



**GEORGE  
MASON**  
UNIVERSITY

School of Law

# **USING BOND TRADES TO PAY FOR THIRD-PARTY RESEARCH**

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

**George Mason University Law and Economics  
Research Paper Series**

**10-33**

This paper can be downloaded without charge from the Social Science  
Research Network at [http://ssrn.com/abstract\\_id=1647277](http://ssrn.com/abstract_id=1647277)

---

## USING BOND TRADES TO PAY FOR THIRD-PARTY RESEARCH

D. Bruce Johnsen<sup>\*</sup>  
George Mason University School of Law  
3301 N. Fairfax Drive  
Arlington, VA 22201  
703-978-7601  
[djohnsen@gmu.edu](mailto:djohnsen@gmu.edu)

© July 19, 2010

---

<sup>\*</sup> The author is Professor of Law at George Mason University School of Law. He holds his B.A., M.A., and Ph.D. (Economics) from the University of Washington and his J.D. from Emory Law School. He thanks CCM, Inc., for research funding and Michael Wheatley for able research assistance.

---

## USING BOND TRADES TO PAY FOR THIRD-PARTY RESEARCH

### *Executive Summary*

Much of the money under professional management in the coming years will be held either in pension funds or in individual retirement accounts. As baby boomers age, their portfolios will inevitably shift away from corporate equities and toward fixed income securities, including various types of bonds. In this environment, how should money managers pay for the research necessary to make proper investment decisions for their managed retirement accounts? To answer this question, this paper makes the following important observations:

- According to a 1975 *Senate Report* on the use of client commissions to pay for investment research, “research [is] not an expense of management.”
- Section 28(e) of the Securities Exchange Act of 1934, added by Congress in 1975, provides money managers with a safe harbor to “use client funds to obtain ‘brokerage and research services’ . . . without being presumed to have breached their fiduciary duties or violated federal law.”
- An authoritative 1998 SEC report recognizes that “research is the foundation of the money management industry. Providing research is one important, long-standing service of the brokerage business.”
- If money managers were required to pay for all research out of management fees they would very likely be under-researched according to a recent study by Horan & Johnsen (2008). They find that from 1979 to 1997 every penny money managers paid in premium commissions to obtain research increased investment performance by 4.3 basis points per quarter, holding other factors constant.
- In its *2006 Guidance*, the SEC stated that “the safe harbor encompasses third-party research and proprietary research on equal terms.”
- The *2006 Guidance* finds that transactions covered by the safe harbor must be sufficiently transparent to allow the manager to make a good faith determination that the commission premium is reasonable in relation to the value of the brokerage and research services received.
- Bond trade reporting systems such as TRACE and MSRB provide sufficient transparency to fall within the scope of the safe harbor.
- The *2006 Guidance* finds that bond trades performed by non-positioning broker-dealers on agency or certain riskless trades are covered by the safe harbor. Yet only about 20 percent of money managers acquire fixed income

---

research through client commissions on bond trades, while over 90 percent of money managers acquire equity research through client commissions. This is because most fixed income broker-dealers are actively engaged in positioning bonds.

- Several non-positioning broker-dealers have recently entered the inter-dealer market to perform agency and certain riskless principal trades. Not only do these broker-dealers provide money managers with valuable investment research, but they provide full transparency that allows money managers to be certain of price improvement.

Money managers' use of client commissions on bond trades to pay for fixed income investment research is both legally permissible and in their investors' best interest as long as the trades are executed by a non-positioning broker-dealer on an agency or certain riskless principal basis.

---

# USING BOND TRADES TO PAY FOR THIRD-PARTY RESEARCH

## TABLE OF CONTENTS

- I. Introduction
- II. Does Research Add Value?
- III. The Market for Investment Research, Then and Now
  - A. Brief History of the Section 28(e) Safe Harbor*
  - B. Bond Trading and Fixed Income Research under Section 28(e) – Early Status*
  - C. Two Types of Eligible Bond Transactions*
    - 1. Agency Transactions
    - 2. “Certain Riskless Principal” Transactions
  - D. The Impact of Banks Entering the Brokerage Industry*
    - 1. The Consolidation of Banks and Broker-Dealers
    - 2. Efficient Bond Market Execution
  - E. The Global Settlement and the Move from Proprietary to Third-Party Research*
  - F. The Current State of 28(e) under the SEC’s 2006 Guidance*
- IV. The Incentive Effects of Using Client Commissions to Pay for Research: Conflict or Cooperation?
  - A. The Client-Fiduciary Problem in Money Management*
    - 1. Conventional Wisdom
    - 2. The Simple Economics of Client-Fiduciary Relations
  - B. Empirical Tests*
    - 1. Theoretical Implications
    - 2. Empirical Effects
- V. Summary and Concluding Remarks

---

## USING BOND TRADES TO PAY FOR THIRD-PARTY RESEARCH

D. Bruce Johnsen

### I. Introduction

Forces at work in U.S. financial markets over the past decade are reshaping the way Americans' retirement savings are being managed. To avoid conflicts of interest in the provision of proprietary research, the *Global Settlement* of 2003 mandated that ten prominent, bulge-bracket banks sever the links between their research analysts and their investment banking units. This caused a shift away from proprietary research and toward independent, third-party research. What is more, as baby boomers retire the market will experience massive rollovers from 401(k) plans to individual retirement accounts, many of which will be managed by an influx of small investment advisers formerly employed as brokers (registered representatives) at bulge-bracket investment banks. Finally, whether their retirement accounts are managed by investment advisers or pension plans, baby boomers' portfolios will inevitably shift from equities to fixed income securities.<sup>1</sup> These trends raise an important question: How should money managers pay for the research necessary to make proper investment decisions for their managed retirement accounts? This paper demonstrates that money managers' use of client commissions on bond trades to pay for research is both legally permissible and in their account holders' best interest.

Money managers' use of client commissions on equity trades to pay for research has been routine and widespread for decades. Figure 1 illustrates the relations between the parties. In a typical client commission arrangement, the money manager (M) offers the broker (B) a premium commission to execute portfolio trades, with the commissions being paid by client-investors (C) out of portfolio assets (P). Either before or after the

---

<sup>1</sup> A fixed income security is one that pays the holder a contractually fixed stream of payments over a specified term. Examples include mortgages, corporate bonds, and government bonds. Barring default by the issuer, receipt of the promised payments by the holder is riskless, although changes in market interest rates, default risk, and other factors will cause the price at which the security trades in the market to change. Equity securities, in contrast, promise the holder a share of the issuer's profits. Examples include corporate stock and limited partnership interests. It is widely understood that investors should weight their retirement accounts increasingly toward fixed income securities and away from equities as they approach and enter retirement to ensure a steady stream of retirement income.

---

manager orders the trades, the broker provides the manager with research as a *quid pro quo* for the agreed commission premium. The manager uses the research to identify mispriced securities and then executes the associated trades through the broker to enhance investor returns. Since the beginning of organized securities trading, it has been common practice for brokers-dealers to provide clients with proprietary in-house research using brokerage commissions as a *quid pro quo* for their clients' trading business. Owing to the *Global Settlement*, however, managers now increasingly rely on the use of client commissions to acquire independent third-party research, with their brokers paying a portion of the commission premium to the independent research vendor (V).

Money managers' use of client commissions to pay for investment research — commonly termed “soft dollar brokerage”<sup>2</sup> — is specifically protected by a statutory safe harbor under Section 28(e) of the Securities Exchange Act (1934) known as the “paying up amendment” of 1975.<sup>3</sup> In the SEC's words, Congress passed the safe harbor “to allow money managers to use client funds to obtain ‘brokerage and research services’ for their managed accounts under certain circumstances without being presumed to have breached their fiduciary duties to clients or violated federal law.”<sup>4</sup>

---

<sup>2</sup> In its 1998 Inspection Sweep, the U.S. Securities & Exchange Commission appropriately re-characterized soft dollars as “client commissions.” The reason for the change is that term “soft dollars” was traditionally used to describe a broker's provision of third-party research, whereas client commissions is intended to describe the provision of both proprietary and third-party research. Any time a manager receives “brokerage or research services” other than execution from a broker the arrangement raises conflict-of-interest concerns. In Frequently Asked Questions on Form ADV and IARD, for example, the SEC emphasized that managers receiving proprietary research from full-service brokers should treat this as potential Participation or Interest in Client Transactions on form ADV. See Frequently Asked Questions on Form ADV and IARD, *available at*, <http://www.sec.gov/divisions/investment/iard/iardfaq.shtml#additional> (stating in relevant part, “Answer ‘Yes’ to Item 8.E if you receive *any* research or other product or service that is not execution from any broker-dealer or third party in connection with client securities transactions. Neither the source of the research (i.e., whether it is produced by a third party or produced on a proprietary basis by the executing broker) nor your affiliation with the research provider should have any effect on your answer to Item 8.E.”); See also, Part 1A, Item 8.E of Form ADV, *available at*, <http://www.sec.gov/about/forms/formadv-part1a.pdf>.

<sup>3</sup> *15 U.S.C. Section 78bb(e)* (1988) (as amended). Section 28(e) was part of the Securities Acts Amendments of 1975 deregulating fixed commissions. Pub. L. No. 94-29, Section 7, 89 Stat. 11 (codified as amended at *15 U.S.C. Section 78k-1(a)(2)* (1988)).

<sup>4</sup> *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*], at 1-2.

---

Prior to 2001 the SEC's view was that the safe harbor applied exclusively to agency trades,<sup>5</sup> which are compensated by a commission, but not to principal trades, which are compensated by a mark-up or mark-down.<sup>6</sup> Accordingly, the SEC interpreted the safe harbor as providing no protection for investment research on trades in OTC equities or bonds, which were traded on a principal basis. In 2001, however, the SEC modified its interpretation of the term commission to include certain riskless principal trades on which the mark-up or mark-down is reported on the confirmation and there is a trade reporting system in place to assure adequate transparency. Sufficient trade reporting systems for corporate, agency, municipal, and other bonds — TRACE and MSRB, for example — have evolved in recent years.<sup>7</sup> Even though most fixed income broker-dealers prefer to engage in positioning, several non-positioning brokers have stepped into the inter-dealer market to fill the void,<sup>8</sup> greatly expanding the opportunities money managers have to obtain third-party research through client commissions on fixed income trades.

A threshold question is whether investment research adds value to personal pension accounts, or to any other managed account for that matter. The relationship between investment research and investment returns has proven surprisingly controversial and the controversy itself surprisingly resilient. Many industry participants defend investment research almost viscerally as an indispensable input to money management. Others point to powerful theoretical and empirical work by academic economists concluding that securities markets are informationally efficient. If all securities are efficiently priced, how can active mutual fund managers possibly hope to

---

<sup>5</sup> *Commission Guidance on the Scope of Section 28(e) of the Exchange Act*, Securities Exchange Act Release No. 34-45194 (December 27, 2001), at 1-2.

