

## RESEARCH-COMMISSION, OR SOFT DOLLAR, ARRANGEMENTS

### **WHAT ARE SOFT DOLLAR ARRANGEMENTS?**

- ***Soft dollar, or research-commission, practices are arrangements where commission dollars are used to pay for both research and trade execution services.*** The investment advisor or fiduciary selects the brokers and other service providers to provide execution and research services. Brokers providing soft dollar services disclose in statements to the adviser both the value of the execution and research services delivered. Enacted in 1975, Section 28(e) of the Securities Exchange Act provides a safe harbor for an investment manager to pay more than the lowest amount of commission for brokerage and research services.

### **RECENT HISTORY**

- In July 2006, the Securities and Exchange Commission (SEC) issued an Interpretative Release that provides guidance on money managers' use of soft dollars to pay for brokerage and research services under the safe harbor of Section 28(e) of the Securities Exchange Act. The guidance clarified the scope of brokerage and research services permissible in client commission (soft dollar) arrangements. The SEC's Investment Management Division had also been examining whether more SEC guidance should be provided regarding improvements in the disclosure and documentation of soft dollar arrangements.
- On May 17, SEC Chairman Chris Cox sent a letter to Senate Banking Committee Chairman Chris Dodd (D-CT) and House Financial Services Committee Chairman Barney Frank (D-MA) calling on Congress to consider repealing or significantly revising Section 28(e), thereby prohibiting or restricting the use of soft dollar transactions.

### **POLICY POINTS AND BENEFITS**

- ***Soft dollars are an important mechanism to foster a greater range of research alternatives.*** Soft dollar arrangements provide managers more choices, allowing a wealth of research, including independent research, to be provided and assist managers in the investment decision-making process. Research is essential to the development of effective investment strategies, with superior information leading to superior returns.
- ***Soft dollar arrangements enhance competition among fund managers.*** Research-commission arrangements lower barriers to entry for smaller fund managers, allowing them to better compete with larger fund managers who may, due to their large scale, be able to finance their own in-house research. The increased barrier to entry created by eliminating

Section 28(e) would benefit large and more established mutual funds at the expense of small, new, or boutique fund managers, decreasing choice for small investors in mutual funds.

- ***Soft dollar arrangements enhance competition among research providers.*** The use of soft dollars allows independent research providers to compete with in-house research, resulting in more research choices for asset managers, coverage of more stocks, and more innovative research products. If Section 28(e) were to be repealed, large brokerages which have deep distribution channels would be in a position to more cost effectively convey their research to clients, while independent research producers, who are generally more innovative, would either have to develop their own distribution channels or exit the marketplace. Either result would lessen access to research and reduce innovation and investor choice.
- ***Less than one year after SEC action, the industry is again faced with regulatory uncertainty.*** The SEC completed a multi-year review of research-commission arrangements in July 2006, issuing an Interpretative Release providing clarification on the scope of permissible brokerage and research services. At the same time, the SEC had promised further guidance on improved disclosure of soft dollars. Less than a year after the long-awaited guidance that provided regulatory certainty, the industry is again faced with more uncertainty on the very same issues that were resolved last year.
- ***The industry supports further SEC guidance on disclosure practices.*** While brokers providing soft dollar services disclose in statements to the adviser both the value of the execution and research services delivered, more guidance is anticipated and welcomed by industry to ensure consistent disclosure and transparency of such arrangements. More robust disclosure could accomplish the goal of transparency with minimal incremental costs to the current disclosure regime. It is not clear whether the SEC has or has plans to conduct a cost-benefit analysis if repeal or major changes to Section 28(e) are recommended. Additionally, maintaining the Section 28(e) safe harbor along with improved disclosure would keep the U.S. soft dollar regulatory regime consistent with that of the U.K.'s Financial Services Authority.
- ***If there are abuses of soft dollar practices, they should invite SEC enforcement action rather than repeal of Section 28(e).*** Abuses of soft dollar arrangements are outside the scope of Section 28(e) of the Securities Exchange Act and are subject to enforcement. Abuses should be addressed through SEC enforcement action rather than using the blunt instrument of repealing 28(e).
- ***Soft Dollar arrangements may lessen conflicts of interest.*** If soft dollar arrangements are paid for by a management fee rather than by investor commissions, active fund managers would likely attempt to cut costs by purchasing less research. The resulting impact would be the perverse incentive for such managers to use a “closet indexing” investment approach (the utilization of a strategy of indexing that is undisclosed), while continuing to charge the same, or higher, management fee.<sup>1</sup> Soft dollars assist in helping to provide excellence in stock selection and trade timing and do not impact the obligation of fund advisers and broker-

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<sup>1</sup> D. Bruce Johnsen, “Hard Facts on Soft Dollars,” *Barron's*, March 15, 2004.

dealers to achieve best execution with respect to price, cost, speed of execution and market impact. Additionally, these soft dollar services can only be used for the benefit of the investment decision-making process. Money managers may pay higher transaction fees by using soft dollar arrangements, but under such arrangements they are paying for more than the basic transaction (i.e. the money manager is receiving research that should enhance the client's return).

- ***Elimination of Soft Dollar Safe Harbor may increase litigation.*** The repeal of Section 28(e) would likely lead to an increase in lawsuits alleging a breach of fiduciary obligation as money managers could be subject to lawsuits if they choose to pay more than (or “pay up”) the lowest available commission to obtain execution services. In 1975, Congress added Section 28(e) to the Securities Exchange Act for the very purpose of providing an investment manager with a safe harbor from State or Federal law that would otherwise deem “paying up” an unlawful action or a breach of fiduciary duty. Paying up for execution and/or research services can be beneficial to the investor if receiving superior execution or research services.

