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Rethinking Brokerage Rebate Arrangements: The Case for Collective Cash Pass-through Arrangements

Joseph A. Franco

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Rethinking Brokerage Rebate Arrangements: The Case for Collective Cash Pass-Through Arrangements

Joseph A. Franco*

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I. INTRODUCTION

If advisory clients are to realize the full benefits from the allocation of brokerage on their accounts, then regulatory policy towards brokerage rebate arrangements must be rethought. Rebate practices known as soft dollar arrangements typically directly benefit investment advisers by providing them with research services, but benefit their advisory clients only indirectly, if at all. Other customer-directed rebate arrangements benefit advisory clients directly, but generally are too cumbersome and expensive for most advisory clients to administer. To directly and efficiently benefit all advisory clients a third type of arrangement — collective cash pass-through rebates administered by investment advisers on behalf of clients — should be encouraged by the elimination of existing legal and practical obstacles. The resulting benefits would be three-fold: (i) the conflicts of interest that affect many other rebate arrangements would be avoided; (ii) the decision to obtain services priced using a rebate would be separated from decisions regarding use of rebate proceeds; and (iii) competition in the provision of execution, research and brokerage services would be enhanced by the availability of more transparent brokerage rebate arrangements.

A. THE SOFT DOLLAR DEBATE

Soft dollar arrangements refer to business arrangements in which an investment adviser or money manager obtains either an explicit or implicit rebate in the form of products or services from a broker-dealer based on commissions the broker earns in executing trades for accounts managed by the adviser.¹ Under existing law, rebates obtained in this

¹ Although the safe harbor for soft dollar arrangements found in section 28(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb(e)(1999), ("section 28(e)" or "section 28(e) safe harbor"), establishes conditions which, if satisfied, entitle the arrangement to safe harbor treatment, soft dollar arrangements themselves are not defined under the federal securities laws. Nevertheless there is a rough consensus among regulators and industry participants regarding a generic definition. See, e.g., THE OFFICE OF COMPLIANCE, INSPECTIONS AND
fashion are generally not subject to legal challenge, provided that the rebate is not earned by causing advisory clients to pay unreasonably excessive commissions and that the rebate consists only of research or brokerage services or other forms of soft dollar benefits rather than cash (so-called hard dollars). These conditions are codified as part of the safe harbor found in section 28(e) of the Securities Exchange Act of 1934 ("section 28(e)" or "section 28(e) safe harbor").

2 See 15 U.S.C. § 78bb(e) (1999). It is easy to confuse the relationship between the generic definition of soft dollars and soft dollar arrangements that technically comply with the safe harbor of section 28(e)(1). As discussed below, compliant soft dollar arrangements are limited to arrangements involving research and brokerage services as defined in section 28(e)(3). In this article, soft dollar arrangement will be used generically to encompass compliant and non-compliant soft dollar arrangements, unless specifically referring to section 28(e).
Soft dollar arrangements, including those within the safe harbor, have always been viewed guardedly. Although widely employed in the securities industry, such arrangements entail the potential for significant conflicts between the interests of investment advisers and the clients on whose behalf advisers exercise investment discretion. The source of conflict derives from the fact that an investment adviser, while acting in an agency capacity for its client, generally derives a direct benefit from the soft dollar arrangement, which the client as principal shares, if at all, only indirectly. The obvious risk of conflicted loyalty in this situation accounts for the existence of various restrictions under federal and state laws on rebate practices that do not comply with the safe harbor. The conditions of the safe harbor, however, do not themselves eliminate the possibility of conflicted loyalty but merely ensure that such risks are confined within acceptable bounds.

Debate regarding the merits of soft dollar arrangements has involved two well-defined camps. Critics argue that the practices are injurious to the interests of advisory clients and such practices persist only because they serve the interests of brokers and investment advisers. In other words, such practices allow the adviser to retain profits, earned directly or indirectly at the expense of its clients. A related line of criticism is the inherent complexity and heavy transaction costs associated with negotiating and maintaining such arrangements. Soft dollar practices

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thrive in the view of critics only because such practices enrich investment advisers.

Proponents of the current soft dollar regulatory scheme offer a benign explanation for such practices. The research and brokerage services received by investment advisers pursuant to soft dollar arrangements indirectly benefit the advisers' clients. Moreover, prohibiting rebate schemes entirely would not guarantee a reduction in commission rates. According to proponents, the complexity of soft dollar arrangements reflects the difficulties of pricing brokerage services. Thus, for proponents, soft dollar arrangements promote market efficiency by permitting advisers to deliver higher quality services to clients on a cost-effective basis.

Soft dollars remain a frustrating regulatory issue because there is no method that can determine with certainty which of these two views is correct. Indeed, it is quite conceivable that many soft dollar arrangements support elements of both views and it may not be possible to generalize beyond the facts and circumstances of any particular arrangement. The inability to ascertain with precision the benefits or harms of soft dollar arrangements for advisory clients poses a significant challenge to effective policy formulation.

Repeal of section 28(e), advocated by critics of soft dollar arrangements, would significantly disrupt industry brokerage practices, would entail uncertainty for brokers and investment advisers and would have undetermined consequences for advisory clients. Absent evidence that

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5 The leading treatise in the area provides a catalogue of the well-rehearsed advantages and disadvantages of soft dollar arrangements. See Lemke & Lins, supra note 1, at 15-32. The catalogue evidences the conflicting and unresolved policy considerations associated with such arrangements.
soft dollar arrangements are in fact injurious to investors, it is difficult to imagine mustering the necessary consensus to proscribe them. On the other hand, continuation of existing regulatory policy — as proponents of such practices urge — would perpetuate the status quo (with an industry trend toward increased use of brokerage rebate arrangements), notwithstanding significant reservations regarding the benefit of such rebate arrangements for advisory clients generally.

Over the last two years, there has been a flurry of activity relating to soft dollar arrangements. Most notably, the staff of the Securities and Exchange Commission (“SEC”) undertook a major examination of industry practice with respect to soft dollar rebates and issued a report of its findings and recommendations. In addition, the Department of Labor’s ERISA Advisory Council on Employee Welfare and Pension Benefit Plans formed its own Soft Dollar and Directed Brokerage Working Group (the “DOL Advisory Group”) to evaluate the need for additional regulation of pension plan sponsors and fiduciaries in the area of rebate arrangements. Finally,
two industry groups — the Association for Investment Management and Research and the Securities Industry Association — formed working groups to examine practices in the area and to formulate recommendations regarding so-called “best practices” to foster high standards of commercial conduct.8 While each of the reports provides varying degrees of insight into ways of fostering better compliance by investment advisers and pension plan sponsors with existing regulatory restrictions, these reports (with the exception perhaps of the DOL Advisory Group) do not purport to address the larger issue of the soundness of the regulatory scheme or its coherence.

B. THE NEED FOR ALTERNATIVE REBATE ARRANGEMENTS

This article advocates a new approach toward brokerage rebate arrangements that places primary emphasis on facilitating competition with respect to rebate practices and greater choice for advisory clients. Increased competition would promote more efficient rebate arrangements by enabling advisory clients to exercise more influence over the types of rebate arrangements offered by broker-dealers and selected by investment advisers.

The argument for increased competition, including elimination of legal and practical impediments to certain rebate arrangements rests on three propositions. First, economic considerations suggest that the current policy concerning rebate practices is unduly restrictive and fails

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8 See 1997 AIMR SOFT DOLLAR GUIDELINES, supra note 1; 1997 SIA SOFT DOLLAR STANDARDS, supra note 1. Because both industry groups represent constituencies that regularly employ soft dollar arrangements, it is perhaps unsurprising that neither challenges the existing status quo. Rather each group’s “best practices” standards seek to avoid common legal pitfalls in entering into soft dollar arrangements. These standards emphasize procedures aimed principally at avoiding liability. They do not assess the continued wisdom of such practices.
to address the underlying economic factors that contribute to the use of rebate arrangements. Second, current legal policy toward soft dollars and directed brokerage lacks a coherent overarching rationale. Finally, the removal of legal obstacles to competing forms of rebate arrangements — in particular restrictions that discourage pass-through cash rebates administered on a collective basis — would likely facilitate more efficient rebate practices.

There are existing brokerage rebate arrangements that compete with soft dollar arrangements. The primary form of competing rebate arrangement involves customer directed brokerage where an investment adviser directs a client's brokerage transactions to a broker selected by the client. The advisory client, not the investment adviser, receives any rebate on the brokerage transaction. However, the competition provided by client directed brokerage arrangements to soft dollar arrangements is limited by the complexity and cost of administering client directed brokerage arrangements on an account-by-account basis. Therefore, to provide effective competition for soft dollar arrangements, another more efficient type of arrangement is needed. This article sets forth the argument for one such arrangement, a cash pass-through arrangement administered collectively for all or some of an investment adviser's managed accounts.

Section II of the article reviews the history of the section 28(e) safe harbor and the legal restrictions that apply to brokerage rebate practices not covered by the safe harbor, and discusses the confusion inherent in the legislative intent underlying section 28(e). Many of the historical reasons advanced for enacting section 28(e), which may have been valid in 1975, are no longer valid. More importantly, the drafters of the safe harbor largely failed to anticipate the way in which rebate practices would evolve.

Section III provides an overview of the two principal kinds of brokerage rebate practices used today and their role in defining competition between different categories of brokerage firms.
Section IV explores the economics of brokerage rebate arrangements and salient policy issues. Two underlying economic considerations have fueled the use of rebate arrangements generally (both soft dollar and customer directed rebate arrangements): the agency relationship between the investment adviser and its client and competition among brokers for order flow from managed accounts. There is an inherent divergence between the economic interests of adviser and advisory client when it comes to the issue of rebates. The different competitive strategies brokers have used in catering to these interests have led to the emergence of different kinds of brokers that compete for order flow from advisers and their clients' accounts. These strategies differ in terms of execution quality, how brokerage execution is bundled with research, the type of research services offered advisers and commission rates. Each strategy has potential advantages and disadvantages for advisory clients.

Section V examines flaws in the current regulatory system governing soft dollar arrangements. The continued application of the sometimes arbitrary distinctions in section 28(e) to market circumstances that have radically changed since 1975 has rendered the provision's operation increasingly capricious. The infirmities of current policy are evident in SEC interpretations that define eligible conduct and practices under the safe harbor. In some cases the SEC conduct interpretations reflect economic considerations. In other cases the interpretations are narrowly drawn and appear to lack an overarching policy rationale.

In contrast, the SEC disclosure policies with respect to rebate practices described in Section VI exhibit a more consistent philosophy, namely to ensure that advisory clients receive meaningful disclosure from investment advisers regarding the advisers' use of rebate arrangements. These disclosure policies have enabled clients to become better informed regarding the nature of the practices employed by their investment advisers. However, because of the significant transaction costs faced
by clients in monitoring rebate arrangements and the relative dearth of competitive alternatives, improved disclosure has not translated into genuinely efficient rebate practices.

Section VII describes a new form of rebate arrangement to benefit advisory clients, a cash pass-through arrangement administered collectively for an investment adviser's managed accounts. A collective cash pass-through arrangement should be more commercially feasible than pass-through arrangements administered on an account-by-account basis. Collective arrangements, however, would face legal and operational obstacles that do not exist for arrangements involving individual accounts, specifically: (i) devising a legal standard that reconciles the pass-through arrangement with best execution obligations; (ii) ensuring fair allocation of pass-through benefits among managed accounts (a collective pass-through arrangement would permit a managed account's fiduciary to make brokerage allocation decisions based on rebates jointly shared by the investment adviser's managed accounts); and (iii) designing a mechanism to serve as a conduit for payment of pass-through rebates. This article argues that these obstacles can be overcome.