<sup>6</sup> In an agency trade the broker-dealer promises to use its best effort to execute the trade on its client's behalf and puts none of its own capital at risk. On a buy order the broker searches for the lowest available price, buys the securities for its client's account, and then adds a commission equal to, say, five cents per share times the number of shares purchased. In a principal trade, the dealer puts its own capital at risk, buying the securities for its own account and then reselling them to the client after adding a mark-up, and vice-versa for sell transactions. In some cases, the same trader may act as both a broker and as a dealer on different trades

<sup>7</sup> Pickard & Djinis memo to Mr. Thomas G. Shugrue, Carolina Capital Markets, Inc., *Transactions in Fixed Income Securities, The Safe Harbor of Section 28(e)* (unpublished legal opinion, December 11, 2006) available upon request from Carolina Capital Markets, Inc. [www.carolinacapitalmarkets.com](http://www.carolinacapitalmarkets.com)

<sup>8</sup> These include BNY Brokerage (a division Bank of New York), Capital Institutional Services (CAPIS), Carolina Capital Markets (CCM). See, e.g., Dan Freed, *Trading Bonds on Commission: Increased Regulatory Scrutiny, Declining Trading Profits Prompt Another Look*, *Investment Dealers Digest*, Jan. 22, 2006 (available at <http://www.iddmagazine.com/issues/20060122/11902-1.html>).

---

pick securities that outperform their specified index after charging brokerage commissions and other transaction costs, the advisory fee, and various administrative expenses to the fund? Are the billions of dollars the industry spends on research to identify mispriced securities a huge waste of investor resources?

Section II addresses this question, showing that value-added from research is perfectly consistent with the notion of market efficiency and that early empirical work to the contrary is both fundamentally flawed and inconsistent with more recent and more thorough empirical findings. In addition, recent work shows that personal pension account managers' investment returns increase with the extent to which they pay up for research. An increase of 1.0 cent per share in commissions increased the average money manager's investment returns (alpha) by 4.3 basis points per quarter. Although returns on risky equity securities normally exceed those on less risky fixed income securities, fixed income research can nevertheless substantially increase investor returns. With the life expectancy of U.S. retirees bound to increase over time, it is essential that their personal pension accounts earn the maximum possible return consistent with prudent management and existing regulatory constraints.

As various legal, regulatory, and market forces change how investment research is produced and provided, and as baby boomers inevitably shift their portfolios in favor of fixed income securities, money managers and their clients must be made fully aware of the availability, legality, and importance of investment research. Section III begins with a brief history of the safe harbor for client commissions, starting with the Securities Acts Amendments of 1975.<sup>7</sup> It then describes the early regulatory status of bond trades under Section 28(e) and the two types of trades now eligible for safe harbor protection. Section III discusses various forces at work in U.S. financial markets over the past decade that are reshaping the way Americans' retirement savings are being managed. One force is the widespread entry of commercial banks into securities trading via their mergers with large full-line brokerage houses. These mergers prompted many former registered broker reps of bulge-bracket investment banks to convert to small Registered Investment Advisers (RIA). Another force is the *Global Settlement*, which has generated a marked shift away from proprietary research and toward independent, third-party research.

---

<sup>7</sup> See Securities Acts Amendments of 1975, Pub. L. 94-29, 89 Stat. 97, 161-62 (1975).

---

In light of these forces, the critical question is how money managers can and should get the research to best serve their retirement account clients. Section IV addresses the important role investment research plays in money managers' fiduciary obligation to their clients. The primary concern clients should have is that their managers will have too little incentive to perform research if they are expected to pay for all research out of their own pockets — which is to say out of their management fee. If managers are under-researched, their clients' investment returns will suffer. Rather than reflecting a conflict of interest, Section IV shows that allowing managers to use client commissions to pay for fixed income securities research provides managers with a powerful incentive to aggressively increase their retirement clients' investment returns.

Section V summarizes and provides concluding comments. Given the analysis and empirical findings provided in this essay, Section V discusses the possibility that money managers might be found to have breached their fiduciary duty if they fail to use client commissions to pay up for research. The circumstances under which this might occur are fairly narrow, but the possibility underscores the point that when addressing conflicts of interest there are always Type I and Type II errors to be considered and that the prudent money manager must therefore balance countervailing conflicts to act in the best interest of its client-investors.

---

## USING BOND TRADES TO PAY FOR THIRD-PARTY RESEARCH

### II. Does Research Add Value?

Those who doubt that investment research adds value point to powerful theoretical work on market efficiency by pioneering economist Eugene Fama (1970) and others.<sup>8</sup> Fama's work suggests that if securities markets are informationally efficient neither investors nor their money managers can expect to make money doing research to identify mispriced securities because prices will adjust instantly to newly discovered information. In his framework, markets are "weak-form" efficient if a manager's research based on past prices provides no security selection advantage. They are "semi-strong form" efficient if a manager's research based on publicly available information provides no such advantage. And they are "strong-form" efficient if manager's research based on any information, public or private, conveys no advantage.

Fama surveyed the extensive empirical work on securities market efficiency to see if there was evidence available to reject any form of the efficient markets hypothesis. Foremost in his survey was Michael Jensen's (1968) study of the Net Asset Value (NAV) returns to actively-managed mutual funds from 1945-1964.<sup>9</sup> By their very nature, active managers claim heavy involvement in research to identify mispriced securities, for which they typically charge an asset-based management fee well in excess of those passive index fund managers charge.<sup>10</sup> To adjust for differences in market risk across funds,

---

<sup>8</sup> See Eugene Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. Fin. 383 (1970).

<sup>9</sup> See Michael Jensen, *The Performance of Mutual Funds in the Period 1945-1964*, 23 J. FIN. 389-416 (1968).

<sup>10</sup> Active management fees tend to be in the range of 75 to 150 basis points per year on total assets, while the fees index fund and other passive managers charge are closer to 10 to 30 basis points per year. William F. Sharpe, *A Prosaic Way to Beat the Average Investor*, available at, [http://www-leland.stanford.edu/~wfs Sharpe/art/talks/indexed\\_investing.htm](http://www-leland.stanford.edu/~wfs Sharpe/art/talks/indexed_investing.htm) ("Depending on the market replicated, the cost of managing an index fund should be somewhere between 0.15% and 0.50%, or 15 to 50 "basis points", using financial jargon. Active managers are very different. . . . Their costs are likely to be at least 1.0% (100 basis points) higher than those of passive managers in the same markets."); See also, Burton G. Malkiel, *A Random Walk Down Wall Street*, p. 357, W.W. Norton & Company Inc., New York. 2003. ("actively managed public mutual funds charge annual management market expenses that on average are more than 150 basis points (1 ½ percentage points) per year.").

---

Jensen used the following regression equation based on the Capital Asset Pricing Model (CAPM) developed by Sharpe (1964)<sup>11</sup> and others:

$$R_j - R_f = \alpha + \beta(R_m - R_f) + u$$

The variables  $R_j$  and  $R_m$  are the observed returns to fund  $j$  and to the S&P 500 Market Index after accounting for dividend distributions, and  $R_f$  is the risk-free rate of return on U.S. government bonds, with each variable being observed over each year in the sample. The differences  $R_j - R_f$  and  $R_m - R_f$  reflect the returns rational investors must earn to be compensated for investing in risky assets rather than the risk-free asset, the so-called “risk premium.” The model recognizes that rational managers will sell (or buy) securities whose expected returns are too low (or high) until prices fall (or rise) to provide them with a normal expected return.

The risk premium on any portfolio is affected by a number of factors, but the factor Jensen thought most important was the risk premium on the market portfolio. As shown in Figure 2, the regression equation above amounts to fitting a straight line to a scatter diagram of points reflecting various concurrent observations of  $R_j - R_f$  and  $R_m - R_f$ . Alpha is the intercept of the line (that is, the value of  $R_j - R_f$  when  $R_m - R_f$  is zero) and  $\beta$  is its slope. The scatter diagram itself will rarely form a straight line, and  $u$  is an error term reflecting the deviations of each observation from the fitted line under the conditions that the fit of the line is constructed to minimize the sum of the squared errors and that the sum of all errors is zero.

The portfolio’s  $\beta$  indicates how the risk premium earned by the fund’s portfolio changes, on average, when the risk premium earned by the market portfolio changes. It is the standard measure of undiversifiable “market risk.” Having adjusted for market risk, alpha reveals the fund manager’s ability to pick securities that outperform the market. If alpha is positive, fund investors have enjoyed positive abnormal risk-adjusted NAV returns, perhaps owing to manager skill in performing investment research. If alpha is

---

<sup>11</sup> William F. Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk*, 19 J. Fin. 425 (1964).

---

negative, they have suffered negative abnormal NAV returns, perhaps owing to manager incompetence or indolence.

After netting out brokerage commissions and other transaction costs, advisory fees, and administrative expenses, Jensen found that the average alpha across funds in his sample was a statistically significant negative 1.1 percent per year, indicating that the returns to active management were on average less than the returns on the market portfolio.<sup>12</sup> And although he found several funds whose alphas were persistently positive (though only slightly so) he was unable to rule out the possibility that these observations were due entirely to luck. Jensen concluded that active management (research) adds nothing to “alpha,” and may even reduce it. In his words:

One must realize that these analysts are extremely well endowed. Moreover, they operate in the securities markets every day and have wide-ranging contacts and associations in both the business and financial communities. Thus, the fact that they are apparently unable to forecast returns accurately enough to recover their research and transaction costs is a striking piece of evidence in favor of the strong form of the [efficient markets] hypothesis.<sup>13</sup>

The question of how active management can possibly add value in a strong-form efficient market was answered theoretically by Grossman & Stiglitz (1980).<sup>14</sup> They made the important point that it is impossible for markets to be informationally efficient in the traditional sense. If markets are strong-form efficient, instantly impounding all private information into prices, market participants seeking to discover such information will be unable to cover their research costs and will refuse to engage in price discovery. And yet, we know that price discovery does not fall from the sky.

The traditional notions of market efficiency — weak form, semi-strong form, and strong form — are simply empirically testable statements of a more fundamental version of market efficiency. According to this version, any given security can be mispriced at any given moment. It may be beneficial for market participants to do research to discover mispriced securities and to trade those securities to make money, correcting any

---

<sup>12</sup> Jensen, at 405.

<sup>13</sup> Fama, at 413.

<sup>14</sup> Sanford J. Grossman and Joseph E. Stiglitz, On the Impossibility of Informationally Efficient Markets, 70 A.E.R. 393 (1980).

---

mispricing in the process. But this process is costly. If markets are efficient in the Grossman-Stiglitz sense, money managers can expect to earn only a normal competitive return on their investments in research, though *ex post* some will surely do better and some will do worse. It is therefore quite possible that active fund managers are able to identify mispriced securities from time to time, and perhaps even persistently so if they have above average talent. Although the core of the efficient markets hypothesis remains intact, some measure of mispricing can be expected to persist in equilibrium. Traditional informational efficiency is impossible, and what we are left with is a market equilibrium subject to an optimal amount of disequilibrium.

This compelling theoretical hypothesis fails to explain why the empirical evidence at the time almost uniformly rejected it. Horan & Johnsen (1999)<sup>15</sup> may have been the first to explain these findings. They proposed that mutual funds are akin to an open-access common pool owing to the continuous share issuance and redemption options they provide. No investor has an exclusive claim to fund returns going forward because returns are shared in common. Competition between rational investors to capture returns ensures investment dollars will flow in or out to equalize risk-adjusted NAV returns across funds. The best mutual fund investors can expect is a normal risk-adjusted return on their investment equal to that on alternative investments.

