forms of soft dollar research surely occupy the top of the list, as recognized and protected by the Section 28(e) safe harbor, but there is no reason to think, *a priori*, that retail broker sales effort should be precluded from advisers' consideration under the umbrella of 'brokerage services' in the soft dollar safe harbor. Presumably, the fund manager's specialized expertise in balancing the associated trade-offs is one of the benefits investors hope to capture from investing in the fund in the first place.

ISCT and the Ethics of Institutional Brokerage Rebates

In the following section I make a first pass at combining ISCT and transaction cost economics. I make no claim that this is the last word on the subject. My hope is that my humble efforts here will encourage subsequent scholars to take of the task where I have left it.

The Basics of *ISCT*

In *Ties that Bind*, TD2 carefully lay out the structure of *ISCT* and its rationale. They start with the plausible proposition that business people are limited by 'bounded moral rationality,' which

leads them to the following two conclusions. First, those called on to make ethical decisions “are constrained in their ability to discover and process morally relevant facts.” Second, even ethical theorists “are constrained in their ability to devise a calculus of morality that coheres well with settled moral opinions” (1999, p. 29). People therefore face significant ethical uncertainty, a problem compounded in business settings by the huge variety of commercial systems in which people transact.

Owing to this variety, a one-size-fits-all approach would be decidedly inefficient, and no one can doubt that efficiency is at least *one* important concern for business ethics. Just as the substance of commercial (and other) law varies from one community to the next, so too must business ethics be allowed to vary so as to efficiently fill out the behavioral interstices that lie beyond law’s effective force. *ISCT* embraces moral free space sufficient to allow substantial variation in ethical norms across local communities.

Local communities are free within an *ISCT* framework to specify appropriate ethical norms for commercial conduct as the product of a microsocial contract based on constructive consent. To be authentic, they must meet the limited terms of the macrosocial contract derived from social contract theory and fundamental shared principles outside the community — much along the lines of Constitutional values in a federal system — that limit the scope of local community consent. These terms are informed consent, the option for community members to exit and exercise voice, and consistency with what TD2 characterize as global hypernorms. Some hypernorms are procedural, such as the rights to exit and exercise voice; some are structural, such as those supporting essential political and legal institutions; and some are substantive, such as fundamental conceptions of ‘the right and the good’ (TD2, 1999, p. 52).

Within the community, authentic norms carry a presumption of moral force as long as they are consistent with these macrosocial contract terms.

Local community norms will inevitably come into conflict. This might occur because of globalizing trade that raises issues regarding conflicts of norms. It might also occur *within* an identified community that consists of various vertically-related sub-communities, as with corporate ‘stakeholders.’ When different community norms conflict and both are consistent with the above conditions, the conflict is resolved by applying the following priority rules:

- i) Transactions solely within a single community, which do not have significant adverse effects on other humans or communities, should be governed by the host community’s norms;
- ii) Community norms for resolving priority should be applied, so long as they do not have significant adverse effects on other humans or communities;
- iii) The more extensive the community that is the source of the norm, the greater the priority which should be given to the norm;
- iv) Norms essential to the maintenance of the economic environment in which the transaction occurs should have priority over norms potentially damaging to that environment;
- v) Where multiple conflicting norms are involved, patterns of consistency among the alternative norms provide a basis for prioritization;
- vi) Well-defined norms should ordinarily have priority over more general, less precise norms.

It is worth noting that TD2 refrain from over-engineering *ISCT*. They decline to specify the source of hypernorms. They also eschew a detailed listing of hypernorms, apparently leaving that task to ethical theorists applying *ISCT* as necessary to specific ethical dilemmas.

Transaction Costs and ISCT

Transaction cost economics provides a plausible and potentially empirically testable explanation for soft dollars and directed brokerage according to which they provide clear benefits to investors relative to the alternative forms of organization. With this insight, applying ISCT to these practices to determine whether they are ethical is fairly straightforward. First steps include identifying the macrosocial and microsocial communities within which these practices can be evaluated. There are many candidates for the relevant macrosocial community. A macrosocial community of ‘all human beings’ would ensure that all possible intercommunity spillovers are taken into account, but defining the macrosocial community this broadly would surely be overinclusive and analytically intractable. Turning the lens of the microscope a few clicks is appropriate.