Section VIII argues that public policy favors regulatory steps to encourage such rebate arrangements. Collective cash pass-through arrangements offer advantages for advisory clients over both soft dollar and customer directed brokerage arrangements in that the rebate will directly benefit advisory clients while preserving the investment adviser's discretion in directing brokerage allocation. A collective pass-through rebate would also dramatically reduce the transaction costs associated with monitoring and evaluating rebate practices and make commission rates and the costs of research and brokerage services more transparent. A concomitant benefit of permitting pass-through cash rebates is that it would encourage price competition in the securities industry by
creating favorable market conditions for unbundling the delivery of execution and research services.

II. THE REBATE CONTROVERSY AND THE ORIGINS OF THE SOFT DOLLAR SAFE HARBOR

Regulation of soft dollar arrangements has been shaped by two underlying forces: traditional agency law concepts and the events leading up to and including both the deregulation of brokerage commissions in 1975 and the near-simultaneous enactment of section 28(e). A body of federal and state law restrictions, grounded in traditional agency law principles, generally prohibits receipt of rebates by advisers with respect to client brokerage commissions. As part of the Securities Acts Amendments of 1975, however, Congress enacted a new provision under the Securities Exchange Act — section 28(e). This new provision addressed statutorily for the first time the issue of soft dollar arrangements by creating a safe harbor with respect to certain soft dollar practices and granting the SEC additional specific rule-making authority to regulate disclosure in connection with such arrangements.

A. FIDUCIARY ISSUES

An investment adviser acts in a fiduciary capacity on behalf of its advisory clients. An adviser's fiduciary duty to a client when acting in a discretionary capacity (that is with authority to purchase and sell securities for the client's account) involves not only making investment decisions, but also arranging for the execution of securities transactions. Arranging for securities transactions typically entails directing or allocating

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brokerage to a broker-dealer and monitoring the quality of the execution provided by the broker-dealer.\textsuperscript{11}

An investment adviser's receipt of rebates in connection with its decisions directing brokerage involves an inherent conflict of interest. When rebates are provided to an adviser, a question arises as to whether the investment adviser is exercising its discretion solely in the client's best interests. Under common law agency principles, the adviser's retention of a rebate earned from client transactions can be viewed as a form of unjust enrichment, a transfer of property from the client's account to the adviser (acting as agent).\textsuperscript{12}

Rebates represent not merely an appropriation of the client's property, but also may serve to potentially distort an investment adviser's judgment in directing brokerage on behalf of the client. An adviser should direct brokerage to the broker-dealer that will provide the best execution for a client's trades.\textsuperscript{13} The rebate, however, may skew an

\textsuperscript{11} See Sinclair v. SEC, 444 F.2d 399 (2d Cir. 1971); Arleen Hughes, 27 S.E.C. 629, 639 (1948), aff'd, 174 F.2d 969 (D.C. Cir. 1949). Alternatively, arranging for securities transactions may involve directing an account to trade securities at a markup or markdown with a dealer, transactions not covered by the section 28(e) safe harbor.


adviser’s decision in selecting a broker by inducing the adviser to direct a trade to a particular broker in order to receive the rebate, even if the broker will not provide best execution of the client’s transaction as compared to other brokers.

Rebates may also distort an investment adviser’s decision regarding timing of trades in a particular account. An adviser, all things being equal, is more likely to favor trading by the client, if as a result the adviser obtains a rebate. In abusive situations, the incentives provided by rebates might be conducive to churning — excessive trading designed principally to obtain the rebate.¹⁴ In most conventional soft dollar rebate arrangements (arrangements for research or brokerage services), however, churning as an exclusive factor motivating an ongoing pattern of trading in one account may be rare since the form of rebate only indirectly adds to an investment adviser’s wealth.¹⁵

B. SPECIFIC LEGAL RESTRICTIONS ON REBATE PRACTICES

Because of the conflicts of interest inherent in the receipt of brokerage rebates on client accounts by investment advisers, the receipt of such rebates potentially violates provisions of both federal and state law. The
elimination of fixed commissions in 1975 followed by the enactment of Securities Exchange Act section 28(e) modified the legal environment for brokerage rebates but the basic prohibitions summarized below remain in place.

Arrangements pursuant to which investment advisers receive rebates may violate provisions of the Investment Advisers Act of 1940, the Investment Company Act of 1940 (if the arrangement involves assets of investment companies) and the Employee Retirement Income Security Act of 1974 (ERISA) (if the arrangement involves assets of an employee retirement or pension plan), as well as state fiduciary law requirements. The various types of legal restrictions can be divided into two basic categories: general fiduciary restrictions and express statutory obligations imposed on fiduciaries of specific classes of managed accounts.

The general fiduciary restrictions arise under the Investment Advisers Act, which regulates the activities of investment advisers, and state law. Section 206 of the Investment Advisers Act prohibits fraudulent conduct by investment advisers as well as conduct in breach of fiduciary obligations. An undisclosed conflict of interest constitutes breach of the adviser's fiduciary obligations to its clients. Because soft dollar arrangements invariably present conflicts of interest between an adviser and its client, the SEC has sanctioned advisers for violating section 206 where the advisers have received undisclosed soft dollar rebates in arrangements that do not qualify for section 28(e)'s safe harbor. State common law fiduciary

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restrictions may be viewed as imposing restrictions similar to section 206 of the Investment Advisers Act on rebates obtained by advisers for directing client brokerage.\textsuperscript{22}

The other category of restrictions relating to rebates concern express statutory obligations imposed on investment advisers of specific classes of managed accounts. In particular, the Investment Company Act and ERISA contain express restrictions on money managers and persons acting as fiduciaries on behalf of investment companies or employee benefit plans, respectively, that preclude the receipt of rebates, disclosed or undisclosed, absent exemption.\textsuperscript{23}


\textsuperscript{23} Section 36 of the Investment Company Act, 15 U.S.C. § 80a-35 (1999), establishes a federal standard of fiduciary duty and in the case of investment advisers and their affiliates fiduciary obligations "with respect to the receipt of compensation for services, or of payments of a material nature, paid by [a] registered investment company . . . to [an] investment adviser." Although specifically directed at transactions on behalf of registered investment companies, the nature of the obligation is analogous to the general fiduciary obligations imposed under section 206 of the Investment Advisers Act, 15 U.S.C. § 80b-6 (1999), except in addition to investment advisers, the section extends to officers, directors, and principal underwriters of the fund. I will not separately discuss section 36 as it relates to brokerage rebate arrangements since the analysis would largely echo the discussion of section 206 of the Investment Advisers Act. In addition, banking regulators, principally the Office of the Comptroller of the Currency ("OCC"), have addressed...
Section 17(e)(1) of the Investment Company Act comes into play when an investment adviser acts on behalf of an investment company. It prohibits advisers acting as agents for an investment company from receiving compensation in connection with brokerage transactions, although the SEC retains authority to exempt arrangements where appropriate. An adviser’s receipt of research pursuant to a soft dollar arrangement, absent an exemptive safe harbor, in connection with its management of an investment company’s portfolio would likely be deemed to violate section 17(e)(1)’s compensation prohibition.

Several provisions under ERISA generally prohibit investment advisers, absent exemption, from receiving rebates in connection with directing brokerage transactions on behalf of an employee retirement plan. brokerage rebate issues in connection with their oversight of bank trust departments and bank management of common funds. See generally LEMKE & LINS, supra note 1, at 235-49. The OCC has implicitly deferred to established SEC interpretations of section 28(e). See, e.g., Soft Dollar Arrangements with Municipal Securities Dealer, Trust Interpretation No. 195 (Jan. 13, 1989).

Among the relevant fiduciary standards imposed by ERISA are the so-called "exclusive purpose" requirements that require plan assets be held, and that any fiduciary discharge its duties with respect to the plan, for the exclusive purpose of providing benefits to the plan’s participants or defraying legitimate administrative expenses. The exclusive purpose rules are supplemented by a prudent man requirement that obligates fiduciaries to obtain best execution in directing brokerage. In addition, ERISA imposes specific statutory prohibitions on transactions involving conflicts of interest.


Soft dollar practices that do not comply with the section 28(e)’s safe harbor have given rise to alleged violations of ERISA. See Letter from Charles Lerner, Director of Enforcement, Pension and Welfare Benefit Administration, U.S. Dept. of Labor to Thomas B. Kelley, Chief Executive Officer, Associated Capital Investments, Re: Department of Labor Investigation of Associated Capital Investors (formerly BA Investment Management Company) (dated Aug. 17, 1989) (noting alleged violations of ERISA in connection with use of soft dollar credits to reimburse clients in connection with trade error corrections); Ossey v. Marolda, No. 96 C 296, 1998 U.S. Dist. LEXIS 1767 (N.D. Ill. Jan. 29, 1998) (denying defendant’s motion for summary judgment in civil action for breach of fiduciary duty under ERISA because alleged kickbacks were not legitimate soft dollar arrangements).


Three provisions from section 406, 29 U.S.C. § 1106 are relevant. Section 406(a)(1)(D) prohibits transactions that would result in a direct or indirect transfer of plan assets for the benefit of a “party in interest.” Section 406(b)(1) prohibits self-dealing transactions by plan fiduciaries. Section 406(b)(3) prohibits a plan fiduciary from receiving any consideration for his personal account from another party dealing with the plan in connection with a transaction involving plan assets. See ERISA Technical Release No. 86-1, supra note 27.

Although the foregoing restrictions and other ERISA restrictions generally are not applicable in the case of customer directed brokerage arrangements, there are exceptions. Under ERISA, an investment adviser which acts as a plan fiduciary may have an independent duty to
ERISA creates limited transactional exemptions pursuant to statute and confers exemptive authority on the Secretary of Labor with respect to certain arrangements in furtherance of the interests of plan participants and beneficiaries and protective of their rights.31

C. THE REBATE CONTROVERSY PRIOR TO DEREGULATION OF COMMISSIONS

1. Industry Practices

Despite fiduciary concerns and legal restrictions, rebate practices in the securities industry flourished during the era of fixed commission rates that existed before 1975. Prior to 1975, minimum brokerage commissions were mandated by exchanges.32 These fixed commissions were well above the commissions that would have been charged in competitive markets. A glaring deficiency of the then-prevailing fixed commissions is that the fixed commissions did not reflect the considerable economies of scale associated with the costs of executing larger — institutionally-sized — orders.33 Thus, even though it was far cheaper on a per share basis for brokers to execute a trade for ten thousand shares than for a round lot (100

determine that portfolio transactions on behalf of a plan are receiving best execution, even if the plan sponsor or trustee is technically responsible for directing brokerage under a directed brokerage arrangement. In such situations, the investment adviser must take independent steps to ensure that any directed brokerage arrangement is not inconsistent with the obligations owed to plan beneficiaries to obtain best execution, even if it is not responsible for the offending directed brokerage arrangement. Id.

31 See ERISA section 408(b), 29 U.S.C. § 1108(b) (1999) (enumerated transactions exempt from § 1106’s prohibitions); ERISA section 408(a), 29 U.S.C. § 1108(a) (1999) (the Secretary’s exemptive authority).

32 Because of the dominance of the New York Stock Exchange (“NYSE”) as a market for securities trading, the NYSE’s schedule of commission rates effectively fixed commissions on brokerage transactions in the United States.

33 See PUBLIC POLICY STUDY, supra note 14, at 162-63; U.S. SEC. AND EXCH. COMM’N, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. No. 88-95, at 311-12 (1963) (hereinafter SEC SPECIAL STUDY); Pozen, supra note 3, at 926.
shares), the per share commission cost levied by brokers did not reflect this fact at all until the latter part of the 1960s. Even the introduction of modified commission schedules in the latter part of the 1960s did not fully take into account the diminished execution costs associated with institutionally-sized orders. As a result, institutional brokerage was extremely profitable for broker-dealers. At the same time, because of fixed commissions, broker-dealers were unable to compete with one another on the basis of price (that is reduced commissions) for this profitable segment of brokerage business.