In a seminal article several years later, Berk & Green (2004)<sup>16</sup> formalized this hypothesis. Assuming standard investor rationality, by accounting for the effect of investor expectations and competition on fund flows they easily explained much of the empirical evidence finding that managers have been unable to generate consistent positive alphas. In their model, fund size and total manager compensation — typically based on a periodic share of assets under management — as well as transaction costs, increase in response to perceived manager skill until returns are equalized across funds going forward. Managers' failure to outperform a passive benchmark based on NAV returns does not mean they lack skill. In the words of Berk & Green, “[i]t merely implies

---

<sup>15</sup> Steven M. Horan and D. Bruce Johnsen, *Portfolio Management, Private Information, and Soft Dollar Brokerage: Agency Theory and Evidence* (unpublished working paper, GMU School of Law), available [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=131463](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=131463). See also D. Bruce Johnsen, *Myths about Mutual Fund Fees: Economic Insights on Jones v. Harris*, forthcoming in the JOURNAL OF CORPORATION LAW.[needs full citation]

<sup>16</sup> Jonathan B. Berk and Richard C. Green, *Mutual Fund Flows and Performance in Rational Markets*, 112 J. POL. ECON. 1269 (2004).

---

that the provision of capital by investors to the mutual fund industry is competitive. . . . [Owing to fund flows] investors cannot expect to make positive excess returns, so superior positive [NAV] performance cannot be predictable [or persistent].”<sup>17</sup> This finding is consistent with a Grossman-Stiglitz efficient market equilibrium.

Wermers (2000) assembled a novel and exhaustive database to assess active fund managers’ stock picking skills, transaction costs, and expenses. The database included specific fund security holdings based on SEC filings, NAV returns, portfolio style, annual turnover, and expense ratios for all U.S. equity funds from 1975 through 1994. The database allowed him to differentiate between manager stock picking returns (which he adduced from changes in portfolio holdings), on the one hand, and returns enjoyed by shareholders based on NAV performance, on the other. The difference consists of various transaction costs, flow-driven fees, and administrative expenses.<sup>18</sup> He found that active large-cap funds outperformed the market by 1.3 percent per year, but that their NAV returns (the returns shareholders enjoyed) fell short of the market by 1.0 percent. He attributed 0.7 percent of the 2.3 percent difference to the underperformance of non-stock holdings, mostly cash. To meet redemptions, mutual funds must hold a nontrivial portion of their portfolios in cash. The return on cash falls far short of the return on risky securities and acts as a drag on the NAV returns shareholders earn. The remaining 1.6 percent difference consisted of expenses, including advisory fees and transaction costs.

More recently, Kosowski, Timmerman, Wermers, and White (2006) applied an emergent, statistical method known as a “bootstrap” analysis to the data.<sup>19</sup> Among other things, this method allowed them to determine whether managers who generated positive alphas did so through superior skill in picking securities or purely as a result of luck. If superior performance was based on luck, alone, they expected nine funds in their database to generate alphas (net of costs) exceeding ten percent per year for at least a

---

<sup>17</sup> Jonathan B. Berk and Richard C. Green, *Mutual Fund Flows and Performance in Rational Markets*, 112 J. P. E. 1269, 1271 (2004).

<sup>18</sup> He later likened the ability to assess manager stock-picking returns based on portfolio holdings, rather than on NAV returns, as akin to advances in DNA profiling over fingerprint methods in criminal proceedings. Russ Wermers, *Performance Evaluation with Portfolio Holdings Information*, 17 N. AM. J. FIN. & ECON. 207 (2006).

<sup>19</sup> 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). A bootstrap analysis consists of re-sampling a database to increase the power of the estimates.

---

five-year period. Instead they found 29 funds that did so. This provided overwhelming evidence to reject the hypothesis that active managers lack persistent securities picking skill. Consistent with a Berk-Green equilibrium, a sizeable minority of fund managers was able to generate superior portfolio returns, and these managers' performance tended to persist over time.

Although these findings strongly suggest, in general, that investment research can add alpha, they apply solely to the research performed by active mutual fund managers and not to that of private money managers such as retirement account advisers. Nor do they say anything about the effect of managers' use of client commissions to pay for research. More recent work by Horan & Johnsen (2008) directly addresses these issues. Horan & Johnsen relied on the Mobius database, now owned by CheckFree Investment Services, which has been in the business of selling returns data on money managers to the public since 1989. The database represents both pension assets and institutional money management more generally. Since the database covers private institutional managers rather than mutual fund managers, it contains large index managers such as Wells Fargo-Nikko but not the popular retail Vanguard Index 500 Trust mutual fund. The database does not directly measure money managers' use of client commissions to acquire research and therefore does not differentiate between their receipt of proprietary and third-party research. As an indirect measure for managers' use of client commission to obtain research, Horan & Johnsen used Premium Commissions per Managed Dollar (PCMD) as a proxy, calculated as the average premium commission rate multiplied by annual turnover expressed as a percentage of portfolio value. From the average commission rate of roughly seven cents per share, they deducted the execution-only rate of 2.0 cents per share to arrive at PCMD. During the period covered by the database, 2.0 cents per share was the amount managers generally paid for pure execution.

Many factors other than the use of client commissions to obtain research are likely to affect commission rates and turnover. These include portfolio sizes, number of accounts, and trade difficulty. Their results are reproduced in Table I. Holding other factors constant, Horan & Johnsen found a negative relationship between total portfolio assets and PCMD, undoubtedly because significant economies of scale exist in trading securities. They also found that an increase in the number of accounts included in the

---

portfolio increases PCMD, which is consistent with the notion that a larger number of accounts increases administrative costs for the broker booking the trades.

Horan & Johnsen calculated each portfolio manager's alpha, using various models, including Jensen's one-factor model as described above. The results are unchanged across the various specifications. After performing a number of robustness checks and using multivariate regression analysis to adjust for the effects of total portfolio assets, number of accounts, tax-exempt assets, indexing, and trade difficulty as reflected in various style categories, they found that PCMD is positively associated with alpha at the 99 percent confidence level. Since risk-adjusted returns are net of commissions (and other transaction costs), managers' use of client commissions to pay for research clearly appears to provide a net benefit to investors. For a typical manager having 50 percent annual turnover, increasing PCMD by 1.0 cent per share increases performance by 4.3 basis points per quarter.

Index portfolios under-perform their actively managed counterparts, both in the presence or absence of other strategy class control variables. This is consistent with Wermers' (2000) novel results. Moreover, portfolios with a high proportion of pension assets have relatively low returns compared to portfolios having non-pension assets, which is consistent with evidence presented by Ambachtsheer (1994).<sup>20</sup> A likely reason for this is that pension portfolios are more heavily weighted toward fixed income securities than non-pension portfolios.

---

<sup>20</sup> See K.P. Ambachtsheer, *The Economics of Pension Fund Management*, 50 FINANCIAL ANALYSTS JOURNAL 21 (1994).

---

## USING BOND TRADES TO PAY FOR THIRD-PARTY RESEARCH

### III. The Market for Investment Research, Then and Now

#### A. *Brief History of the Section 28(e) Safe Harbor*

From its inception in 1792, the association of stock and bond brokers and dealers known until recently as the New York Stock Exchange (NYSE) (now merged with the NASD into the Financial Industry Regulatory Authority, or FINRA), operated under a system of legally mandated minimum commissions.<sup>21</sup> Under “the old, fixed commission system,” full-service brokerage houses produced the bulk of investment research, largely in the form of proprietary conclusions and analyst reports best seen as *outputs* in the investment research process. Brokers included the costs of proprietary research in the brokerage commission and allocated the research sequentially to clients favored, in part, based on the amount of trading the clients did with the firm.

Slowly but surely, political support for fixed commissions waned. The SEC adopted Rule 19b-3 under the Exchange Act, which ended fixed commission rates on national securities exchanges effective May 1, 1975. Just one month later, Congress passed legislation unfixing commission rates as part of the Securities Acts Amendments of 1975.<sup>22</sup> Commissions fell dramatically and trading volume surged. There is little doubt that deregulation of fixed commissions on exchanges represented a tectonic shift for the U.S. securities industry, and that it continues to affect the provision of investment research to this day.<sup>23</sup>

---

<sup>21</sup> 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).

<sup>22</sup> 2006 SEC Guidance, at 41980.

<sup>23</sup> 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).

---

In addition to providing for freely negotiated brokerage commissions, the 1975 amendments added Section 28(e), the so-called “paying up” amendment, to the Securities Exchange Act of 1934. Congress designed Section 28(e) as a safe harbor to allay widespread concern by money managers that their state common law and statutory fiduciary duties of best execution, as well as federal duties under the Employee Retirement Income Security Act (ERISA) (1974) and conflict-of-interest provisions of the Investment Company Act (1940), 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.<sup>24</sup> Section 28(e) provides, in relevant part:

(1) No person [who exercises] investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law . . . solely by reason of having caused the account to pay a member of an exchange, broker, or dealer an amount of commission . . . in excess of the amount of commission another member of an exchange . . . would have charged . . . if such person determined in good faith that it was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion. . . .

(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

---

<sup>24</sup> 2006 SEC Guidance, at 41980-81. Industry concern over paying up post-deregulation was no doubt fueled in part 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).

---

(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 . . . .<sup>25</sup>

The Senate Committee Report on Section 28(e) makes several important points that help to understand its motivation and scope.<sup>26</sup> It is worthwhile quoting the Report at length:

Under the present environment, most money managers obtain supplementary research support and analysis from brokerage firms which execute their transactions on national securities exchanges charging the fixed commission rate now in effect. . . . Investment managers in turn have relied on the fact that portfolio activity would generate a supply of research and analysis from the brokerage industry.

. . . The small investment manager has thereby been able to service his clients without being required to charge those clients a higher fee than the [large bank] trust department. . . . Thus, existing investment management relationships, including the size of the management fee, have been based, in part, on an environment which enables the manager to obtain research and other services from broker-dealers, *which services are paid out of portfolio brokerage and are not an expense of management.*[emphasis added]

The transition from the system of fixed to unfixed commission rates is expected by some to cause confusion and disruption. Many fear that governing law applicable to fiduciaries will dictate that the money manager must always seek the lowest execution cost for portfolio transactions and that he may not charge a managed account or fund with an execution-plus research rate which may be higher than an execution-only rate. If that interpretation of fiduciary law should prove accurate, the future availability and quality of research and other services in an environment of unfixed rates could be jeopardized, with potentially harmful consequences to all investors.

S. 249 is therefore intended to permit a fiduciary to cause an account to pay a broker or dealer an amount of commission for effecting a securities transaction in

---

<sup>25</sup> 15 U.S.C. section 78bb(e) (1988) (as amended).

<sup>26</sup> SENATE REPORT NO. 94 - 75; 94TH CONGRESS, 1st Session; S. 249, Section IV, *Payment for Research Services with Brokerage Commissions* (April, 1975).

---

excess of the commission another broker-dealer might have charged for effecting that transaction so long as the investment advisor or fiduciary determines in good faith that the commission was reasonable in relation to the value of the brokerage and research services provided by such broker-dealer. This standard of “reasonableness” does not require that the value of research and brokerage services be imputed to any specific account; rather reasonableness is to be measured in view either of that particular transaction or the fiduciary’s overall responsibilities with respect to the accounts over which he exercises investment discretion. It is thus unnecessary for the money manager to show that specific services benefited specific accounts.