I propose that the relevant macrosocial community consists of the entrepreneurs and investors who seek to sell and buy the corporate securities held, in part, by mutual funds. Assuming away substantial relevant spillovers on other dimensions, corporate entrepreneurs and investors share a common interest in maximizing the gains from trade through the supply of capital to finance commercial opportunities. There are many alternative ways to do this. Investors can buy and hold corporate securities directly through individual retail brokerage-house accounts or in-person investment advisers or trustees, or they can hold indirectly through

pension plans, banks, and insurance companies. They also have the option to hold securities issued and traded in markets outside the U.S.

Within the macrosocial community, investors search between the alternatives for the securities likely to provide them with the highest risk-adjusted returns net of the transaction costs of search, monitoring, risk assessment, etc. On its face, it would appear they have ample opportunities to exit from mutual fund ownership. As it turns out, however, virtually all of these specialized financial intermediaries, both in the U.S. and elsewhere, engage in some form of institutional brokerage rebate. To err in favor of finding soft dollars and directed brokerage unethical, the only relevant 'rebate-free' alternative is individual retail accounts. The local microsocial community consists of the universe of available mutual fund managers, institutional brokers, and, to some extent, retail brokers selling mutual fund shares. By hypothesis, a corporate investor seeking to exit this community would view the community of retail brokers selling corporate securities directly and managing investor accounts as the relevant alternative, although the practices followed by the various intermediaries listed above also provide a relevant benchmark to perform the ISCT analysis. Note that exit from mutual fund share ownership to direct corporate share ownership is as simple for an investor to do as calling his retail broker and paying a small transaction fee to make the switch.

Both local communities offer investors some prospect of voice. Although few mutual fund shareholders actually cast their votes, it is far from clear that those shareholders directly holding corporate shares are any more engaged in governance. But even if they were, the effectiveness of voice in mutual fund share ownership must account for the fund's ability to vote the corporate securities it holds in its portfolio. Assuming the fund manager and its board of

directors are loyal agents for the common good of fund investors when voting corporate shares, fund investors have added, though indirect, voice in the governance of their investments.

The one sticking point is whether fund shareholders are sufficiently informed about their managers' reliance on soft dollars and directed brokerage to constitute informed consent. Mutual funds are required by SEC regulations to state in their prospectus that the manager receives research from brokers as a quid pro quo for his or her brokerage allocation decisions. Some have argued that this 'blanket' disclosure is insufficient and have proposed more detailed disclosure identifying which brokers the manager uses, how much trading he or she does with these brokers, and specifically what research products he or she receives in exchange. This and similar proposals suffer from huge deficiencies. First, keeping track of these details and effectively reporting them to fund shareholders would be costly, and at least part of these costs would be borne by shareholders in the form of higher fees. Second, understanding the details would impose direct costs on shareholders unless, of course, they chose to ignore the disclosure. In all but one of the civil cases following the SEC's action against MFS for failure to adequately disclose its directed brokerage practices, federal courts have granted summary judgment in favor of the defendants because they found the omitted details immaterial in relation to the value of the brokerage commissions at stake, something like a few pennies per ten thousand dollars of investment (Johnsen, 2008b). As the Second Circuit Court of Appeals stated as early as 1996, "[i]f brokerage firms are slightly inflating the cost of their transaction fees, the remedy is competition among the firms in the labeling and pricing of their services, not resort to the securities fraud provisions."²¹

Finally, and most important, the detailed information is very likely proprietary in nature. Which brokers a fund manager uses and how many trades they direct to them is a closely

guarded secret. One of the main reasons to trade through a broker is to maintain anonymity to avoid price impact. It is unsurprising that an SEC proposal to mandate detailed disclosure of soft dollar brokerage arrangements was met with a storm of protest from the industry and was quickly abandoned (Johnsen, 2008a). Similarly, the innovative forms of organization fund managers used in partnering with brokerage houses over directed brokerage were proprietary. No doubt they were part of the competitive process by which managers and brokers sought to prevail over business rivals. Mandating detailed disclosure of proprietary information can hardly benefit fund shareholders and would very likely hurt them over the long run.