Broker-dealers nevertheless did compete indirectly with one another during this period by providing services and various types of rebates to investment advisers in return for their brokerage business. During the 1960s and the early 1970s, regulators became increasingly concerned by the proliferation of special side-deal and rebate practices in connection with the system of fixed brokerage commissions. Three types of rebate arrangements emerged: reciprocal arrangements, give-ups and recapture arrangements.

In return for reciprocal benefits, investment advisers rewarded broker-dealers with brokerage commissions earned by the broker from brokerage directed from accounts managed by the adviser. The “reciprocals” consisted typically of services rendered by the broker that benefited the adviser. Some of the most common arrangements involved sale of shares of investment companies advised by the adviser, direct wires to the broker to facilitate trade execution and pricing of mutual fund portfolios. The surplus associated with the inflated commission rates in effect paid for these services. One of the clearest examples of an abusive reciprocal arrangement concerned broker sales of shares of a mutual fund managed by an adviser which, in return, directed

brokerage from the fund to the selling broker.\textsuperscript{35} The principal beneficiary of the additional sale of fund shares was the fund adviser since the sale of shares increased the amount of assets under management, thereby serving to increase the asset base used in calculating the adviser's fee.

Give-ups involved a generalization of the basic reciprocal arrangement. In the case of a give-up, an investment adviser directed a broker-dealer to surrender some portion of the brokerage commissions from accounts managed by the adviser to persons not having a role in the execution of portfolio transactions. The adviser directed the give-up to compensate these third-parties for services to the adviser. Like reciprocal arrangements, the economic benefits of give-ups flowed primarily to the investment adviser rather than to its clients. As a result, give-ups became a way for advisers to receive benefits and services from third parties at client expense.\textsuperscript{36}

Recapture arrangements entailed a variant on give-ups. Instead of directing the give-up to a third-party, the investment adviser directed the give-up to an affiliate.\textsuperscript{37} In this way, the adviser "recaptured" through the affiliate a portion of the brokerage commission derived from the adviser's client whose brokerage generated the commission. Because the recapture arrangement represented a strategy for recovering a portion of the inflated commissions paid by the advisory client, issues arose as to who was entitled to the rebated benefit — the adviser or the adviser's client — and as to whether


\textsuperscript{36} See SEC Special Study, supra note 33, at 316-17; Public Policy Study, supra note 14, at 169-75.

\textsuperscript{37} See Institutional Investor Study, supra note 35, at 2296-99; Public Policy Study, supra note 14, at 173. Affiliates were used to overcome the anti-rebate rules of the NYSE and other exchanges which barred members from giving rebates on commissions to customers.
investment advisers were under a general duty to recapture commissions for their clients' benefit. 38

2. The Commission Response

Between 1965 and 1975, the SEC engaged in a two-pronged strategy to eliminate abusive give-up and reciprocal arrangements. First, the SEC sought to address the issue of fixed commissions. The SEC recognized a major cause of the give-up and recapture problem was the artificially high fixed commission schedule imposed by the exchanges. 39 The SEC initiated a series of steps during this period that eventually led to the elimination of fixed commission rates. Beginning in 1968, the SEC effected a gradual relaxation of fixed commissions by encouraging the exchanges to permit negotiated commissions for large-sized orders. Gradually the circumstances in which negotiated commissions could be used were expanded until finally the SEC adopted Securities Exchange Act rule

38 These issues resulted in a series of decisions that addressed the fiduciary obligations of investment advisers and boards of directors to seek recapture as well as the disclosure obligations of mutual funds in connection with those issues. See Moses v. Burgin, 445 F.2d 369, 383-84 (1st Cir. 1970) (stating that fund investment adviser breached its fiduciary duties in violation of section 36 of Investment Company Act in failing to disclose opportunity for recapture to fund's independent directors), cert. denied, 404 U.S. 994 (1971); Fogel v. Chestnut, 533 F.2d 731, 745-50 (2d Cir. 1975) (same); Tannebaum v. Zeller, 522 F.2d 402, 432-34 (2d Cir. 1977) (holding fund's proxy statement false and misleading in failing to disclose to investors opportunity for recapture, notwithstanding disclosure made to fund's independent directors); see also Commissions of Portfolio Brokerage of Mutual Funds – Obligations of Management and Brokers, Exchange Act Release No. 8746, [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,760 at 83,746 (Nov. 10, 1969), 34 Fed. Reg. 18,543 (letter from SEC General Counsel addressing these issues). See generally Gavin Miller & Robert E. Carlson, Recapture of Brokerage Commissions by Mutual Funds, 46 N.Y.U. L. Rev. 35 (1971) (comprehensively discussing recapture issues prior to final judicial disposition of these disputes); Tannebaum v. Zeller, 522 F.2d at 405-10 (summarizing regulatory and judicial history regarding recapture arrangements, including SEC's "possibly conflicting views" over preceding ten years).

39 See PUBLIC POLICY STUDY, supra note 14, at 162-63; SEC SPECIAL STUDY, supra note 33, at 311-12.
19b-3, eliminating fixed commissions effective May 1, 1975 — "May Day."\(^{40}\)

During this period, the SEC took a more aggressive posture in policing rebates. The SEC recognized that brokerage rebate arrangements presented conflicts of interest between clients, investment advisers and brokers, and that such arrangements raised specific concerns regarding whether trades from managed accounts received best execution or whether managed accounts were churned for brokerage commissions. The SEC issued numerous reports identifying regulatory concerns with respect to give-ups and reciprocal arrangements because of the fundamental conflicts of interest they presented investment advisers.\(^{41}\) The SEC brought administrative proceedings against broker-dealers and investment advisers highlighting undisclosed conflicts of interest in connection with mutual fund brokerage allocation.\(^{42}\) The SEC also used its considerable administrative resources through proposed rule-making, oversight of the exchanges (and exchange mandated commission rates) and oversight of the National Association of Securities Dealers, Inc. to discourage give-ups and reciprocal arrangements.\(^{43}\)


Simultaneously, fund shareholders brought successful judicial challenges based on contractual and disclosure theories regarding the failure of fund advisers to recapture brokerage commissions for the benefit of managed funds.\(^4\)

While policing rebate practices that it believed to be abusive, the SEC, nevertheless, recognized that certain services provided by brokerage firms, such as research, were “ancillary to the brokerage function,” and thus stood on a different footing from other types of arrangements that resulted in payments for services that had nothing to do with a customer’s securities transactions.\(^5\) This distinction was blurred somewhat in the SEC’s Delaware Management Company decision which sanctioned an investment adviser in part because it engaged in securities transactions at inferior prices with a dealer that provided the adviser with research.\(^6\) One possible reading of the decision — a reading particularly alarming to advisers and full-service firms — was that it construed an adviser’s best execution obligations as precluding the adviser from considering research benefits obtained in determining whether a broker provided best execution for a client’s order.\(^7\)

Shortly thereafter, and in part to dispel concerns raised by the implications of the Delaware Management decision, the SEC undertook to clarify its position with respect to preferential compensation in connection with such sales. The rule is currently codified at NASD Manual, NASD Conduct Rule 2830(k). See Securities and Exchange Commission Concurrency in NASD Reciprocal Brokerage Rule, Exchange Act Release No. 10,147, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,372, at 83,086 (May 14, 1973) (approving NASD’s anti-reciprocal rule). Subject to the rule’s requirements, however, sales may be used as a basis for allocating portfolio brokerage, if fully disclosed to the investment company’s shareholders. Id.

\(^4\) See supra note 38.

\(^5\) See PUBLIC POLICY STUDY, supra note 14, at 164 & 170 (contrasting reciprocal arrangement providing services ancillary to brokerage function, such as research, and give-ups made to “a broker who has nothing to do with the transaction”).

\(^6\) Delaware Management, supra note 42.

\(^7\) See Senate Committee on Banking, Housing, and Urban Affairs, Securities Industry Study, 93rd Cong. 61-62 (1973); Moran & O’Kelly, supra note 22, at 67-70.
the relationship between research and best execution. The SEC rejected the view that “an adviser [was] . . . required to seek the service which carries the lowest cost” and instead stated the adviser should consider the “full range and quality of a broker's services which benefit the account under management,” including “information” and “analysis” supplied by a broker. But the SEC contemplated use of such factors in assigning brokerage only where it could be reasonably shown that the research obtained contributed to the performance of the account under management, a somewhat narrower approach than was ultimately adopted in section 28(e).

D. THE 1975 SECURITIES ACTS AMENDMENTS AND SECTION 28(e)'S SAFE HARBOR

The legislative history of section 28(e) provides a context for understanding subsequent commercial and regulatory developments and the continuing debate over soft dollar practices. In connection with Congress's codification of the abolition of fixed commissions in the Securities Acts Amendments of 1975, Congress added section 28(e) to

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48 See FRANKEL, supra note 41, at 626 (indicating in context of Investment Company Act that SEC's position shifted away from treating research as form of compensation for purposes of that Act's section 17(e)(1) to treating it as potential conflict of interest).

49 See, e.g., Policy Statement Regarding the Future Structure of Securities Market, 37 Fed. Reg. 5286, 5290 (Mar. 14, 1972) (“In our opinion, the providing of investment research is a fundamental element of the brokerage function for which the bona fide expenditure of the beneficiary's funds is completely appropriate, whether in the form of higher commissions or outright cash payments.”)


51 The 1975 Securities Acts Amendments marked the most significant changes to the federal scheme of securities regulation since enactment of the federal securities laws during the Depression. One provision of the wide-ranging legislation was codification of the SEC's administrative abrogation of fixed commissions at section 6(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 78f(e)(1999).
the Securities Exchange Act which concerns receipt of research and brokerage services by investment advisers from broker-dealers. This issue was of great significance in light of legal and commercial uncertainty regarding brokerage allocation and rebate practices as the securities industry made the transition from a fixed commission environment to a competitive commission regime. Section 28(e) was principally designed to address three related but potentially divergent concerns: (i) overcoming possible disruptions to securities markets in the transition to deregulated commission rates; (ii) ensuring the continued production and dissemination of financial research in markets with competitive brokerage commissions; and (iii) establishing bright-line standards that would preclude the reemergence of abusive give-up arrangements.

The deregulation of commission rates rendered the issue of duty to recapture largely moot. Instead, regulatory and industry attention began to shift toward the duty of investment advisers to obtain best execution in markets with unfixed commissions, and the implications of that duty for full-service firms which had traditionally bundled execution and research in providing services to institutional clients.\(^5\) The critical issue was whether an adviser, consistent with the fiduciary obligations owed to its clients, could direct brokerage to firms charging more than the lowest commission, especially when brokerage was directed in part on the basis of the firm's willingness to provide research to the adviser. The answer directly affected the way full-service firms conducted business.

The securities industry, for obvious reasons, opposed abolition of fixed commissions. Not only would brokers face greater price competition, but established brokers feared that institutional customers with whom long-term relationships had been developed would be forced to use the broker that charged the lowest commission regardless

of other aspects of the relationship such as execution quality or research services.