The Committee intends Section 28(e) to be exclusive and plenary unless otherwise expressly provided by contract and to supersede state common law and any other state or federal law in existence prior to the enactment of the amendment insofar as such law might apply to such conduct. . . .

The definition of brokerage and research services is intended to comprehend the subject matter in the broadest terms, subject always to the good faith standard in Subsection (e) (1). . . . [T]he touchstone for determining when a service is within or without the definition in Section 28(e) (3) is whether it provides lawful and appropriate assistance to the money manager in the carrying out of his responsibilities.

Several of these points deserve emphasis. *First*, one function of the safe harbor is to allow small advisory firms to compete with their larger and more established rivals. *Second*, market-driven management fees are insufficient to fund investment research, and research, therefore, is not an expense of management to be covered by the management fee. For decades, if not longer, money managers had been using client commissions to acquire research, and therefore were not expected to pay for research out of management fees. *Third*, all investors are harmed if the threat of fiduciary suits leads money managers to be under-researched. *Finally*, the scope of 28(e) is to be interpreted permissively subject to the good faith standard.

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. Early on, the SEC interpreted the term “brokerage and research services” in a way that confined its application to proprietary research products. But in response to the “changing array of research products and the impact of new

---

technology on brokerage practices,” and believing “that the issue is ultimately one of good faith on the part of the money manager” best addressed through disclosure,<sup>27</sup> in 1986 the SEC relaxed its interpretation of brokerage and research services to include anything that “provides lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities.”<sup>28</sup> The 1986 Release explicitly allowed generic research inputs to be included in the safe harbor and was followed by considerable expansion in independent research, largely at the expense of established full-service brokerage houses.

*B. Bond Trading and Fixed Income Research under Section 28(e) – Early Status*

There is no indication either Congress or the SEC ever intended to exclude bond trades or fixed income research from the safe harbor provisions of Section 28(e). The SEC’s Division of Market Regulation addressed the provision of brokerage and research services on fixed income securities trades under Section 28(e) in a No-Action Letter dated July 25, 1990, responding to an inquiry from the Department of Labor (DOL). Before taking enforcement action in several pending cases under ERISA, which regulates the management of private pension funds, the DOL requested the SEC’s opinion on whether the safe harbor applies to trades in fixed income securities and over-the-counter (OTC) stocks. This included trades listed on the National Association of Securities Dealers Automatic Quotation System (NASDAQ), which at the time were traded primarily by dealers on a principal basis rather than by brokers on an agency basis. In contrast to the commissions, which brokers receive for acting as agents, when trading for their own account as dealers they earn a mark up or mark down equal to the difference between the price at which they buy and the price at which they sell. In many cases they sell out of their inventory or buy to add to their inventory, which is to say they “engage in positioning.”

---

<sup>27</sup> 1986 *Interpretative Release*, at 13-14.

<sup>28</sup> 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.

---

Section 28(e) specifically 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 on principal trades. In the narrow sense of the term, only brokers earn commissions on agency trades, while dealers, as principals, earn mark-ups and mark-downs as if they were acting as a market maker. Since Congress passed Section 28(e) to mitigate problems owing specifically to the unfixing of *commissions*, the No-Action Letter found that *principal* transactions in fixed income and OTC equity securities fall outside the safe harbor. In a supplemental No-Action Letter to Hoenig & Co., Inc., dated October 15, 1990, the Division of Market Regulation reiterated this position and clarified that “a transaction fee paid to a broker-dealer for effecting a transaction in a principal capacity is not within the safe harbor irrespective of the label placed on the fee.” “The fact that the broker-dealer imposes a charge that is denominated as a ‘commission’ or ‘commission equivalent,’ rather than a mark up would not be relevant to the application of Section 28(e) . . . even though the confirmation received by the money manager reflects a commission equivalent.” Based on the Hoenig letter, it is generally believed that only non-positioning brokers may provide money managers with research on agency trades in fixed income securities. Legitimate agency functions include providing clients with anonymity and searching the market for a better price than what is available to the client on a principal basis.<sup>29</sup>

### *C. Two Types of Eligible Bond Transactions*

#### 1. Agency Transactions

The SEC interprets Section 28(e) to be available for research and brokerage services obtained through client commissions from a broker-dealer acting in an agency capacity. Regarding bonds, moreover, neither the text nor the legislative history of Section 28(e), distinguish between equities securities and other types of securities. The statutory language of Section 28 (e) refers only to “securities,” defined in Section 3(a)

---

<sup>29</sup> Thomas P. Lemke and Gerald T. Lins, *Soft Dollars and other Brokerage Arrangements 2008-2009 Edition*, Securities Law Handbook Series (Thomson Reuters/West, 2009), at 104.

---

(10) of the Securities Exchange Act of 1934 to include “any note, stock, bond, debenture, or any instrument commonly known as security . . . .” The safe harbor protections of Section 28(e) therefore extend to client commissions on bond trades done on an agency basis by a non-positioning broker.<sup>30</sup>

The SEC staff believes that in most cases Section 28(e) of the Exchange Act does not cover a money manager who pays up on principal transactions. In some cases, however, the broker-dealer may execute transactions in fixed income securities such as government, municipal, corporate debt instruments, and mortgage backed securities on an agency basis, receiving a normal commission for its services. Because the broker-dealer actually acts as an agent, these transactions can be contrasted with those precluded by the Hoenig Letter. In connection with a non-positioning agency trade, the broker-dealer is free to provide research or other services to the money manager through client commissions under the Section 28(e) safe harbor.<sup>31</sup>

## 2. “Certain Riskless Principal” Transactions

In the SEC’s *2001 Guidance on the Scope of Section 28(e) of the Exchange Act*, the SEC modified its interpretation of Section 28(e) to find “certain riskless principal” transactions eligible for safe harbor protection. Relying on the safe harbor’s requirement that the money manager must have sufficient transparency to make a good faith determination that the commission premium is reasonable in relation to the value of brokerage and research services provided, the SEC found that the term “commission” in Section 28(e) of the Exchange Act may include a “markup, markdown, commission equivalent, or other fee paid by a managed account to a dealer for executing a transaction where the fee and transaction price are

[i] fully and separately disclosed on the confirmation and [ii] the transaction is reported under conditions that provide independent and objective verification of

---

<sup>30</sup> Pickard & Djinis memo to Mr. Thomas G. Shugrue, Carolina Capital Markets, Inc., Transactions in Fixed Income Securities, *The Safe Harbor of Section 28(e)* (unpublished legal opinion, December 11, 2006) available upon request from Carolina Capital Markets, Inc. [www.carolinacapitalmarkets.com](http://www.carolinacapitalmarkets.com)

<sup>31</sup> Thomas P. Lemke and Gerald T. Lins, *Soft Dollars and other Brokerage Arrangements 2008-2009 Edition*, Securities Law Handbook Series (Thomson Reuters/West, 2009), at 104.

---

the transaction price subject to self-regulatory organization oversight i.e. a trade reporting system.<sup>32</sup>

The SEC also found that “as other markets develop equivalent regulations to ensure equivalent transparency, transaction charges in those markets that meet the requirements of this interpretation *will* be considered to fall within the interpretation” [emphasis added].<sup>33</sup> Currently, TRACE provides sufficient reporting of corporate and government agency bond trades (GNMA, FNMA, etc.) while MSRB provides sufficient reporting of municipal bond trades. Reporting of mortgage bond trades on TRACE will soon follow.<sup>34</sup> Yet money managers appear to be unaware of this development. A 1998 SEC audit sweep reported that over ninety percent of money managers used client commissions to acquire research on equity trades, while only about twenty percent of managers used them to acquire research on fixed income trades.<sup>35</sup>

#### *D. The Impact of Banks Re-Entering the Brokerage Industry*

##### 1. The Consolidation of Banks and Broker-Dealers

In November 1999, Congress passed the Gramm-Leach-Bliley *Financial Services Modernization Act*.<sup>36</sup> This legislation repealed the New Deal-era Glass-Steagall Act (1932), which had succeeded for decades in mandating strict separation between commercial banking, investment banking, and insurance underwriting. Anticipating Gramm-Leach-Bliley’s passage, many large insurers, commercial banks, and investment banks, along with their affiliated broker-dealers and asset management units, had begun to merge pursuant to an expanded Federal Reserve Board exception to Glass-Steagall,<sup>37</sup> in many cases they turned themselves into bank holding companies with access to

---

<sup>32</sup> SEC Interpretation: Commission guidance on the Scope of Section 28(e) of the Exchange Act, Release No. 34-45194, pg. 7.

<sup>33</sup> SEC Interpretation: Commission guidance on the Scope of Section 28(e) of the Exchange Act, Release No. 34-45194, pg. 7.

<sup>34</sup> FINRA Notice to Members, Regulatory Notice 10-23:  
<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121317.pdf>

<sup>35</sup> See Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds, The Office of Compliance, Inspections and Examinations, U.S. Securities & Exchange Commission, September 22, 1998.

<sup>36</sup> <http://www.pbs.org/wgbh/pages/frontline/shows/wallstreet/weill/demise.html>

<sup>37</sup> <http://www.pbs.org/wgbh/pages/frontline/shows/wallstreet/weill/demise.html>

---

Federal deposit insurance but subject to relatively strict banking regulations, including specific capital requirements. By 2003, Citicorp and Travelers Insurance Company, along with Primerica, Shearson Lehman, Smith Barney, and Solomon Brothers had merged to become the giant financial services firm Citigroup, Inc. UBS bought Paine Webber. Credit Suisse, already the product of a merger with First Boston, quickly swallowed Donaldson, Lufkin & Jenrette. Around the same time, JP Morgan, Chemical Bank, and Chase Manhattan Corporation merged to become the colossus “JP Morgan Chase” and soon also acquired Bank One Corporation.<sup>38</sup>

In their broker-dealer divisions, these banks employ individual brokers to manage retail investor accounts and institutional brokers to trade equities on behalf of institutional clients in an agency capacity. These banks also have trading desks that buy and sell equity securities and bonds for their own and the house’s account. Bank acquisition of many broker-dealers resulted in the loss of a large number of bond trading desks. And few of the large broker-dealers have ever traded bonds strictly in an agency capacity. In addition, banks have the borrowing capability to buy and hold bonds that provide an attractive coupon rate relative to the bank’s cost of capital and earn a riskless income stream on the “carry.” When a money manager asks the banks’ trading desk to execute a bond trade, the bank broker has the discretion to fill the order out of inventory or to enter the dealer market, take a position, and then offset that position to fill the manager’s order. The bank can then charge a mark-up or mark-down for the service. The chance to earn a carry on advantageously priced bonds creates a conflict of interest for the bank. When a client seeks to buy bonds the positioning bank-dealer happens to hold in inventory (because they promise an attractive carry), the dealer will be tempted to enter the dealers market to fill the order at a less advantageous price rather than releasing the bonds from inventory. The converse is also true. The result is that small and mid-size money managers have seen an increase in transaction cost and a reduction in liquidity in the positioning bank-dealer bond market.