The relevant benchmark for evaluating the partners programs, in which brokers earned back-end loaded fees, is how investors would fare with individual retail brokerage accounts in which they hold corporate securities directly. In this setting retail brokers have traditionally earned an up-front brokerage commission on each share traded, which can be duplicated as many times as the broker can convince the client to trade. Cases of retail brokers making unsuitable recommendations and churning client accounts are legion. This is probably one reason corporate investors have gradually migrated over the past fifty years away from direct corporate share ownership and toward mutual fund share ownership. And this is true in spite of dramatic reductions in retail brokerage commissions.

The main problem with informed consent is that mutual fund investors are widely dispersed, often hold only a small fraction of a fund's shares, and are largely apathetic monitors owing to the collective action (free rider) problem they face. No doubt collectively their buy and sell decisions reflect some measure of informed decision making. Mutual fund investments tend to flow toward funds whose managers outperform the market, for example. Simply because individual fund investors know little, in fact, about their manager's brokerage allocation

practices does not mean they would object if they did know. The behavior of pension plan sponsors is a relevant example. These sponsors — the firms who manage pension assets for their workforce — directly bear any losses or gains on their portfolio investments, but they face no collective action problem. In this case, the principal is a single entity who is fully capable of monitoring its portfolio managers to gather information about their brokerage allocation practices. Yet, pension plan sponsors routinely consent to allowing their managers to receive research rebates from institutional brokers.

The ethical issues at hand with soft dollars and directed brokerage are sufficiently mundane that global hypernorms generally impose no binding constraint in finding them ethical. Once having dealt with the procedural hypernorms of exit, voice, and informed consent, these practices simply do not invoke issues regarding essential political or legal institutions or fundamental conceptions of “the right and the good.” It may be that the local norms held by fund shareholders conflict with those held by the fund managers and brokers on which they choose to rely. But given the ease with which investors can exit the community of fund shareholders, the fact that they have chosen not to do so makes a compelling case that soft dollars and directed brokerage are ethical. My transaction cost analysis of these practices is strongly consistent with TD2’s priority rule iv: Norms essential to the maintenance of the economic environment in which the transaction occurs should have priority over norms potentially damaging to that environment

Conclusion

One of my points in this paper has been to show that institutional brokerage rebates are likely efficient given the available facts and what we now know about economic organization from

transaction cost economics. Because the quality of institutional securities brokerage is difficult to assess, investors can benefit from structuring the temporal flow of costs and benefits in a way that helps to assure high quality. Efficiency increases the size of the pie, but no injustice occurs by serving one party his or her slice earlier rather than later. A second point is that *ISCT* can benefit from further refinements based on transaction cost economics. Among other reasons, this is because innovative but efficient business practices such as soft dollar and directed brokerage often appear puzzling or even evil to outside observers, and their collective outcry of “unethical conduct” can drown out any reasoned analysis. My hope is that transaction cost economics will contribute to the evolution of *ISCT* and to a deeper understanding of business ethics.