In 1975, the principal form of soft dollar arrangement involved proprietary research (that is internally-generated research) provided by full-service firms to their clients. These firms maintained significant research departments as part of the multifaceted investment services offered by such firms. Industry favored section 28(e) as a means of partially insulating the way in which these firms conducted business with institutional clients from the effects of cut-throat commission competition.\footnote{Section 28(e) took shape out of watered-down provisions found in earlier drafts of legislation that ultimately became the Securities Acts Amendments of 1975. In 1975, after the unexpected failure to enact legislation in the preceding legislative session, a final effort was made to pass comprehensive securities legislation. The principal vehicle for the legislation — S. 249 — was amended shortly after its introduction to create a proposed safe harbor: section 28(e) of the Securities Exchange Act. The proposed language was also incorporated in a substantially similar form in the parallel House legislation — H.R. 4111. For a brief overview of the salient features of the legislative history of the Securities Acts Amendments of 1975, see Harvey A. Rowen, The Securities Acts Amendments of 1975: A Legislative History, 3 SEC. REG. L.J. 329 (1976). Specific details of the legislative history relating to section 28(e) are explored in Harvey E. Bines, The Law of Investment Management §§ 9.02-9.03 (1978) as well as Loss & Seligman, supra note 40, at 2885-97.} In particular, the safe harbor ensured that such firms would be able to continue bundling execution services with delivery of ancillary research and brokerage services.

The industry’s argument — put forward principally by the full-service firms — was premised on the unique benefits obtained by investors through access to securities research.\footnote{See Hearings on S.249 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 94th Cong. 323 & 459 (1975) (hereinafter S.249 Hearings) statements of Donald B. Marron ("Marron Statement"); William W. Graulty ("Graulty Statement"); and Ray Garrett ("Garrett Statement").} Unlike other forms of give-up arrangements, research indirectly benefited advisers’ clients. Moreover, transition to a negotiated rate regime would entail significant hardships for some advisers if research were no
longer available from full-service firms.\textsuperscript{55} The loser, according to the industry, would have been the small investment adviser, whose costs would rise disproportionately relative to larger investment advisers.

Finally, industry appealed to the need for greater certainty regarding the legal implications of competitive commission rates for investment advisers. Even if investment advisers could reasonably argue that research services should be considered in evaluating what constituted best execution, the inherent uncertainty in the area would militate against the commercial viability of commission rates based in part on research services.\textsuperscript{56}

The SEC's position could best be described as agnostic. The SEC gave its blessing to the proposed section 28(e), notwithstanding the provision's effect of eliminating "the necessity of tracing the imputed value of any specific research to a specific account."\textsuperscript{57} The SEC's position acknowledged "uncertainties" stemming from the transition to competitive commission rates on "the future availability and quality of research and other services."\textsuperscript{58} While effectively conceding the force of industry concerns regarding the necessity at that time for a soft dollar safe harbor, the SEC nevertheless harbored misgivings regarding the potential for abuse presented by such arrangements. The SEC expressly indicated hope that, as new patterns of money management developed, the need for reliance on section 28(e) would decline.\textsuperscript{59}

The Congressional reports accompanying the legislation recognized the need to have a more flexible definition of best execution: one that encompassed execution quality and receipt of research services. Thus, both the relevant House and Senate committees affirmed that a primary

\textsuperscript{55} See Marron Statement, supra note 54, at 324 & 325; Graulty Statement, supra note 54, at 459, 467-68.

\textsuperscript{56} See Marron Statement, supra note 54, at 322 ("The confusion should be ended and we believe the proposed amendment will resolve this issue") & 324; Graulty Statement, supra note 54, at 459-60.

\textsuperscript{57} See Garrett Statement, supra note 54, at 202.

\textsuperscript{58} Id. at 203 & 201.

\textsuperscript{59} Id. at 203.
purpose of section 28(e) was to codify the principle that a fiduciary's duty to provide best execution did not require fiduciaries to direct brokerage to brokers providing execution for the lowest commission. On the whole, the Senate appeared more solicitous than the House of industry concerns. Its committee report explicitly noted fears regarding industry dislocation resulting from displacement of the then-existing fixed rate structure in “supporting the cost of generating . . . research” and the potential disruption of the legitimate expectations of broker-dealers and money managers if research and other brokerage services were no longer available.\(^6\) In light of these concerns, the Senate report expressed the hope that the safe harbor would be construed liberally in terms of research and brokerage services encompassed.\(^61\)

Congress, however, also exhibited caution in embracing a safe harbor. This caution was most pronounced on the House side where the committee report emphasized that if the safe harbor proved unwise Congress and the states would not be precluded from undertaking remedial legislative action at a later time “as we gain experience in a competitive rate environment.”\(^62\) The Conference Report stressed that section 28(e) would not be used to shield abusive give-up and reciprocal arrangements, emphatically stating “this bill will in no way permit [give-ups to] return.”\(^63\)

In retrospect, several factors concerning the legislative history bear scrutiny. At the time of section 28(e)’s enactment, Congress and the SEC believed that use of soft dollar arrangements would not be extensive, that the safe harbor would be confined principally to full-service firms and that the market significance of such arrangements would diminish over time. On each of these scores, their expectations could not have been more wrong as will become clear in the next section.

\(^{60}\) S. REP. No. 94-75 69 (Apr. 14, 1975).
\(^{61}\) Id. at 71.
Another feature worth noting is that some of the reasons for the safe harbor that appeared compelling in 1975 have little force today. The period of transition ushered in by the 1975 Securities Acts Amendments has long since ended. The completion of the adjustment to deregulated commissions followed by rapid innovation in industry products and technology have radically altered the shape of the securities industry in the intervening generation. These changes diminish the importance of concerns expressed regarding the continued production of financial research and the continued viability of small investment advisers.

While the safe harbor also may have been necessary to shield research operations of full-service firms temporarily, the market has long since adjusted to the realities of deregulated commissions and rapid innovation in financial research and products. Alternate providers of securities research have greatly multiplied\(^6\) and full-service firms would likely continue investing in research to support retail and investment banking operations regardless of section 28(e). Nor is a desire to shield small investment advisers from the competitive effects of deregulated commissions a sufficient basis for continued maintenance of section 28(e).\(^5\) The number of advisers

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\(^5\) Such sentiments are still expressed today. See U.S. SEC. AND EXCH. COMM'N, TRANSCRIPT OF ROUNDTABLE ON THE ROLE OF INDEPENDENT INVESTMENT COMPANY DIRECTORS 192 (Feb. 23-24, 1999) (hereinafter 1999 SEC ROUNDTABLE) (brokerage official stating that many advisers regard research obtained pursuant to soft dollar arrangements as their "lifeblood").
has greatly multiplied since 1975. Quite simply, if some advisers are not able to survive commercially without the permanent research subsidy afforded by section 28(e), it is worth questioning whether they are in fact efficient service providers.

Other rationales, some of which are discussed in Section IV, may argue for the safe harbor’s retention. Most of these center on efficient pricing of brokerage services including research. But such rationales imperfectly track the legislative intent of section 28(e). In order to achieve a coherent approach toward brokerage rebate arrangements, it may be necessary to question the continuing vitality of the legislative intent underlying section 28(e).

66 Pursuant to section 203A of the Investment Advisers Act and rules 203A-1 through 203A-3 thereunder, responsibility for registration of investment advisers is divided between federal and state authorities. See 15 U.S.C. § 80b-3a (1999); 17 C.F.R. § 275.203A-1-3(1999). Federal registration is required of several different classes of investment advisers. The most significant of these classes numerically are investment advisers having assets under management in excess of $25 million, investment advisers to a registered investment company, pension consultants to employee benefit plans with aggregate assets valued in excess of $50 million and certain investment advisers affiliated with advisers required to register under this scheme. As of early 1999, approximately 8,500 investment advisers were required to register with the SEC under the federal registration scheme. See Securities Uniformity: Annual Conference on Uniformity of Securities Laws, Securities Act Release No. 7,664, 69 SEC Dkt. 1020 (Mar. 31, 1999). Another approximately 16,000 smaller investment advisers are registered with the states. The large number of significant investment advisers — as evidenced by the number of registered advisers under the federal scheme — indicates that the protection of advisers should not be a paramount policy goal in shaping legal policy governing brokerage accounts.

67 See Section IV.C.

68 To some extent, such rationales may not even require the safe harbor under section 28(e) since many concerns regarding fiduciary obligations with respect to certain practices have been allayed by best execution interpretations since 1975 which have provided considerable guidance regarding the scope of an adviser’s best execution obligations in a deregulated commission environment. See discussion, supra note 13.
III. AN OVERVIEW OF CURRENT BROKERAGE REBATE PRACTICES

Contrary to the expectations of Congress and regulators, soft dollar and other brokerage rebate arrangements have burgeoned in a competitive commission environment. This section provides an overview of brokerage rebate arrangements commonly used today and in particular the two dominant forms of rebate arrangements: soft dollar arrangements and customer directed brokerage arrangements.

Soft dollar arrangements that meet the requirements of the safe harbor in section 28(e) and customer directed brokerage arrangements are widely employed because they are not subject to the legal restrictions that would otherwise stand as an obstacle to rebate arrangements. In a section 28(e) soft dollar arrangement, the investment adviser obtains an explicit or implicit rebate from the broker-dealer in the form of research or brokerage services. In a customer directed brokerage arrangement in contrast, the advisory client, not the adviser, bargains with the broker-dealer to receive a rebate. The client then provides the adviser with instructions regarding allocation of brokerage among brokers.

The two different types of rebate arrangements — soft dollar rebates and customer directed brokerage — represent competing approaches toward rebates. In a soft dollar arrangement, the adviser directs the brokerage while the advisory client performs that task (although typically in conjunction with the adviser) in the customer directed brokerage arrangement. The adviser is typically the direct recipient of the rebate in a soft dollar arrangement while the client is the rebate recipient in the customer directed arrangement. As previously noted,

customer directed brokerage arrangements do not entail the agency or conflict of interest problems at the core of soft dollar arrangements precisely because directed brokerage rebates go directly to the advisory client and not the adviser.

A. SOFT DOLLAR ARRANGEMENTS

Soft dollar arrangements provide virtually the only legitimate avenue by which an investment adviser may obtain rebates from clients’ brokerage transactions. Although we have described soft dollar arrangements in general terms, the arrangements have evolved over time into fairly intricate commercial arrangements. This complexity stems from the fact that soft dollar arrangements are a significant means by which brokers compete for order flow from advisers. In many ways, an understanding of soft dollar arrangements requires a basic understanding of the process by which brokers compete.

Brokers compete for investment adviser directed order flow based primarily on three factors: commission costs, execution quality and provision of ancillary research and brokerage services. The provision of research and brokerage services is effected through soft dollar arrangements. Brokers tailor their operations to exploit advantages in competing with respect to one or more of these factors. This process has led to the emergence of roughly three different classes of brokers: full-service, third-party and execution-only brokers. Two of these classes — the full-service brokers and the third-party brokers — provide soft dollar benefits to advisers but on somewhat different bases.70

70 The description of full-service and third-party brokers below is highly stylized to emphasize the contrasting methods of doing business between the two types of firms. In practice, the differences may be somewhat grayer. For example, although full-service firms are identified with proprietary research, many currently will supply independent research and provide other soft dollar benefits to compete with third-party firms described below. See 1999 SEC ROUNDTABLE, supra note 65, at 172-91; Michael Scotti, Negotiating the Soft Dollars Market, TRADERS MONTHLY, Jan. 1995, at 22. By the same token, some third-
Full-service firms — sometimes referred to as the “Street firms” — were, as noted above, the principal proponents for enactment of the soft dollar safe harbor. These well-capitalized multiservice firms offer extensive trading expertise and proprietary research capabilities. Because these firms' trading operations are well-capitalized, they can offer higher quality execution for difficult trades by risking firm capital to minimize the market impact that a transaction may have on trading costs and by working the order.71 These firms also generally employ analysts and large research staffs to support not only trading but underwriting and retail operations.72 Full-service firms

party brokers internally generate some research, such as Lynch, Jones & Ryan's redbook on retail activity.


Working an order refers to the ability of a firm with extensive trading operations to secure best execution by using superior knowledge of sources of market liquidity and market trading patterns and superior access to different securities markets. See Silfen Testimony, supra at 714.