As a result of the repeal of Glass-Steagall, many banks acquired broker-dealers with the specific purpose of managing the individual’s securities accounts of the broker-dealer clients. These banks shut down many of their acquired broker-dealers’ bond

---

<sup>38</sup> [http://en.wikipedia.org/wiki/List\\_of\\_bank\\_mergers\\_in\\_the\\_United\\_States](http://en.wikipedia.org/wiki/List_of_bank_mergers_in_the_United_States)

---

desks. The reduction in the number of bond desks led to decreased liquidity for money managers involved in secondary bond transactions, ultimately resulting in an increase in transaction costs. This decrease in the number of competing broker-dealer bond desks has had the result of decreasing liquidity in the secondary bond market for pension fund managers and increasing their transaction costs.

Large banks tend to view bond positioning as a way to profit for their own accounts on the differential between their borrowing costs and the yield on bonds. As a result, they have devoted much of their available leverage to bond positioning rather than to providing liquidity for the distribution of bonds to pension fund and other money managers. As banks have acquired broker-dealers, broker-dealer bond desks have embraced this business practice, which has continued the decline of liquidity for money managers and increased transaction costs in fixed income markets. Beginning in the fall of 2008 and extending into 2009, bank-owned broker-dealers terminated a large number of institutional sales people and traders covering pension money managers,<sup>39</sup> causing a further decline in fixed income liquidity. Broker-dealers now use their capital primarily to position bonds as proprietary trading desks, using street brokers in the inter-dealer market as their form of liquidity. They offer bonds to pension fund managers at much higher prices than can be found from street brokers in the inter-dealer market.

Unsurprisingly, many of these giant financial industry firms hold substantial retirement and other investor assets under management, either directly or through money management affiliates. Much of this money has been managed for brokerage house (now bank) clients by employee-brokers (known as “registered representatives”). But many of these brokers have grown frustrated with the bureaucracy associated with their massive bank holding company employers and have left the banks to set up their own Registered Investment Advisory (RIA) firms. They have largely taken their clients’ money with them. A recent Wall Street Journal story reports that “[t]he number of brokers serving individual clients at major firms fell 14% to less than 55,000 in the three years ending in December 2008, while the number of independent financial advisers rose 29% to

---

<sup>39</sup> See, e.g., *Naked Capitalism, Real Economy Crunch Arrives: Layoffs Rise Sharply*, October 25, 2008 (available at <http://www.nakedcapitalism.com/2008/10/real-economy-crunch-arrives-layoffs.html>). See also, e.g., *Investment Watch, US Layoffs – The Latest Casualty Count*, December 5, 2008 (available at <http://investmentwatchblog.com/the-us-layoffs-list-the-latest-casualty-count/>).

---

33,000.”<sup>40</sup> As these managers’ baby boom clients retire, their employer sponsored 401(k)s will have to be rolled over to personal pension accounts.

## 2. Efficient Bond Market Execution

Inter-dealer brokers have become efficient executors of bond trades because of their access to the “broker’s” market, also known as the “inside market,” illustrated in Figure 3. When a non-positioning inter-dealer broker executes a bond trade in an agency capacity, the best available price is passed on to the money manager-client and fully disclosed according the established regulatory standards under the Securities Exchange Act of 1934, Rule 10(b)-10.<sup>41</sup> The broker charges the client a normal commission on the transaction, which is also fully disclosed. The client commission is now eligible to pay for fixed income research under Section 28(e). A simple example illustrates how a client commission arrangement might work. Suppose that after searching the dealer market the inter-dealer broker finds that the best bid/offer for Bond X is 96 to 96-1/8. If the client is buying and the inter-dealer broker acts strictly as an agent (a non-positioning broker), the broker would be required to execute the transaction for the client at 96-1/8, the same price received by the seller. The client and the broker would negotiate a commission that is reasonable in relation to the value of the research provided and the broker would use an agreed share of the commission to pay for third-party research on the client’s behalf. In today’s trading environment, money managers searching among bank-based dealers on their own behalf are seeing offerings that are much less advantageous than what an inter-dealer broker sees in the dealers market at, for example, 95 to 97. This is because the inter-dealer broker sees the “inside market.” Unless the money manager relies on an inter-dealer broker acting strictly as an agent, he or she is very likely to suffer a substantial increase in transaction costs that will erode the alpha they earn from identifying mispriced securities.

What is more, unlike the bank-based bond dealer, the inter-dealer broker acting strictly as an agent must provide complete transparency whenever a portion of the

---

<sup>40</sup> E.S. Browning, *More Brokers Flee Big Firms, Taking Investors With Them*, Wall Street Journal, January 4, 2010, p. A1.

<sup>41</sup> <http://www.law.uc.edu/CCL/34ActRIs/rule10b-10.html>

---

commission goes to pay for research. This allows the money manager to ensure that the broker has provided price improvement compared to the manager's outside opportunities with bank-based dealers.

*E. The Global Settlement and the Move from Proprietary to Third-Party Research*

In April 2003, then New York Attorney General Eliot Spitzer concluded his investigation into deceptive analyst reports at the ten largest Wall Street brokerage firms. Spitzer used the Martin Act to compel disclosure from these firms. Merrill Lynch was the first firm to honor the request, and quickly gave up the names of other firms engaging in deceptive practices. Analysts at these firms had been publicly recommending stocks during the dotcom boom of the late 1990's. At the same time, these analysts were privately ridiculing the same stocks as bad opportunities. Spitzer uncovered a pattern that suggested that these large firms were promoting certain stocks in an attempt to win the same companies' investment banking business.<sup>42</sup> The scandal unraveled into the widely-publicized *Global Settlement*, which condemned these Wall Street firms for allowing their analysts to engage in conflicts of interest that subjected them to investment bank influence.<sup>43</sup> Collectively, Bear Stearns, Credit Suisse First Boston, Goldman Sachs, Lehman Brothers, J.P. Morgan, Merrill Lynch, Morgan Stanley, Citigroup Global Markets (f.k.a. Salomon Smith Barney), UBS Warburg LLC (UBS), and U.S. Bancorp Piper Jaffray Inc., paid fines and penalties of \$1.4 billion. Of this amount, \$432.5 million was earmarked to fund independent, third-party research. The settlement also required each firm to contract with independent research providers and to make "objective" research available to their customers for a period of five-years.

More importantly, to ensure that analysts' recommendations remain untainted by efforts to obtain investment banking fees, the Global Settlement mandated that analysts' compensation could not be based directly or indirectly on investment banking revenues, and that investment banks must not participate in the analysts' job performance

---

<sup>42</sup> <http://encyclopedia.jrank.org/articles/pages/4033/Spitzer-Eliot.html>">Spitzer, Eliot - Governor of New York, Career, Sidelights</a>.

<sup>43</sup> Available at <http://www.sec.gov/news/press/2003-54.htm>

---

evaluation. The effect of these restrictions has been dramatic. The *Global Settlement* has clearly created a marked shift away from proprietary research in favor of third-party research. The financial press reports a mass exodus of the most talented research analysts from full-service broker-dealers, who have set up private research shops tailored to providing money managers with all types of research. One industry publication reported that from 2000 to 2007, 9,300 (or 40 percent of) large brokerage house analysts left, and projected another one-third would do so by 2008. As a result, nearly 17 percent of publicly traded issuers lost their analyst coverage.<sup>44</sup> As *Fortune Magazine* put it,

Analyst pay has been slashed in half--or more. Highly paid stars have been ushered out the door, replaced by junior analysts. Most big research departments have shrunk by more than a third. But more profound changes are coming, because Wall Street research finds itself under a far graver threat than even Eliot Spitzer: Its business model is under assault. Dozens of new research boutiques have cropped up in recent years claiming to offer truly independent research.<sup>45</sup>

The year 2008 witnessed publication of the long-awaited *Rand Study*, which examined securities brokerage and investment advisory industries, especially as they are perceived by small retail investors.<sup>46</sup> The study's most important finding is that retail investors are confused about the legal status of the professionals to whom they entrust their money, the method by which these professionals are compensated and the associated conflicts of interest with this compensation.<sup>47</sup> Securities brokers have only limited duties to their clients, while investment advisers have full-blown fiduciary duties thought to provide investors with far better protection. Being paid a transaction-based commission rather than an asset-based fee, it is widely believed brokers face a conflict of

---

<sup>44</sup> Thomas D. Saler, *Rethinking Research*, *Barons Online*, January 22, 2007 (available at [http://online.barrons.com/article\\_print/SB116925398457082185.html](http://online.barrons.com/article_print/SB116925398457082185.html)).

<sup>45</sup> Joseph Nocera Reporter, Associate Abrahm Lustgarten, *Wall Street On The Run*, CNN Money, June 14, 2004 (available at [http://money.cnn.com/magazines/fortune/fortune\\_archive/2004/06/14/372633/index.htm](http://money.cnn.com/magazines/fortune/fortune_archive/2004/06/14/372633/index.htm)). See also Edward Robinson, *Research Renegades*, Bloomberg Market, Nov. 2009 at 32.

<sup>46</sup> Angela A. Hung, Noreen Clancy, Jeff Dornitz, Eric Talley, Claude Berrebi, and Farrukh Suvankulov, *Technical Report: Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*, Institute for Civil Justice, RAND Center for Corporate Ethics, Law, and Governance (RAND Corporation, 2008).

<sup>47</sup> The touted explanation for investor confusion is so-called asymmetric information. Investors, the *Study* concludes, lack the information necessary to assess the incentives of those to whom they entrust their wealth. An alternative explanation for apparent investor confusion between brokers and advisors is that at least some investors are well aware of the differences but that the differences are so inconsequential at the margin that it does not pay the average investor to gather the information to be informed.

---

interest that encourages them to “churn” their clients’ accounts to generate commissions. The looming regulatory issue is whether brokers should be subject to fiduciary duties that would greatly temper this tendency.<sup>48</sup> Industry reports express concern that brokers will “find themselves embroiled in far-flung lawsuits and arbitration hearings that no one in their right mind could envision, all under the banner of ‘breach of fiduciary duty’.”<sup>49</sup> Regulation to this effect appears imminent and will no doubt hasten brokers’ departure from bulge-bracket brokerage houses in favor of registering as independent investment advisers, which are compensated by asset-based fees.

As stated previously, approximately 90 percent of third-party equity research is paid for through client commissions. However in the fixed income market there is a misunderstanding. While remuneration on principal trades in fixed income securities is not allowed to pay for research under the safe harbor, a money manager can execute bond trades with a non-positioning broker-dealer on an agency or “certain riskless principal” basis. In either case, the commission or mark-up qualifies for the safe harbor. In reality, the reason broker-dealers prefer principal transactions more in fixed income securities than in equities is because most fixed income bonds have a coupon that normally earns a positive return for that positioning firm. To this day, a large number of money managers do not realize that paying for third-party research using fixed income trades is permissible because most fixed income broker-dealers engage in positioning and their trades are therefore ineligible for safe harbor protection.

---

<sup>48</sup> See Kathleen M. McBride, *FINRA’s Ketchum Speaks of Fiduciary Duty*, *Wealth Manager*, Oct. 28, 2009 (available at <http://www.wealthmanagerweb.com/News/2009/10/Pages/FINRAs-Ketchum-Speaks-of-Fiduciary-Duty.aspx>).