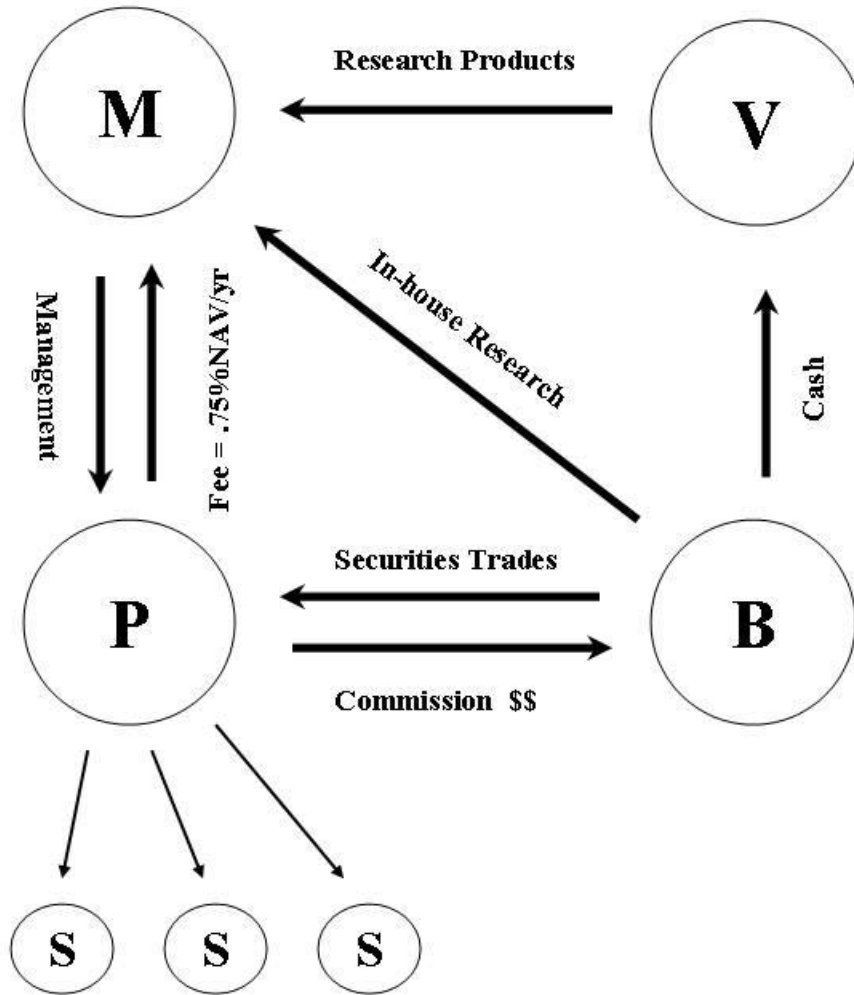


Figure 1
Relations Between the Parties
Soft Dollars

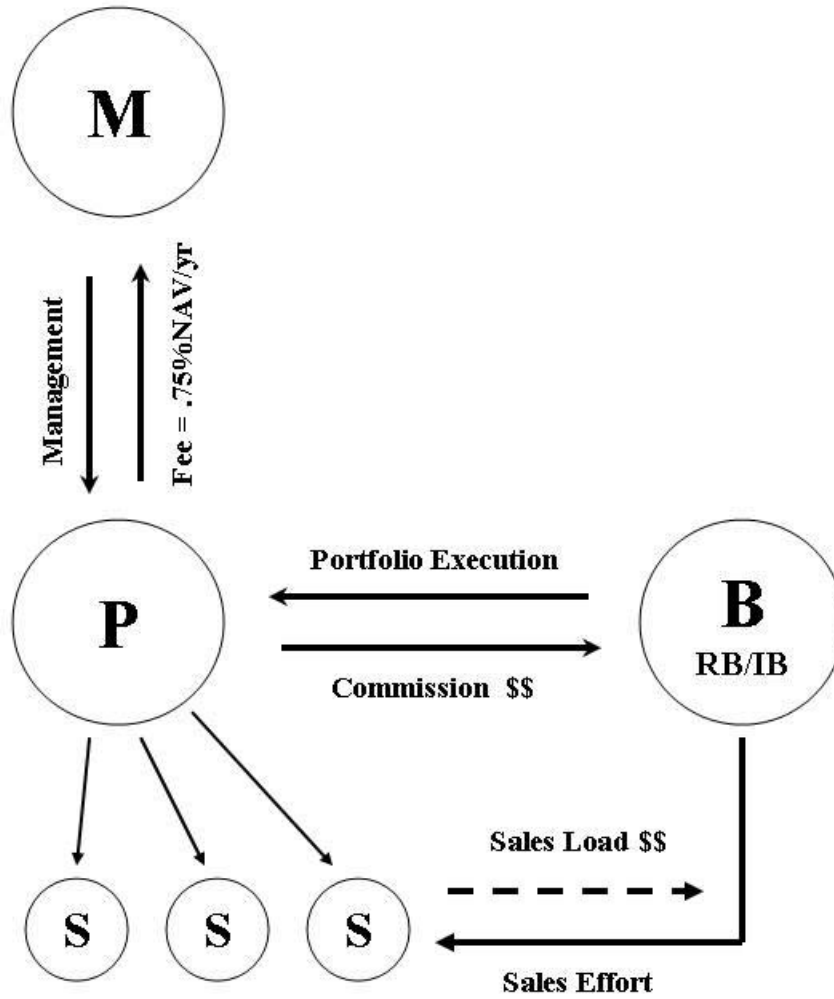


Figure 2
 Relations Between the Parties
Directed Brokerage

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¹ In contrast, closed-end funds issue shares but do not offer shareholders a redemption option. To cash out, a shareholder must sell his or her shares to other investors in the market.

² 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*, *JOURNAL OF LAW & ECONOMICS* 21 297 (1978).

³ 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 terms 'adviser' and 'manager' interchangeably unless the context requires greater care.

⁴ 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.

⁵ 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).

⁶ A basis point is one one-hundredth of a percentage point.

⁷ 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*.

⁸ 15 U.S.C. section 78bb(e) (1988) (as amended).

⁹ The term “directed brokerage” is sometimes used to refer to the situation in which a pension plan sponsor directs a manager of its pension portfolio to send brokerage commission business to specific brokers in exchange for various benefits they provide to the plan sponsor.

¹⁰ Investment Advisors Act Release No. 2224, Investment Company Act Release No. 26,409, 82 SEC Docket 2036 (Mar. 31, 2004).

¹¹ Compared to transacting at a uniform price, for example, price discrimination redistributes the gains from trade between the parties.

¹² Johnnie L. Roberts and Richard Gibson, ‘Friction’ Theorist Wins Economics Nobel, Wall Street Journal, Oct. 16, 1991, Section B, page 1