Market impact is a real concern where order size is large and the issue is less liquid (has a relatively low average daily trading volume). In such cases, a full-service firm with more extensive trading operations may block position. Block positioning involves the firm acting as principal to purchase and hold part of a customer’s position in selling the position. Id. Portfolio managers tend to monitor execution quality with respect to market impact because of the potential of market impact to affect adversely investment performance. See 1999 SEC ROUNDTABLE, supra note 65, at 168-69, 205.

72 There are no regularly reported figures on the research budgets of full-service firms. An exchange in the 1993 House Soft Dollar Oversight Hearing indicated that the research budget of Goldman, Sachs had grown from $65 million in 1989 to “well north of $100 million in 1993.” Silfen Testimony, supra note 71, at 735. This number has probably increased substantially since then and it is reasonable to believe that Goldman, Sachs' budget is probably comparable to the research budgets of the other leading investment banking firms, such as Merrill Lynch, Morgan Stanley, Dean Witter and Salomon Smith Barney. Because research produced by full-service firms must satisfy the requirements of their different lines of business, its value for money
provide advisers with proprietary research from analysts as well as access to these analysts in return for order flow.

As might be expected, commission rates at full-service firms are relatively high compared to commission rates at firms which provide execution only. In directing brokerage to a full-service firm with higher commissions, the investment adviser seeks higher quality executions for its client’s difficult trades and soft dollar benefits in the form of proprietary research. The full-service broker does not break out the value of the soft dollar benefits it provides, rather it offers its services on a bundled basis. In other words, an adviser’s clients will pay the same commission regardless of the value the adviser attaches to the proprietary research obtained from the full-service firm. By bundling its services in this fashion, the soft dollar benefit is never quantified as a portion of the commission but rather remains as an implicit rebate of undetermined value.

Third-party research brokers are the other type of broker that offer soft dollar benefits. In third-party research arrangements, research provided to an investment adviser by the executing broker is not internally generated by that broker (as is the case with full-service firms), but rather is procured by the broker for the adviser. Thus, for example, managers has been questioned from time to time. Recurrent anecdotal evidence has appeared suggesting that significant quantities of proprietary research materials generated by full-service firms are not read by the recipients or are of little value. See Association of Investment Management and Research, Adoption of AIMR Soft Dollar Standards — Attachment 3: Soft Dollar Comment Letters — Major Themes 18 (Dec. 1997) (comments from members suggesting “much [proprietary research] is meaningless and thus thrown out”); Schwartz Statement, supra note 64, at 648-50; Statement of Russell J. Brooks, 1993 House Soft Dollar Oversight Hearings, supra note 64, at 693 (“To make matters more difficult, much of what [full-service] firms produce has a sameness to it, no matter who produces it.”); 1997 ERISA ADVISORY COUNCIL REPORT, supra note 3, at 12 (minority report noting earlier study which showed that “portfolio managers read only about 30% of the research reports that they receive”); see also Gretchen Morgenson, Market Watch: So Many Analysts, So Little Analysis, N.Y. TIMES, July 18, 1999, § 3, at 1. Indeed, the explosive growth of third party brokers indicates an unsatisfied demand for research not satisfied by the proprietary research products of full-service firms.
in a third party research arrangement, an investment adviser earns soft dollar credits on commissions from brokerage directed to a third-party broker. The broker then arranges for the adviser to receive research from a third-party research provider.\footnote{While third-party research services are selected in consultation with the adviser receiving the service, proprietary research provided by full-service firms is distributed generally to clients on a relationship basis. As a result, third-party research is frequently more specialized than proprietary research from full-service firms and is typically selected to meet the particular needs of the adviser.}

Brokers who specialize in providing third-party research along with execution services operate in a fundamentally different commercial fashion than the full service firms. First, although third-party brokers bundle execution and research services for delivery to clients, the cost of producing the two services — execution and research — is clearly separable for the third-party broker since the broker provides one service, execution, internally, and provides the other, research, by procuring it from an external source.

Second, third-party arrangements entail a more formal understanding between the broker and the customer regarding any soft dollar arrangement (although the understanding typically does not take a written form). At the outset of the relationship, the broker and investment adviser will reach a non-binding understanding regarding the adviser’s informal commitment to direct a certain level of brokerage commissions to the broker-dealer over a fixed period of time, the commission rate and a conversion rate reflecting the rate at which commission dollars will be rebated in soft dollars.\footnote{The conversion ratio is typically quoted in terms of the amount of commission dollars required to obtain a dollar’s worth of soft dollar credits. Thus, the lower the ratio the more advantageous for the brokerage customer and the less advantageous for the broker, i.e., a lower ratio means it takes fewer commission dollars to obtain a credit. For example, 1.7:1 — for every $1.70 in commissions the adviser would receive one dollar of soft dollar credit — would be more favorable for customers than a ratio of 4:1). 1998 SEC STAFF SOFT DOLLAR REPORT, supra note 1, at 21-22. One provider of third-party research has identified the following factors in determining the conversion ratio:}

- [Image 0x0 to 507x722]
arrangement contrasts with the implicit soft dollar rebates provided by full-service firms. Although the full-service firm may have an expectation regarding the amount of brokerage commissions required to obtain proprietary research, the full-service firm does not generally convert commissions to explicit soft dollar credits before providing advisers with proprietary research.  

The remaining class of broker — execution-only brokers — provides execution services without any soft dollar rebate. Such brokers compete solely on the basis of commission costs. Like the third-party broker, the execution-only broker typically lacks the trading capital to provide high quality executions for difficult trades, that is, where the transaction size is large relative to the overall liquidity of the security being traded. Nevertheless, although I describe these brokers (as well as third-party brokers) as providing only average quality execution, they may provide best execution for a significant class of transactions, such as transactions involving highly liquid issues. As to these transactions, usually regarded as easier or low-cost trades, execution quality may be as good as that provided by any full-service firm even though the full-service firm may have the capability to provide high quality execution services. Investment advisers can exploit these differences by routing low-cost trades to execution-only firms to save on commissions while routing difficult trades to full-service firms to minimize market impact costs. A relatively new brokerage niche, analogous to the

"Relationship size (i.e., annual commission volume), Commission flow/timeliness (i.e., will client remain "ahead" with a positive balance?), Trade characteristics (i.e., average shares, commission rate, etc.), Research bills (frequency, number, etc.)." See Paragon Financial Group (visited July 20, 1999) <http://www.pfgi.com>.  

75 Another way to think about the full-service firm's approach is that it provides advisers with research without metering the advisers' use of the research. Thus, advisers receive a wide array of proprietary research on a relationship basis and the research obtained is not tailored to an adviser's specific needs. This approach has been dismissed by customized research providers as "selling research by the pound" and leaving clients with the task of "filter[ing] out only what they need . . . ." Letter to the editor from Russell J. Brooks, PENSION AND INVESTMENTS, Feb. 3, 1992, at 12.
execution-only broker, involves proprietary electronic trading networks — sometimes referred to as ECNs or ATSs (alternative trading systems) — such as Instinet. These systems, which are being used increasingly by money managers, provide an alternative low-cost means for investment advisers and institutional investors to trade which bypass soft dollar arrangements.\footnote{It is impossible to overstate the potential significance of electronic trading systems on patterns of institutional trading. See GREENWICH ASSOCIATES, ADVANCES AND ANOMALIES IN "NON-TRADITIONAL" TRADING — A REPORT TO INSTITUTIONAL INVESTORS IN THE UNITED STATES (Apr. 1999) (hereinafter GREENWICH ASSOCIATES NON-TRADITIONAL TRADING REPORT) (noting “firestorm of institutional interest in nontraditional trading” and finding that 70% of surveyed large institutions use such systems for some trading in listed shares and almost 63% of total surveyed institutions use such systems for some Nasdaq trading); See 1999 SEC ROUNDTABLE, supra note 65, at 171, 172 (fund officials estimating that one large mutual fund family uses electronic trading systems for approximately 10-12% of all trades and another mutual fund complex uses electronic trading systems for 10-15% of trades in managed funds and up to 25% of trades in index funds); Rebecca Buckman and Aaron Lucchetti, Wall Street Wired: Electronic Networks Threaten Trading Desks on Street, WALL ST. J., at C1 (Dec. 23, 1998) (mutual fund family uses electronic trading systems for 50% of its Nasdaq stock-trading generating almost 40% saving). Some electronic trading systems will actually offer soft dollar arrangements. See Instinet website (visited July 22, 1999) <http://www.instinet.com> (explaining soft commission services); Instinet Corp., SEC No-Action Letter, (pub. avail. Jan. 15, 1992) (section 28(e) safe harbor can be applied to brokers providing electronic trading systems).}

The principal features of these three different types of brokerage are summarized in the following table and in Diagram 1.
<table>
<thead>
<tr>
<th>BROKERAGE FEATURE</th>
<th>TYPE OF BROKER</th>
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<tbody>
<tr>
<td></td>
<td><strong>Full-service Firm</strong></td>
</tr>
<tr>
<td>Commission (execution price)</td>
<td>high average commission</td>
</tr>
<tr>
<td>Execution Capability</td>
<td>high quality capability</td>
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<tr>
<td>Research Rebate</td>
<td>proprietary research</td>
</tr>
<tr>
<td>Rebate Pricing</td>
<td>general access to research based on client relationship</td>
</tr>
</tbody>
</table>
Diagram 1: Soft Dollar and Execution-Only Brokerage Arrangements

- Third-party broker
- Execution-only broker
- Full-service broker

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- Third-party research vendor
- Investment Adviser
- Adviser's Trading Desk
- Managed Account #1
- Managed Account #2
- Managed Account #3
- Managed Account #4
B. Customer Directed Brokerage Arrangements

Customer directed brokerage arrangements, the principal rebate alternative to soft dollar arrangements, offer a means by which advisory clients can obtain rebates generated from commissions on transactions from their own account. In a customer directed brokerage arrangement the client enters into a brokerage arrangement with a broker-dealer in return for rebates on commissions generated from its account. The client will then instruct its investment adviser to direct some portion of that client's brokerage to the broker-dealer over a stated period, such as a year, and the broker-dealer will provide the agreed-upon rebate to the client bypassing the adviser altogether. Customer directed rebates do not implicate section 28(e), which is solely designed to address the issue presented by an adviser's receipt of rebates on client brokerage.

Commission recapture arrangements (illustrated in Diagram 2) are a common example of directed brokerage arrangements. Commission recapture programs differ from soft dollar arrangements in that the rebate takes the form of cash (in other words, a hard dollar rebate). Because the customer is the recipient of the cash rebate, no conflict of interest is present. In theory, the client should be able to trade off execution quality for the rebate in accordance with its own self-interest.


A variation on commission recapture programs is an expense reimbursement program. In an expense reimbursement program, the customer directs brokerage and commissions to a broker which pays for services rendered to the customer directly — generally services other than ordinary research services. In effect, customers are allowed to recoup expenses that they would otherwise directly incur in connection with the management of their money. Moreover, under such a program, an advisory client can receive reimbursement for expenses incurred by the client that the client’s investment adviser would not be entitled to receive under the section 28(e)’s safe harbor.79

Commission reimbursement and expense programs resemble traditional soft dollar arrangements in the sense that they are rebate schemes, but they also differ because the client, rather than the investment adviser, is the rebate recipient. As a result, conflict of interest issues are generally eliminated and the arrangements are not subject to the same conduct and disclosure requirements that apply to soft dollar arrangements. This results in much greater flexibility in structuring directed brokerage arrangements than soft dollar arrangements. For example, commission recapture arrangements, unlike soft dollar arrangements, may involve receipt of cash rebates.80

79 A firm that regularly enters into expense reimbursement arrangements enumerated the following types of expenses as reimbursable providing reimbursement is authorized by the plan documents: “actuarial expenses, consulting fees, accounting, legal fees, conferences, custodial fees, publications.” Lynch, Jones & Ryan, Inc., (visited July 21, 1999) <http://www.ljr.com>. Of these, custodial fees alone would be reimbursable as a soft dollar brokerage service, provided the other requirements of section 28(e) are met.