<sup>49</sup> See, e.g., David A. Genelly, *Fiduciary Duty for Brokers would Oppress, Not Protect*, October 18, 2009 6:01 am ET, *Investment News*, Oct. 18, 2009 (available at <http://www.investmentnews.com/article/20091018/REG/310189989>).

---

*F. The Current State of 28(e) under the SEC's 2006 Guidance*

In May 2004, the SEC requested the National Association of Securities Dealers (NASD) to form a task force to report and provide recommendations on how to “improve the transparency of mutual fund portfolio transaction costs and distribution arrangements.”<sup>50</sup> The NASD Task Force’s report appeared in November 2004.<sup>51</sup> Chaired by Robert R. Glauber and co-chaired by Mary Schapiro (current SEC Chairman), the *Report* concluded that “the safe harbor set forth in Section 28(e) of the Exchange Act should be preserved” and

that investors will be best served if research of all types, including both proprietary and third-party research, continues to be widely available to all investment managers. . . . [and] that soft dollar practices may be especially beneficial to the clients of smaller investment advisers. These smaller advisers can afford neither a large internal research staff nor extensive hard dollar payments for research. They can, however, supplement their internal research efforts through the use of soft dollar arrangements.<sup>52</sup>

For an increasing proportion of money managers, safe harbor protection appears essential to ensure they are not under-researched.

In 2006, the SEC issued its long-awaited release *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*.<sup>53</sup> The *2006 Guidance* reflects the SEC’s most recent and most definitive statement on the scope of the safe harbor. It makes a number of important points:

---

<sup>50</sup> (Nov. 11, 2004) [hereinafter *NASD Report*] (available at <http://www.nasd.com/web/groups/rules-regs/documents/rules-regs/nasdw-012356.pdf>.)

<sup>51</sup> NASD, (Nov. 11, 2004) [*NASD Report*] (available at <http://www.nasd.com/web/groups/rules-regs/documents/rules-regs/nasdw-012356.pdf>.)

<sup>52</sup> Report of the Mutual Fund Task Force, *Soft Dollars and Portfolio Transactions Costs*, Nov. 11, 2004; pg 4, Section D.

<sup>53</sup> *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*, Exchange Act Release No. 54165, 71 FR 41978 (July 24, 2006) [hereinafter *Guidance*].

- 
1. The safe harbor protects fixed income trades executed on an agency basis, as well as “certain riskless principal” trades as defined in the *2001 Guidance*.<sup>54</sup>
  2. To take advantage of the safe harbor, a money manager must be able to make a good faith determination that the amount of the commissions, mark-ups or fees is reasonable in relation to the value of the brokerage and research services provided by the broker-dealer.
  3. Even though proprietary research has always been implicitly bundled into client commissions rather than paid out of management fees, “the safe harbor encompasses third-party research and proprietary research on equal terms.” The language from Section 28(e) referring to eligible research as “advice, analysis and reports” therefore includes a broad array of research products and services consisting of, among other things, seminars, webinars, conferences, and specialty research beneficial to particular managed accounts that are not regularly available to the general public and are directly related to assisting a money manager’s investment decision making process. Consistent with the *1975 Senate Report*, these forms of research “are not an expense of management.”
  4. The specialties of different broker dealers must be reconciled with the money manager’s fiduciary duty of best execution. Under Section 28(e), “Commission Sharing Agreements” allow broker-dealers to share commissions, where one broker provides the research and another broker executes the trades. Splitting the commission between the brokers allows a money manager the freedom and flexibility to execute trades with a broker-dealer that has specialized trading capabilities while receiving research from another broker-dealer that has the commission management platform the manager prefers.
  5. The SEC modified its interpretation of what it means for research to be “provided by” a broker. The *1986 Guidance* stated that for research to qualify under Section 28(e) the broker-dealer had to be legally obligated to pay for that research. This severely restricted what research a broker-dealer could provide given the financial liability it had to take on its balance sheet. The obligation also posed conflicts of interest for a money manager

---

<sup>54</sup> *2006 SEC Guidance*, at 41980 Footnote 27. Managers may not use client funds to obtain brokerage and research services under the safe harbor in connection with fixed income trades that are not executed on an agency basis, principal trades (except for “certain riskless principal” trades) or other instruments traded net with on explicit commissions.

---

required either to do execution business with the broker providing the research or to lose access to that research if he or she failed to meet the minimum required trading levels set by the providing broker-dealer. In contrast, the *2006 Guidance* gives the money manager a wider choice of client commission arrangements with eligible broker-dealers and the flexibility to efficiently and effectively pick and choose what research is important to manage their client's funds. But the broker-dealer "providing" research must now meet a three-pronged test to be eligible to pay for the research without financial obligation.<sup>55</sup>

The requirements of this test are as follows:

- i. the broker-dealer pays the research preparer directly;
- ii. the broker-dealer reviews the description of the services to be paid for with client commissions under the safe harbor for red flags that indicate the services are not within Section 28(e), and agrees with the money manager to use client commissions only to pay for those items that reasonably fall within the safe harbor;
- iii. the broker-dealer develops and maintains procedures so that the research payments are documented and paid for promptly.

---

<sup>55</sup> The SEC's new interpretation states that safe harbor applies "in situations where broker-dealers use a money manager's client commissions to pay for eligible research and brokerage for which such broker-dealer is not directly obligated to pay if such broker-dealer pays the research preparer directly and takes steps to assure itself that the client commissions that the manager directs it to use to pay for such services are used only for eligible brokerage and research." *2006 SEC Guidance*, at 41994.

---

## USING BOND TRADES TO PAY FOR THIRD-PARTY RESEARCH

### IV. The Incentive Effects of Using Client Commissions to Pay for Research: Conflict or Cooperation?

This essay has already established that research adds alpha, as proxied by “active” management in the context of publicly-held equity mutual funds, and as proxied by premium commissions per managed dollar in the context of privately-managed retirement and other accounts. Money managers are increasingly shifting toward independent third-party research. The financial services industry is experiencing an influx of independent research firms, start-up investment advisers, rollovers from 401(k) accounts to personal pension accounts owing to baby boomer demographics, and a steady weighting towards fixed income securities. Finally, repeated SEC rulings indicate that using client commissions on fixed income agency and certain riskless principal trades to pay for research is covered by the safe harbor. This section shows that money managers’ access to client commissions properly motivates them to perform the research necessary to maximize the returns their retirement account clients earn. It provides further empirical evidence in support of this proposition.

Because money managers receive only a small fraction of the alpha they generate, they do not capture the full benefits of their costly research efforts.<sup>56</sup> If called on to pay for all research out of their management fee, money managers will be tempted to do too little research. So-called “closet indexing,” in which the manager charges a high fee for active (well researched) management but quietly follows a low-cost indexing strategy, is a notorious case in point. When a manager is paid a recurring asset-based fee of, say, 25 basis points, he or she receives only a small fraction of any gains generated through investment performance. It is quite natural that in this arrangement, and in other client-fiduciary settings, the client should want to subsidize a fiduciary’s use of research. Indeed, both the law of agency and the law of trusts allow the agent/trustee to deduct legitimate business expenses from the managed account without immediate client

---

<sup>56</sup> An asset-based fee consists of a recurring percentage of the value of the client’s account, often around 30 basis points. An “incentive” fee might consist of an asset-based fee plus or minus a larger share of alpha relative to a stated benchmark, with the money manager bearing a share of both positive and negative alpha within prescribed limits.

---

approval. Section 244 of the *Restatement Second of Trusts* states, for example, 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.”<sup>57</sup>

A. *The Client-Fiduciary Problem in Money Management*

1. Conventional Wisdom

Following the deregulation of fixed commissions, a number of commentators argued that soft dollars maligned managers’ incentives, leading them to churn the portfolio to generate additional brokerage commissions to pay the research bill they should instead pay out of their management fee. Others argued that soft dollars lead the manager to compromise execution quality out of a misplaced sense of loyalty to a providing broker whose execution quality is low.<sup>58</sup> This sentiment seems to have persisted over time and has become the conventional wisdom regarding the conflicts of interest client commissions pose for money managers. Lee Burgunder and Karl Hartmann (1986) reflect a commonly held sentiment when describing the conflicts which arise from using client commission in cost benefit terms. In their words:

In an environment without Section 28(e), research would be purchased until the last hard dollar spent for the research equalled [*sic*] the value of that research to the clients. Any additional research would benefit the clients less than its cost, and thus would be an unreasonable expenditure. Thus, if one argues that managers are more willing to buy additional research with soft dollars than they would using hard dollars, then one admits that the purchases are unreasonable in relation to their cost.<sup>59</sup>

---

<sup>57</sup> Comment (b) to Section 244 further illustrates this point. It states 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 property in discharging the liability, by repaying himself out of trust property.” *Restatement (Second) of Trusts* (1959).

<sup>58</sup> Dennis E. Logue, *Managing Corporate Pension Plans* 271 (1991).

<sup>59</sup> Lee B. Burgunder & Karl O. Hartmann, *Soft Dollars and Section 28(e) of the Securities Exchange Act of 1934: A 1985 Perspective*, 24 Am. Bus. L.J. 139, 176 (1986).

---

The sentiment conveyed by these and other commentators is no doubt the source of the SEC's continuing concern over the conflicts of interest thought to plague soft dollar brokerage.<sup>60</sup> Owing to their apparent ignorance of the simple economics of client-fiduciary relations, however, these commentators have made an entirely backward statement about the incentive effects of using client commissions to acquire research.

## 2. The Simple Economics of Client-Fiduciary Relations

A substantial body of scholarly literature in economics and finance addresses what is generically known as the “agency problem.” In law, an agency relationship exists any time someone, a principal, authorizes another person, the agent, to transact business on his or her behalf. Examples of agents include attorneys, realtors, accountants, money managers, and securities brokers. According to this literature, agents may not always act strictly in the interest of the principals, which lead to costly actions by both parties to reduce the associated inefficiencies. “Agency costs” consist of “monitoring costs” incurred by the principal, “bonding costs” incurred by the agent, and “residual losses.”<sup>61</sup> The law of agency and the law of trusts both prescribe default rules that determine the relationship between principals and their agents in the absence of specific agreements to the contrary. In many cases, the law imposes on an agent a fiduciary duty to the principal — that is, the duty of utmost good faith and fair dealing. The prospect of legal enforcement ex post reduces agency costs ex ante.

---

<sup>60</sup> It is commonplace to hear soft dollar critics proclaim that all conflicts of interest must be “eliminated.” This is an unworkable goal because conflicts, both specific and general, arise whenever a principal acts through a specialized agent, whom all parties recognize is self interested.

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. It is a breach of loyalty that gives rise to a legal claim against an agent, not the mere fact of a conflict of interest. Agents should, of course, make all reasonable efforts to inform their principals of the presence of specific conflicts of interest

<sup>61</sup> Michael C. Jensen and William H. Meckling, 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).