¹³ Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

¹⁴ The SEC’s 2003 *Concept Release* quoted revealing statements by others at note 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.” See Alison Sahoo, SEC Weighs Trading Cost Rule, Seeks Industry Input,

Ignites.com (July 22, 2003) (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.” Justin Schack, Trading Places, Institutional Investor (Nov. 2003) at 32. *Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs*, Investment Company Act Release No. 26,313, 68 Fed. Reg. 74,820, at 74,820–21 (Dec. 24, 2003).

¹⁵ Frontrunning occurs when a broker or his tippee purposely trades a security ahead of the client’s trades in anticipation of a price correction. The inevitable result is price impact.

¹⁶ For a legal case in which a famous law and economics scholar and now Seventh Circuit judge recognizes that it is not an option for the parties to transact for lower commissions see *Wsol v. Fiduciary Management Associates, Inc., and East West Institutional Services, Inc.*, 266 F.3d 654 (Seventh Circuit, 2001) (J. Posner: “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.”)

¹⁷ See Klein/Leffler (1981), 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/Brand Names.html>.

¹⁸ “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.

¹⁹ See INVESTMENT COMPANY INSTITUTE, INVESTMENT COMPANY FACT BOOK 117 (47th ed. 2007), available at http://www.icifactbook.org/pdf/2007_factbook.pdf.

²⁰ Morgan Stanley DW, Inc., Securities Act Release No. 8339, Exchange Act Release No. 48,789, 81 SEC Docket 1993, 1993 (Nov. 17, 2003).

²¹ *Feinman v. Dean Witter Reynolds, Inc.*, 84 F.3d 539, 541 (2d Cir. 1996).