80 Two other expense arrangements are worth noting: expense cap arrangements and expense offset arrangements. Expense cap arrangements are potentially relevant to the discussion of rebate arrangements. In an expense cap arrangement, the investment adviser agrees (on a voluntary basis) to reimburse a managed account for expenses exceeding a prescribed level. Where an expense cap exists, soft dollar rebates in the form of brokerage services or a customer directed brokerage arrangement which reduces the managed account’s expenses will also benefit the adviser directly by reducing the adviser’s potential liability under the expense cap. Thus, an expense cap can alter an adviser’s incentives regarding how rebate arrangements are structured. See Payment for Investment Company Services with
Directed brokerage arrangements, however, can present problems for the investment adviser. The adviser's client in such an arrangement (for example, a pension fund), rather than the investment adviser, must, in effect, select the broker. Customer selection may compromise the adviser's fiduciary obligations to the client with respect to best execution. In such cases, the adviser will discuss with the pension sponsor the need to reconcile best execution and rebate objectives. Another controversy has been retention of pension plan and investment consultants through directed brokerage arrangements.


Expense offset arrangements involve situations where the expenses of an advisory client are reduced by agreeing to forego income that would otherwise be derived from use of the advisory client's assets. Examples include compensating balance arrangements where custodial fees are reduced to reflect the custodian's economies of scale or securities lending arrangements where the custodian is able to generate income from lending portfolio securities of managed accounts. Although expense offset arrangements represent a form of rebate, the rebate differs from brokerage rebate arrangements in that there is no rebate on a brokerage arrangement but rather a compensating benefit based on some other relationship with the service provider. See Payment for Investment Company Services with Brokerage Commissions, Investment Company Act Release No. 21,221 (July 21, 1995) 60 Fed. Reg. 38,918, 38,919-20 (July 28, 1995) (establishing final rule amendments) (hereinafter 1995 Investment Company Brokerage Arrangement Accounting Release); Payment for Investment Company Services with Brokerage Commissions, Investment Company Act Release No. 20,472, 59 Fed. Reg. 42,187 at 42,190 (Aug. 17, 1994) (proposing rule amendments).


82 The controversy arises from an apparent conflict of interest for consultants in being paid pursuant to a directed brokerage arrangement and advising pension plans about the use of directed brokerage arrangements. Concerns in this area were specifically highlighted in the 1997 ERISA ADVISORY COUNCIL REPORT, supra note 3, at 12-13 — Recommendations Involving Plan Sponsor Guidance A-F (advocating increased attention to potential conflicts created by financial arrangements between consultant and brokerage firms). For similar expressions of such concern, see Gary W. Findlay & M. Steve
C. Brokerage Rebate Arrangements in Current Market Practice

Brokerage rebate arrangements today are a common feature in transactions on behalf of managed accounts. The market significance of rebate arrangements is confirmed by transaction volume, dollar value of transactions and figures indicating relative use by money managers.\(^83\) Some estimates indicate that third-party arrangements exceeded $1 billion in commissions in 1996, although more conservative estimates put the figures at approximately \(\frac{3}{4}\) of that.\(^84\) Estimates have consistently shown that more than 90% of money managers use soft dollar arrangements for listed equity securities.\(^85\) Third-party brokerage transactions constituted 12% of all commissions from a cross-sectional sample of investment

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\(^{83}\) This situation was recently confirmed in the 1998 SEC Staff Soft Dollar Report, which contains a wealth of information about actual industry practices and details the pervasive use of such arrangements. See supra note 1.

\(^{84}\) 1998 SEC Staff Soft Dollar Report, supra note 1, at 1 (noting more conservative estimates by Greenwich Associates from 1996). Recent estimates indicate that total soft dollar commissions in domestic equity transactions have flattened out over the past two years in the same range while trading volume has increased significantly. Greenwich Associates Non-Traditional Trading Report, supra note 76, at vi & 14. It should be noted that Greenwich Associates figures combine soft dollar and directed brokerage commissions together. The relative flattening out stands in contrast to the significant and steady increase in soft dollar commissions from a decade ago. Figures from 1989 indicated third-party arrangements commanded from $460 million in commissions and by 1991, $585 million. See Silfen Testimony, supra note 71, at 708.

\(^{85}\) See 1997 ASIR Soft Dollar Paper, supra note 4, at 4; 1998 SEC Staff Report, supra note 1, at 37. In other types of securities trading, such as trading in OTC equity and fixed income securities where dealer markets are traditional, soft dollar transactions are less widely used. See discussion infra note 189.
advisers examined by the SEC staff.\textsuperscript{86} Using the average conversion ratio found by the SEC staff (1.65:1),\textsuperscript{87} the value for soft dollar benefits from third-party arrangements alone could range anywhere from $440 million to $588 million annually. A true measure of the magnitude of soft dollar benefits, of course, would need to include the portion of commissions directed to full-service brokers to obtain proprietary research and brokerage services.

The SEC Staff’s recent report shows significant disparities in use of soft dollar arrangements between small investment advisers who service retail accounts and large advisers that manage institutional accounts. The small advisers use soft dollar arrangements more extensively as a proportion of their commission trades; soft dollars constitute a higher percentage of small advisers’ operating expenses; and the ratio of soft dollar rebates to total advisory fees is far greater for small advisers versus large advisers.\textsuperscript{88}

\textsuperscript{86} See 1998 SEC STAFF SOFT DOLLAR REPORT, supra note 1, at 42. Figures from Greenwich Associates indicate that such figures are more characteristic of very large money managers that generate commissions in excess of $5 million per annum. GREENWICH ASSOCIATES NON-TRADITIONAL TRADING REPORT, supra note 76, at 15. In commissions for listed securities and for somewhat smaller money managers, the percentage of commissions represented by soft dollars ranges between 20 to 40% of commissions. Id. The discrepancy in estimates stems from differences in the relevant pools used for comparison. Use of soft dollars appears greatest in the most liquid markets such as NYSE trading and is much smaller in less traditional markets, such as electronic trading systems.

\textsuperscript{87} The SEC staff actually found that from its sample of 75 third-party brokers that brokers on average provided a conversion ratio of 1.7:1 (1998 SEC STAFF SOFT DOLLAR REPORT, supra note 1, at 22) and from its sample of 285 advisers that advisers on average received conversion ratios of 1.6:1. I have used the mid-point of these two samples — 1.65:1. Of course, the conversion ratio is negotiable and so will vary among arrangements.

\textsuperscript{88} 1998 SEC STAFF SOFT DOLLAR REPORT, supra note 1, at 42-43 (reporting, based on a large sample of investment advisers, that small advisers use over 50% of commissions to earn soft dollar arrangements while large advisers used only 8.3% of their commissions for that purpose, that soft dollars constitute less than 5% of large advisers operating expenses and a much smaller fraction of operating income.
Directed commission arrangements are another substantial source of rebates with an estimated value of $90 million.\textsuperscript{89} Surveys have consistently shown that directed arrangements are used by $1/3$ to $1/2$ of all public pension plans, corporate pension plans and endowments to direct anywhere from $20\%$ to $1/3$ of their commission-based trading.\textsuperscript{90}

The vast amount of soft dollar benefits obtained by investment advisers is in the form of research, construed for regulatory purposes permissively to include a wide range of research benefits, such as reports (company, industry, market and general economic), news, computer equipment and pricing information. Currently, over 1800 vendors of independent research products make their services available through third-party brokers.\textsuperscript{91}

The pervasiveness of rebate arrangements is further reflected in specialization of third-party brokerage firms and the resources that they devote to marketing such arrangements. The SEC Staff Report notes that some

\begin{itemize}
\item whereas small advisers reported appreciable rebate income as a fraction of client fees.
\item \textsuperscript{89} Greenwich Associates Non-Traditional Trading Report, supra note 76, at vi. Due to inconsistent industry usage, it is not clear whether this figure encompasses the entire universe of directed rebate arrangements or is limited solely to commission recapture arrangements. The 1998 figure shows a slight reduction from 1997 when Greenwich Associates estimated the amount to be approximately $95 million.
\item \textsuperscript{90} See Greenwich Associates, How Funds Are Coping with Uncertain Market at 72 (Feb. 1999) (annual study of the investment practices of tax-exempt funds in the United States) (showing figures for 1994 to 1998); see also Lemke \& Lins, supra note 1, at 9 (citing Bennett \& Kustra, Market Commentary: Challenges and Opportunities Facing a Changing Industry, in Third Annual Pension Executive’s Program on Soft Dollars 19 (1994)). Generally larger funds in all classes of tax-exempt funds are more likely to direct than smaller funds. Greenwich Associates, supra. Public pension funds use directed arrangements as an off-budget means of augmenting resources available to the fund’s administrative staff that otherwise face state or local governmentally imposed budgetary constraints. See 1997 ERISA Advisory Council Report, supra note 3, at 32-33 (summary of testimony of Steven Wallman, Commissioner, U.S. Sec. and Exch. Comm’n).
\item \textsuperscript{91} As of 1994, one advisory firm had compiled a list of approximately 1800 vendors of soft dollar services. Harold S. Bradley, supra note 82 (presentation exhibit).
\end{itemize}
brokerage firms devote staffs of a dozen or more sales representatives to market soft dollar arrangements. The largest commission recapture firm serves almost 700 institutional investors. Third-party firms must engage in elaborate commercial recordkeeping, tracking order flow from investment advisers and their clients as well as soft dollar and directed brokerage credit balances.

Brokerage rebate arrangements, apart from the key elements summarized here, can easily become more intricate in a commercial setting. For example, one type of transaction that has caught regulator attention is the so-called step-out transaction. A step-out transaction involves use of two brokers in a single transaction. Typically the principal executing broker is requested by the investment adviser on behalf of the client to step-out some portion of a large trade after execution. In stepping-out, the primary executing broker in effect surrenders the commission on the portion of the transaction that is stepped out, and typically each broker will be responsible for clearance and settlement as to their portion of the

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93 See Schwartz Recapture Arrangement Statement, supra note 78. Directed brokerage arrangements are concentrated among pension plan clients. Interestingly, mutual funds are not significant users. Compare 1999 SEC Roundtable, supra note 65, at 161 (Vanguard fund family regularly directs sub-advisers to use directed brokerage to reduce fund expenses) with id. at 167 (T. Rowe Price fund family prohibits traders from using directed brokerage arrangements).

94 In the case of soft dollar arrangements where soft dollar benefits may be advanced by the broker, customer balances may be either positive or negative and may be carried forward year to year. See 1998 SEC Staff Soft Dollar Report, supra note 1, at 29.

In a directed brokerage arrangement, step-out transactions may be used as a means of satisfying an advisory client's informal commitment to provide commissions to the broker that receives the step-out portion of the trade in return for rebate benefits to the advisory client.

Perhaps the most important feature of brokerage rebate arrangements is their alleged effect on brokerage commissions. In the wake of deregulation of commissions in 1975, average commissions dropped from roughly 71 cents a share to approximately 11 cents a share. By the early 1990s commission rates were approximately 6 cents a share and have remained in that range for full-service and third-party brokers. The lack of any further

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97 Step-out transactions may be viewed as a device aimed at unbundling execution and rebate issues. The elaborately choreographed step-out appears to be aimed at reconciling best execution obligations and efforts to use rebates for services that could not be obtained from the executing broker. The first broker enables the investment manager to meet best execution concerns while the second broker provides the advisory client with a favorable rebate opportunity. See Scotti, supra note 70, at 27.