---

This is the legal setting in which investors, such as pension clients, contract with money managers for portfolio management. According to both the common law and statutory law, money managers owe their clients a fiduciary duty. In the context of money management, the client can limit the divergence of a manager's actions by establishing appropriate incentives, such as sharing profits or other benefits and providing the fiduciary with various inputs complementary to the production process. The client can also monitor the manager's compliance through performance standards, with the threat of termination, if the fiduciaries' actions prove sub-optimal. In some situations the client will pay the manager to spend resources bonding the manager against actions that would reduce the benefits of the relationship to the client. In many fiduciary relationships, the parties incur both monitoring and bonding costs. In addition, it is inevitable that some potentially beneficial exchange fails to occur that would have occurred absent agency costs. These are the residual losses. As long as residual losses persist, the parties have an interest in innovating new types of business arrangements to reduce them, that is, to increase the gains from trade.

The extensive literature on the economics of agency relations uniformly recognizes that fiduciaries, such as money managers, whose compensation is based on a fractional share of benefits to their clients, have too little incentive to produce gains for their clients if they are required to pay the entire expense of generating those benefits out of their own account. It is therefore in the client's interest to subsidize inputs that complement the manager's labor effort. The standard market-driven arrangement between money managers and their clients is to use client commissions to acquire research. The obvious alternative to using client commissions to pay for research would be to increase managers' compensation by the expected cost of such inputs and to require them to bear the research expenses directly. But unless the client (or clients) can effectively monitor their managers' to ensure managers are fully researched this would very likely lead managers to be inefficiently frugal. Following this logic, the primary concern money management clients should have 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 management fee.<sup>62</sup> Contrary to conventional wisdom, the critical conflict of interest is that money managers will spend too little on research, devote too little labor effort to identifying mispriced securities, and execute too few profitable trades.<sup>63</sup>

The efficiency of using client commissions to pay for research reduces the manager's tendency to shirk, as illustrated in Figure 4. 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  $\Delta NAV$ . 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  $MC = \Delta NAV$ , and total portfolio wealth is maximized. But because he receives only a small fractional share,  $\theta$ , of  $\Delta NAV$  he instead provides management inputs only up to  $M^\circ$ , where MC equals  $\theta \Delta NAV$ .<sup>64</sup> This outcome fails to maximize the parties' joint wealth because an additional dollar spent on research generates more than a dollar in  $\Delta NAV$ . Presumably the cost to clients from monitoring the manager to ensure he completely refrains from shirking are prohibitive. Burgunder & Hartmann are correct when they assert that using client commissions to acquire research leads managers to do more research than they would otherwise do. By failing to account for the manager's tendency to do too little research, however, the conclusion they draw — that managers will therefore use too much research — is simply wrong. No one familiar with the simple economics of agency relations could draw this conclusion.

By agreeing to pay brokerage commissions covering pure execution costs, the client 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 use brokerage

---

<sup>62</sup> 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.

<sup>63</sup> They may also engage in sub-optimal monitoring of execution quality, but the use of a quality-assuring performance bond reduces this problem.

<sup>64</sup> It is important to note that managers' share of the portfolio residual is substantially larger than their one-period management because they receive a recurring fee. Any permanent increase in portfolio wealth provides them with an increase in compensation equal to the present value of the increase in future fees.

---

commissions to acquire research, the client further reduces the manager's 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.<sup>65</sup> Managers earn no expected surplus as a result of the research subsidy because competition bids down fees to a level that exactly covers their expected opportunity costs. The important point regarding incentive alignment is that, at the margin, using client funds to pay for research adjusts the terms of exchange to encourage managers to do more research and more trading, which benefits portfolio investors.<sup>66</sup> According to the simple economics of agency relations, research can be expected to add alpha.

### *B. Empirical Tests*

The work by Horan & Johnsen (2008) discussed above examines the effects of client commission arrangements on investor welfare. Horan & Johnsen derive testable implications for what they call the incentive alignment and unjust enrichment hypotheses and use a large database of quarterly money manager portfolio returns from 1989 to 1997 to perform empirical tests.

#### 1. Theoretical Implications

One way to distinguish between the incentive alignment hypothesis and the unjust enrichment hypothesis is to examine the effect of paying up for research on management fees. Under the unjust enrichment hypothesis, using client commissions to acquire research constitutes a “second best” form of manager compensation. In a competitive managerial labor market at least a portion of the associated wealth transfer should be reflected in a lower management fee. Alternatively, if using client commissions to pay for research improves managers' and brokers' incentives when other mechanisms fail,

---

<sup>65</sup> 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.

<sup>66</sup> Dennis E. Logue, *Managing Corporate Pension Plans* 271 (1991).

---

management fees should be either unrelated or positively related to using client commissions to pay for research under the plausible assumption that managers collectively share in the gains from an efficient economic organization.

The most obvious way to distinguish between the two hypotheses is to examine the effect of paying up for research on risk-adjusted returns. The incentive alignment hypothesis predicts that using client commissions to acquire research leads to higher risk-adjusted returns as a result of the manager's increased use of research, labor effort, and brokerage executions. The unjust enrichment hypothesis predicts that using client commissions to pay for research will result in lower risk-adjusted returns because the cost of the premium commissions from misappropriating client assets exceeds the value to the portfolio of improved research and execution and any reduction in the management fee.

## 2. Empirical Effects

Horan & Johnsen (2006) calculate each portfolio manager's risk adjusted returns (alpha) using various models, including Jensen's one-factor model. The results are unchanged across the various specifications. Performing a number of robustness checks, and using multivariate regression analysis to adjust for the effects of total portfolio assets, number of accounts, tax-exempt assets, indexing, and trade difficulty as reflected in various style categories, they find that PCMD — their proxy for the use of client commissions to pay for research — is positively associated with risk-adjusted returns at the 99% confidence level. Since risk-adjusted returns are net of commissions (and other transaction costs), using client commissions clearly appears to provide a net benefit to those clients. As seen in Table 1, for a typical manager having 50 percent annual turnover, increasing the average commission rate by 1.0 cents per share to acquire research increases alpha by 4.3 basis points per quarter.

Consistent with Wermers (2000), the above results suggest that indexed portfolios under-perform their actively managed counterparts both in the presence or absence of other strategy class control variables. Moreover, portfolios with a high proportion of pension assets have relatively low returns compared to portfolios with non-pension

---

assets, which is consistent with evidence presented by Ambachtsheer (1994).<sup>67</sup> One reason for this might be that pension portfolios are more heavily weighted toward fixed income securities than non-pension portfolios. These results are inconsistent with the unjust enrichment hypothesis but fail to reject the incentive alignment hypothesis.

Horan & Johnsen (2006) find that management fees expressed in basis points for various account sizes appear unrelated to the use of client commissions to acquire research, regardless of account size. Fees tend to increase with past performance, suggesting that managers who recently reported positive risk-adjusted returns gain the power to bargain for higher fees. Although the estimated coefficients on alpha are statistically insignificant, their significance increases with account size, and the expected negative relation between indexing and management fees is clear. Horan & Johnsen find that the relation between using client commission and management fees is generally positive and statistically significant for large accounts. A typical manager of a \$100 million account having 50 percent annual turnover who pays an extra 2 cents per share in brokerage commissions to obtain research is able to charge an extra 1.05 basis points in management fees. It appears that managers do not accept lower management fees in an attempt to unjustly enrich themselves through client commission arrangements. Rather, investors appear to reward managers that use client commissions to acquire research with slightly higher management fees or, at least they do not appear to punish the practice. These results withstand various robustness checks and are consistent with the incentive alignment hypothesis but inconsistent with the unjust enrichment hypothesis.

---

<sup>67</sup> See K.P. Ambachtsheer, *The Economics of Pension Fund Management*, 50 *Financial Analysts Journal* 21 (1994).

---

## USING BOND TRADES TO PAY FOR THIRD-PARTY RESEARCH

### V. Summary and Concluding Remarks

This essay has made several novel and important points regarding money managers' use of client commissions to obtain fixed income research. *First*, the prevailing evidence shows that research adds alpha, both in the context of public mutual fund management and in the context of private institutional money management. *Second*, allowing money managers to acquire research using client commissions efficiently incentivizes the managers to be fully researched. *Third*, top analysts have departed bulge-bracket banks to set up private research shops providing independent third-party research, while many established brokers are departing to set up their own RIA firms, undoubtedly bringing much of their established client base with them. *Fourth*, as baby boomers near retirement, they will increasingly weight their portfolios toward fixed income securities and away from equities. Their actual retirement will bring a wave of rollovers from 401(k) plans to personal pension accounts. Much of this money will likely find its way into the hands of startup RIA's who lack established research departments. *Fifth*, the SEC has affirmatively stated that money managers' receipt of research using agency and certain riskless principal trades is protected by Section 28(e)'s safe harbor. Safe harbor protection on bond trades is clearly eligible when using a non-positioning, fixed-income broker acting as an agent on behalf of the money manager's clients. *Finally*, client commission arrangements on fixed income trades will allow money managers to obtain the research necessary to fulfill fiduciary obligations to their client-investors by increasing alpha while maintaining suitably low portfolio risk for retired investors.

Money managers have a fiduciary duty to be fully researched, as reflected by  $M^*$  units of management in Figure 4. Given the research subsidy inherent in using client commissions to acquire research, the possibility remains that managers use too much research, perhaps going beyond  $M^*$ . If the manager receives third-party research in the form of generic inputs, he or she has little to gain from overuse, however, because generic research has no intrinsic value unless the manager provides his own labor effort to transform it into conclusions regarding profitable trading opportunities. From this

---

perspective, it may be that managers overuse *proprietary* research. With proprietary research the *broker* provides the labor effort to identify mispriced securities, thereby allowing the manager to conserve his or her own labor effort. This suggests yet another possible conflict of interest.

Several commentators have suggested that a manager's failure to be fully researched might subject him or her to civil suits for a breach of fiduciary duty under certain circumstances. Recent developments in Delaware State corporation law suggest, for example, that its courts are increasingly willing to impose liability on corporate fiduciaries for omissions, that is, for failure to act in the face of an affirmative duty to do so.<sup>68</sup> As Lemke & Lins describe in the context of money management,

Some in the industry have raised the possibility that it could be a breach of fiduciary duty for a money manager *not* to take advantage of the wide variety of brokerage or research services made available with [client commissions]. . . . '[And] some money managers have expressed concern about being sued for paying up for research . . . . It appears they should be more concerned about being sued for acting imprudently if they deliberately cut themselves off from street research or refuse to pay up for other needed brokerage services to the detriment of the accounts they manage.'<sup>69</sup>

Being under-researched could be an especially troublesome prospect for the new wave of RIA's migrating away from their former positions as brokers in bulge-bracket banks, especially if poor performance can be causally linked to a failure to employ research inputs widely regarded as prudent by industry standards. Lacking established research departments, it is essential that smaller management operations use all available resources within their obligation of prudence and existing law to obtain the research necessary to benefit their clients.

---

<sup>68</sup> See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858 (Supreme Court of Delaware, 1985)(holding corporate directors in a control transaction liable for gross negligence in failing to inform themselves of alternative buyers); *In re Caremark Intl. Inc.*, 698 A.2d 959 (Del. Chancery Ct., 1986)(Chancellor Allen: "the core element of any corporate law duty of care inquiry [is] whether there was good faith effort to be informed and exercise judgment. . . . Liability for failure to monitor . . . is theoretically possible [in] circumstances in which a loss eventuates not from a decision but, from unconsidered inaction."); *Stone v. Ridder*, 911 A.2d 362 (Del. S. Ct., 2006)("A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, . . . or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." J. Holland quoting *Brehm v. Eisner* (In re Walt Disney Co. Derivative Litig.), 906 A.2d 27 (2006).