98 See Schwartz Statement, supra note 64, at 637; 1997 ASIR SOFT DOLLAR PAPER, supra note 4, at 19.

99 Id.; 1998 SEC SOFT DOLLAR REPORT, supra note 1, at 28. A Greenwich Associates analysis has documented a gradual reduction in average commissions on listed domestic equities between 1994 and the expected average in 1999 from approximately 6.1 cents per share to 5.3 cents per share (which appears to reflect the effects of competition provided by non-traditional trading systems). See GREENWICH ASSOCIATES NON-TRADITIONAL TRADING REPORT, supra note 76, at v. The staff of the SEC has indirectly indicated concern regarding the apparent stickiness in commissions paid by advisers in light of the recent dramatic reductions in commissions paid by retail brokerage customers. The staff recently initiated a sweeping review of how funds seek best execution and attempt to minimize brokerage costs. See Aaron Lucchetti, SEC Probes Funds' Commissions, WALL ST. J., C1
reduction in commission rates is surprising for two reasons. Execution costs for brokers have declined with increased volume and greater reliance on technology. Moreover, the advent of electronic trading systems has seen commissions for relatively small retail customers drop well below the 6 cent per share level paid by advisory clients. This is particularly significant since until recently retail transactions have been subject to much higher commission costs.

IV. BROKERAGE REBATE ARRANGEMENTS: ECONOMIC AND POLICY ISSUES

Brokerage rebate arrangements evidence purposeful economic conduct by brokers, investment advisers and even advisory clients. Market practices are shaped predominantly by the economic incentives of these key participants, the participants' access to information and monitoring costs and competitive forces. Existing regulation with respect to rebate arrangements is based on a partial recognition of these economic factors but, as we will see in subsequent sections, it is also unduly rigid and stands as an obstacle to realizing a more coherent economic approach to regulation of such arrangements. While the flaws in current legal policy are examined in subsequent sections, that analysis rests on an understanding of the basic economic factors contributing to brokerage rebate arrangements.

Soft dollar and other brokerage rebate arrangements are shaped predominantly by two economic considerations: (i) the principal-agent relationship that exists between the investment adviser and advisory clients and

(Sept. 16, 1999). Such a review, following so closely on the heels of the 1998 SEC STAFF SOFT DOLLAR REPORT, supra note 1, evidences continuing doubts by the SEC staff in the area of advisory brokerage arrangements.

100 Carrie Lee, Making the Trade — How to Pick, WALL ST. J., JUNE 14, 1999, at R8 (showing brokers offering commission prices to retail investors of under $.02 a share for transactions in excess of from 1,000 to 5,000 shares).
(ii) competition among brokers for order flow from managed accounts. These elements and their implications for public policy are described below.

A. The Economics of Agency Relationships

Economic analyses of agency relationships provide a rigorous approach to understanding the effect of rebates on the investment adviser/advisory client relationship.\textsuperscript{101} Agency problems arise in the economic sense from three conditions: (i) delegation of decision-making by one party (the principal) to another (the agent); (ii) the principal's inability to observe directly the conduct of the agent in discharging its responsibilities on behalf of the principal; and (iii) an inherent divergence between the principal's interests and the agent's incentives in carrying out tasks on behalf of the principal. The divergence between the principal's interests and the agent's incentives stems from a number of factors, most notably the different economic rewards enjoyed by the principal and agent in connection with the agency relationship.\textsuperscript{102} Divergence in interests of the principal and agent alone, however, would not be a


\textsuperscript{102} When economists note that an agent's and principal's economic interests will diverge, they do not mean that the agent will invariably put its own interests ahead of the principal's. After all, the agent will recognize that conduct that does not appear faithful or efficient to the principal will eventually lead to termination of the relationship. Rather, economists focus on deviations in the standard of care and urgency that the agent may exercise in the conduct of the principal's affairs relative to the care and urgency the principal would wish exercised on its own behalf. The degree of divergence will depend on factors previously
source of problem but for the fact that principals cannot monitor the actions of their agents costlessly to ensure faithful and efficient service.

It is in the economic interests of both principals and agents to minimize so-called agency costs, that is, the costs associated with the agency relationship attributable to the divergence between the principal's interests and the agent's incentives. From the principal's perspective, the agent will not act with optimal efficiency in carrying out its delegated tasks and from the agent's perspective, minimization of agency costs will allow the agent to command higher compensation from its principal.

Economists who have analyzed the problem of efficient agency relationships have noted strategies for minimizing agency costs. One is monitoring of the agent by the principal and the other is bonding performance by the agent. Each of these strategies entails costs for the principal and agent, respectively. Thus, a principal will incur monitoring costs up to the point where the marginal return from monitoring in terms of improved performance by the agent offsets the principal's marginal monitoring costs. At some point, the marginal costs of monitoring will exceed marginal losses from the agent's sub-optimal performance and the principal will accept such losses willingly rather than incur additional monitoring expenses.

Bonding refers to any action taken by the agent to signal credibly its faithfulness and reliability to its principal. In practice, agents find many ways to signal faithfulness credibly, whether through guarantees, business reputation or investments in capital resources needed to serve clients. These actions induce reliance by clients (the principals) by signaling to the principal the agent's belief that it will be able to recoup these costs through superior performance as an agent. As with monitoring costs of the principal, however, an agent will willingly incur such

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103 E.g., Jensen & Meckling, supra note 101; Eugene F. Fama, Agency Problems and the Theory of the Firm, 88 J. POL. ECON. 288 (1980).
bonding costs only to the extent that his marginal returns in terms of enhanced agency compensation exceed the marginal costs of bonding.

As previously noted, the relationship between an investment adviser and its clients is one of agency. Clients retain investment advisers precisely because of the clients' lack of expertise in financial markets. Because knowledge of financial markets is both specialized and costly to acquire, advisers have decided advantages over their clients in evaluating execution quality of brokers and implementing cost-effective execution strategies in choosing among brokers.

The rational advisory client must consider the economic consequences of brokerage rebates. Receipt of a rebate, such as a soft dollar inducement, increases the potential divergence between the adviser's incentives and its clients' interests in directing brokerage: the adviser is likely to be marginally less diligent in seeking best execution for its client and marginally more likely to accelerate or increase trading in a client's account. These concerns, as noted above, are addressed by applicable legal principles designed to curb misconduct by agents, including investment advisers.

Another strategy to constrain the adverse consequences of rebates is for advisory clients to monitor the actions of the investment adviser. While investors may face significant costs in evaluating the effect of soft dollar arrangements on their expenses, there are low-cost proxies for monitoring. Clients may monitor expenses directly. Alternatively, they may indirectly gauge the effects of the soft dollar arrangement by monitoring investment performance because performance reflects both any expenses associated with the soft dollar arrangement as well as any benefits from improved investment performance resulting from investment adviser access to additional research.

Disclosure requirements, which impose standardized methods of calculating performance, offer a low cost
means of monitoring investment performance.\textsuperscript{104} Mutual fund performance disclosure is augmented by readily available third-party services, such as Lipper or Morningstar, which provide rankings with respect to performance of publicly offered investment funds.\textsuperscript{105} In addition there are a number of fee-based third-party rating services which evaluate the performance of money managers.\textsuperscript{106} While it is unclear how sensitive advisory clients are to higher expenses and the potential for diminished overall performance as a result of higher expenses, investor access to such information serves as a constraint on egregious rebate abuses.\textsuperscript{107}


\textsuperscript{107} A repeatedly expressed concern is that investors, whether from lack of understanding or other reasons, pay insufficient heed to fund expenses in making investment decisions. See U.S. Sec. and Exch. Comm'n Press Release: SEC Introduces New "Mutual Fund Cost Calculator" (visited Apr. 6, 1999) <http://www.sec.gov> ("SEC research suggests that most of the nation's 77 million mutual fund investors don't know how much they're paying for their funds."); Remarks of Paul Roye, Director of the Division of Investment Management, U.S. Sec. and Exch. Comm'n, Media Briefing on Mutual Fund Cost Calculator (Apr. 6, 1999) ["There is a gap between the widespread availability of mutual fund cost information in the fee table and investors' ability to use that information effectively."]; Karen Damato, How Investors Failed to Note A Fund Benefit: A Cut in Fees, WALL ST. J., Apr. 29, 1999, at C1 (noting that investors do not appear to be sensitive to savings of less than one percentage point in current bull market); Judith Burns, SEC to Take "Wait-and-See" Approach to Mutual Fund Fees, D.J. Newswire, July 6, 1998 (noting SEC official who believed "few investors pay any attention to [fees]"). However, contrary evidence exists as well. See Richard A. Oppel, Jr., Fund Expenses: They're Going Down, Down, Down; Conventional Wisdom is Belied by the Numbers, N.Y. TIMES, July 4, 1999, at § 3, at 11 (noting certain mutual fund experts have observed
B. The Economics of Competing for Order Flow from Managed Accounts

Broker rebate arrangements provide a means for brokers to compete for order flow from managed accounts. This competition exists at two different levels. As noted, three different classes of brokers compete for order flow from managed accounts: full-service firms, third-party brokers and execution-only brokers. Within these classes, brokers compete against one another by trying to provide better execution and services at lower cost than the other brokers within that class. Competition among the three different classes of brokers is more interesting for our purposes for what it reveals about rebate arrangements. We have previously described the essential features of each class of broker (summarized in Table 1). The combination of these features advances the economic interests of each class of broker in competing for order flow.

Prior to deregulation of commissions in 1975, full-service firms were the dominant form of brokerage firm. This fact is hardly surprising given the widely held perception that fixed commissions were well above competitive levels. As a result, full-service firms competed with one another through non-price competition (such as providing enhanced execution quality for the same commission rate) or through research and give-ups (implicit price discounts).

In a negotiated commission environment, full-service firms have continued to provide high quality executions but charge a relatively high average commission (albeit a commission that is much less than the former fixed commission rates). In return for order flow, full-service firms provide clients general access to the firm’s proprietary research. Two questions come to mind: (i) why do full-service firms provide execution and research on a trend among investors to “migrat[e] toward lower-cost funds and lower-cost families”).

108 See Blume, supra note 81, at 39 (“The existence of soft dollars [including directed brokerage arrangements] has a significant impact on the allocation of brokerage to different types of brokers.”)
bundled basis (that is, why do they not charge separately for execution and research) and (ii) why do they generally charge a uniform commission rather than negotiating each commission based on the difficulty of the transaction?

Economic principles provide some guidance in answering these questions. To determine an appropriate commission in the institutional brokerage market, the full-service firm faces an intricate pricing problem that entails two distinct features. First, the pricing scheme must take into account that the firm produces multiple products (or more accurately, services), that is, investment banking, research, brokerage, proprietary trading and market making.\textsuperscript{109} For example, firm research regarding the computer industry may be relevant both to advising institutional brokerage customers and to securing investment banking work in the computer industry. Second, the same research can be provided virtually costlessly to many clients (in other words research has zero marginal costs when provided to each additional client after the first). Third, the services produced by the full-service firm are used by clients with very different demand characteristics and, in the case of certain markets being served such as the institutional brokerage market, price discrimination strategies may be feasible.\textsuperscript{110}

\textsuperscript{109} As a result, the firm may have both common fixed and variable costs with respect to different lines of its business. The firm must apportion any common costs across its lines of business subject to certain economic constraints. The most important constraints are those represented by price competition from firms that cater to institutional brokerage exclusively (and thus who may have very different cost functions) and the fact that the full-service firm's own cost function probably increases over the relevant range of operation (i.e., there are decreasing returns to scale and so the industry is not one that is likely to give rise to a natural monopoly). See William W. Sharkey, \textit{The Theory of Natural Monopoly}, 37-42 (1982). As discussed in the text below, the full-service firm experiences significant economies of scale in providing research to customers since once the research is produced it can be disseminated to an unlimited number of customers. This fact, however, does not convert the full-service firm into a natural monopoly since the decreasing returns experienced by full-service firms in other parts of their business outweigh the economies that exist with respect to research.