<sup>69</sup> Thomas P. Lemke and Gerald T. Lins, *Soft Dollars and other Brokerage Arrangements 2008-2009 Edition*, Securities Law Handbook Series (Thomson Reuters/West, 2009), at 120.

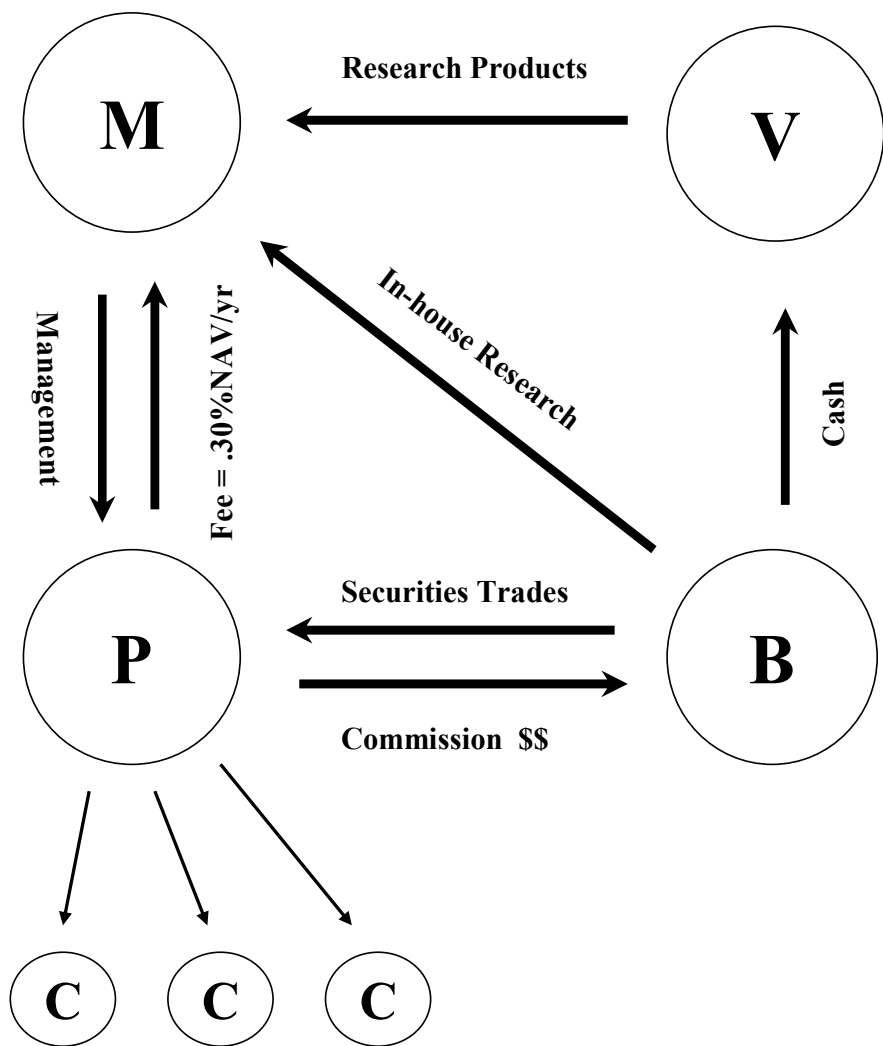


Figure 1: Relations  
Between the Parties

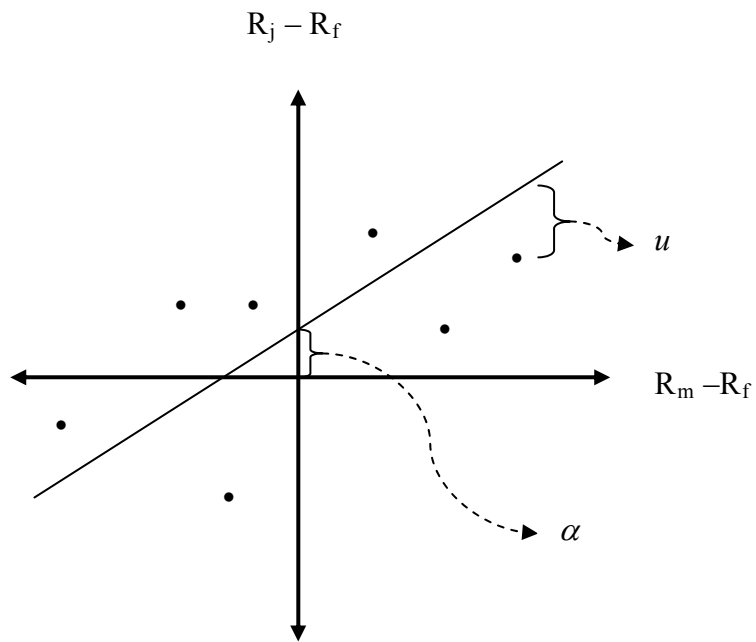
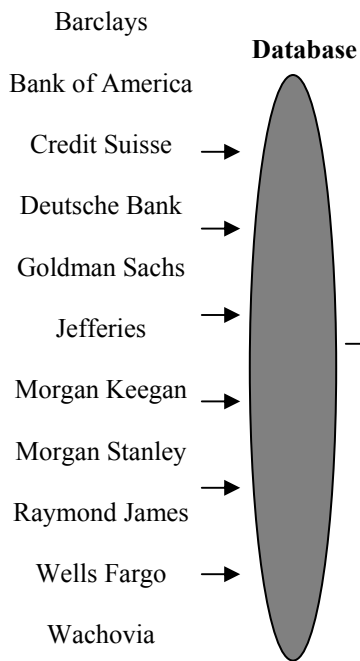


Figure 2: Regression Line

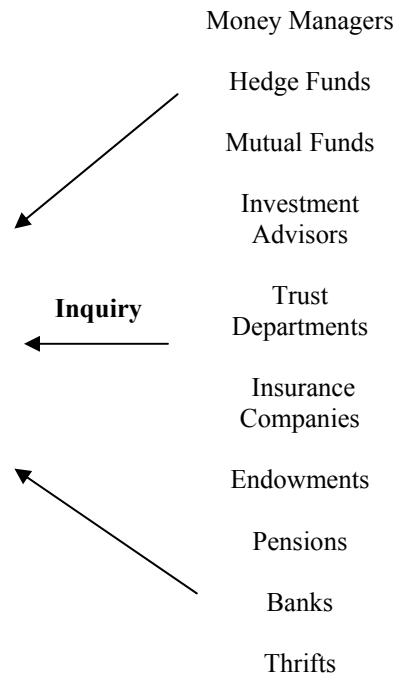
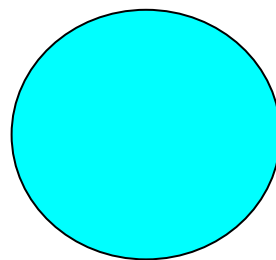
**SUPPLIERS**



Over 70 broker/dealers

**CUSTOMERS**

**DISTRIBUTOR**



Over 1500 Institutional Clients

Figure 3: Bond Distribution

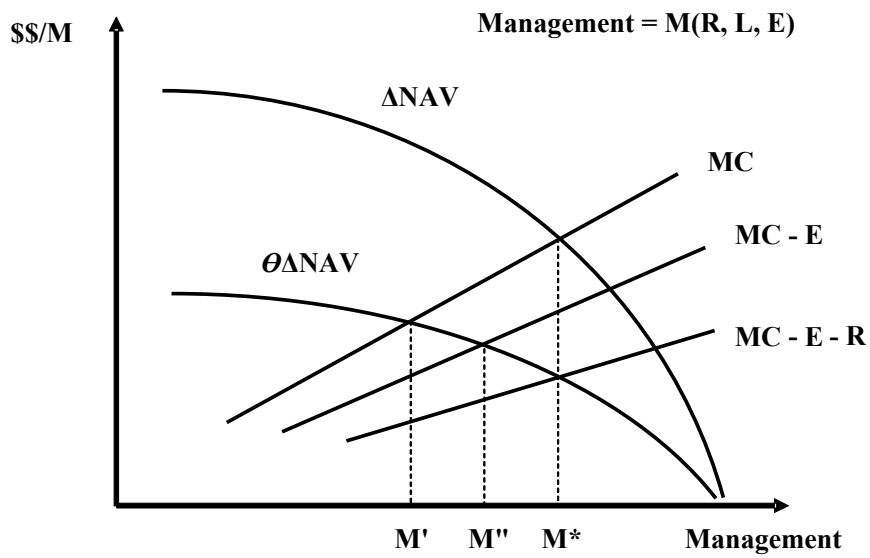


Figure 4: The Agency Problem in Delegated Portfolio Management

Table 1: The Effect of Soft Dollars on Performance

	<i>Estimated alpha from Fama and French (1993) OLS regressions</i>		
Intercept	0.675***	0.928	.905***
Premium Commissions per Managed Dollar	0.043***		
Premium Commissions per Managed Dollar Residual		0.036***	0.023***
Ln (Assets)		0.010	0.002
Ln (Accounts)		0.019	0.037**
% Tax-exempt assets		-0.256***	-0.200**
Value			-0.104***
Growth			0.119***
Small Capitalization			0.186***
Broad Market			-0.035
Market Timer			-0.011
Sector Rotator			-0.056
Index		-0.247***	-0.198***
Contrarian			-0.075**
Theme Selection			0.048
Defensive			-0.054
Core			-0.095***
Mutual Fund Timing			-0.382***
N	1038	1038	1038
F-value	35.62***	15.33***	21.93***
Adj. R-squared	.03	.06	.24

Note -- Intercepts from OLS regressions of equity and cash quarterly portfolio excess returns on the Fama and French (1993) benchmarks,  $R_{it} - r_{ft} = \alpha_i + b_i(R_{mt} - r_{ft}) + s_iSMB_t + h_iHML_t + \varepsilon_{it}$ . Specifically, *MKT*, *SMB*, and *HML* capture the market effect, firm size effect, and book-to-market effect in security returns, respectively. Portfolio returns are taken from data provided by Mobius Group, Inc. and cover the 1979 through 1997 first quarter period. To be included in the analysis, a portfolio must have at least 12 quarterly returns in the database. The product of Soft Dollar Commission and Annual Turnover is Premium Commissions per Managed Dollar. Ln (Assets) is the natural log of portfolio assets. Ln (Accounts) is the natural log of the number of accounts managed. The Index variable and other strategy class variables are measured on a discrete scale of 0 to 3. Three is descriptive of the fund's strategy, while zero is not descriptive. Percent tax-exempt assets is the proportion of the portfolio composed of pension assets. To avoid colinearity, the Premium Commissions per Managed Dollar Residual term is the OLS residual from having Premium Commissions per Managed Dollar as the dependent variable and all other factors as independent variables. The residual term represents the portion of soft dollar brokerage left unexplained by the remaining independent variables.

\*Significant at the 10% level.

\*\*Significant at the 5% level.

\*\*\*Significant at the 1% level.