\textsuperscript{110} See Louis Phillips, \textit{The Economics of Price Discrimination} 5 (1983) noting that price discrimination is typically defined as selling the same
As a multiproduct firm, full-service brokerage firms face a challenge in setting competitive prices and covering costs across their various lines of business. The commissions charged by a full-service firm, which are generally high average uniform commissions, reveal the firm’s view of its optimal pricing strategy.\footnote{111} The full-service firm does not charge high average uniform commissions for routine execution services alone, but rather seeks to bundle its provision of execution services with other services. Specifically, the full-service firm bundles high quality execution services with general access to its proprietary research services. This bundling strategy contrasts with other possible pricing strategies, such as unbundling (charging separately for) execution and research or bundling execution services of average quality with research provided on a metered basis.\footnote{112}

good to different consumers at different prices. In a thorough examination of the issue, Professor Philips explains, however, that this definition needs some updating in light of more sophisticated contemporary commercial practices involving multiproduct firms and differentiated products. \textit{Id.} at 6-7. Thus, in his view, price discrimination is more properly defined as encompassing sale of one or more varieties of a product or service to two different buyers at different net prices (i.e., prices that differ by more than any cost differential in producing or providing the different varieties of the product or service). \textit{Id.} at 6.

\footnote{111} If using a price discrimination strategy in the institutional brokerage market, the profit-maximizing full-service firm will choose a commission or commission scheme where marginal revenue from each group of investors equals marginal cost. \textit{Id.} at 4. The multiproduct character of the full-service firm will affect the optimal strategy for price discrimination to the extent that certain of the firm’s fixed and variable costs are common costs shared across different lines of business. In such cases, allocation of the variable costs may affect the imputed marginal costs for the full-service firm in supplying research to the institutional brokerage market which, in turn, will affect the optimal pricing strategy for price discrimination purposes. In addition, allocation of the fixed cost will require the firm to meet certain revenue objectives in each market. Given the complexity of the problem, there may be no stable competitive equilibrium. \textit{See} \textit{Sharkey, supra} note 109, at 37-42.

\footnote{112} There are several different types of price discrimination. The full-service firm’s pricing strategy reflects a form of imperfect price discrimination known as second-degree price discrimination where the seller seeks to identify discrete groups of purchasers with different demand characteristics and charge each group a different price. Such groups frequently are determined by self-selection as in the case of
The full service firm's approach to pricing and bundling of its services is indicative of a subtle form of price discrimination. Customers, regardless of their specific execution and research needs, pay the same commission. The firm is in effect making customers with lower cost trades and significant research needs pay a premium for execution relative to customers with higher cost trades and making customers with higher costs trades but modest research needs pay a premium for research relative to those with significant research needs. Both types of customers may potentially pay more in aggregate than if the individual services of execution and research (and the different types of research materials) were each priced separately. In addition, the full-service firm's high average commission may enable it to earn a greater profit from some customers than others, for example on transactions involving highly liquid securities that entail little execution risk.

Bundling of services and different products is commonly used to effect a discriminatory pricing strategy. The full-service firm engages in bundling of services at two levels: (i) execution services and research are bundled in that proprietary research is available only to those using the firm to effect trades and (ii) research materials are bundled by providing a stream of materials without regard to the particular research needs of the customer. See id. at 156-57, 165-66, 176-83 (describing block booking, commodity bundling and non-linear pricing strategies). Cf. Roy Kenney and Benjamin Klein, The Economics of Block Booking, 26 J. LAW & ECON. 497 (1983); GEORGE STIGLER, A NOTE ON BLOCK BOOKING IN THE ORGANIZATION OF INDUSTRY 165 (1968).

This bundling enables the full-service firm to derive the maximum amount of profit from each group of customers and thereby extract greater consumer surplus from its customers than if the two components — execution and research — were priced separately.

Of course, imposition of a high average commission also results from uncertainty regarding what the actual costs of execution will be. For example, a broker that block positions with a volatile thinly-traded issue may realize unusually high execution costs. Notwithstanding this potential, the price of the issue may actually remain fairly stable in a transaction and the broker will realize a profit since the actual execution costs will not exceed the high average commission. The use of high average commissions in such cases merely compensates the full-service firm for the added execution risk associated with the transaction and should not be considered price discriminatory. However, as explained in the text there are other respects in which the high average

airline passengers who pay different rates for first and economy class. See PHILIPS, supra note 110, at 12-16.
The effectiveness of this price discriminatory strategy appears to be enhanced by the fact that the research bundled with the trade execution directly benefits the investment adviser — an agent — while the commission is paid by the agent's principal, namely the advisory client. The bundling of execution and research reduces the likelihood that advisory clients with low cost trades will migrate to lower cost brokers that provide execution only because the adviser — charged with responsibility for selecting the broker — derives a separate benefit from the research.

The execution-only broker provides a different, and far simpler, package of services: average quality executions for a lower commission. Customers with demanding trades may fare better with a full-service broker since the average quality execution for a particular transaction may result in significant market impact costs that exceed any savings realized on the lower commission. However, customers with undemanding trades (for example, a moderate sized trade in a highly liquid issue) may fare better with the execution-only broker since execution quality will not be greatly affected but the client will pay a smaller commission.

The difference between the full-service firm and the execution-only broker in such circumstances will be the value of the full-service broker's research and the execution-only broker's lower commission. In theory, the full-service firm should be used only if the value of the research outweighs the higher commission cost. However, in practice, the full-service firm may be selected even when this is not the case because of the different incentives of the investment adviser and the adviser's clients. The adviser derives a benefit from the research but does not directly share in the benefit derived from reduced commission costs. In such circumstances, the adviser may select the full-service firm over the execution-only broker even though the advisory client is served better by the low-

commission charged by full-service firms may be regarded as price discriminatory.
priced package of services offered by the execution-only broker.

The third-party broker pursues an intermediate competitive strategy: it charges a higher average commission that is comparable to the full-service firm, provides an average quality execution comparable to the execution-only firm, but provides specialized research according to a cost-based formula in conjunction with executions (that is, converting a fraction of every commission dollar into soft dollar credits which entitle the investment adviser to obtain research products of equivalent value). By virtue of this intermediate strategy, the third-party broker competes with the full-service firm not in terms of price but rather in terms of providing a different mix of research and execution quality. This strategy enables the third-party broker to compete effectively against the full service firm in situations where the execution-only firm encounters difficulties. In effect, the third-party broker offers average quality execution and high quality research relative to the full-service firm which offers high quality executions and average quality research. The adviser must evaluate the trade-off between execution quality and research quality rather than (as with the execution-only broker) between lower commission costs on the one hand and research and execution quality benefits on the other.

At first blush, it may seem puzzling that the third-party broker is able to offer superior research relative to the full-service firm given that the full-service firm may spend enormous amounts on research staffs and typically makes a larger quantity of research available to customers whereas the third-party broker must go out and purchase research from third-party research providers and allocates such research on a cost-based formula. One explanation may be that the full-service firm provides internally-generated research which is created not solely for the firm's investment adviser clients, but for all of the firm's lines of business. The quality of the research may be diluted because it must meet the needs of the full-service firm's different lines of business such as investment
banking as well as brokerage advice. Of course, the full-service firm could arrange to obtain research from a third-party research provider but in doing so it would lose whatever cost advantages it gains from generating its own research to service its different lines of business.

The third-party broker also has the capability of competing against the execution-only broker through customer directed brokerage arrangements. In such cases, the third-party broker offers commission recapture or expense reimbursement benefits to advisory clients, in lieu of third-party research to the adviser, to counter the low average commission of the execution-only broker. Commission recapture or expense reimbursement effectively reduces the commission paid by the advisory client and permits the recapture firm to compete with the execution-only broker as well.

C. Public Policy and Brokerage Rebate Arrangements

The economic factors discussed above — the agency relationship between investment adviser and client and competition among brokers for order flow from managed accounts — provide significant insight into the economic dynamics of brokerage rebate arrangements. Armed with these insights, we can begin to evaluate the policy issues associated with rebate arrangements.

1. The Wisdom of Brokerage Rebate Arrangements

An obvious question is whether rebate arrangements of the sort described above are desirable or harmful from a public policy perspective. In other words, do such arrangements work against the interests of the clients of investment advisers or against the collective interests of society as a whole? The answer actually implicates two very different lines of analysis: how should brokerage services be priced and, if priced using a rebate, who should get the rebate?

Rebate arrangements in practice reduce the effective price received by someone selling a product or service since the seller's earnings are reduced by the amount of
the rebate. A rebate reflects the producer's perception that a lower effective price for the rebate recipient is commercially warranted. The lower price may be warranted in the producer's mind for any number of reasons. As one example, transactions with customers receiving rebates may induce a greater volume of transactions, thus enabling the seller to reduce costs by taking advantage of scale economies. Alternatively, the seller may recognize that there are groups of customers with different demand characteristics making price discrimination profitable provided that it is feasible to offer the two groups of customers different prices. Volume discounts or preferred-customer discounts are well-established commercial practices that serve legitimate economic purposes from the seller's perspective. A broker's use of rebates or discounts is consistent with such economic purposes. A steady flow of orders may allow brokers to take advantage of economies of scale (or as we have seen in the case of full-service firms, economies of scope) and may serve to minimize costs associated with particular transactions by forging long term client relationships (for example, by conserving time in arranging for a transaction or verifying client expectations in execution of the order). It also permits the broker to minimize the risk associated with pricing on a transaction-by-transaction basis where there are difficulties in assessing the true costs of execution which may vary from trade to trade. The costs of negotiating commissions on a per trade basis might be significant. Brokers in such situations may have a better idea of the overall costs of trading on a long-term basis (where specific transactional

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115 The key elements of a price discrimination strategy were discussed in the preceding section. One aspect of the discussion that was not emphasized concerns the existence of certain conditions which enable a producer to implement a price discrimination strategy. Philips identifies four such conditions: "practical barriers to resale of the producers' goods, difference in the intensity of the demand of consumers, a mechanism for sorting consumers, according to intensity of their demand, and the existence of monopoly power in the weak sense of the word, namely that the producer does not face a perfectly elastic demand curve." Philips, supra note 110.
risk may tend to average out) than on a trade-by-trade basis. A rebate allows a broker to reflect the reduced risks associated with a long-term trading relationship.\textsuperscript{116}

The more problematic side of a rebate is from the purchaser's perspective and may depend on several factors. A rebate reduces the effective price of a good or service from the purchaser's perspective only if the purchaser is the rebate recipient. In a soft dollar arrangement where the investment adviser rather than the client is the rebate recipient, the rebate does not reduce the effective cost of the commission paid by the advisory client, at least from the client's perspective. Indeed, the great question posed by rebates is whether they increase overall agency costs of the client by influencing an adviser's exercise of judgment on behalf of the client.

The problem presented by a rebate arrangement thus is not the rebate itself, but rather more accurately, who is receiving the rebate. After all, rebate arrangements may be an efficient way of pricing brokerage services from the broker's perspective. But rebate pricing raises special concerns where it permits investment advisers to appropriate the value of the rebate in derogation of the client's interests. It is necessary to consider whether rebates in the form of research paid to advisers on the commissions of clients are necessarily adverse to those clients' interests.

2. The Incentive Alignment Hypothesis

In an intriguing analysis, Professor D. Bruce Johnsen argues that soft dollar arrangements may actually promote efficient agency relationships.\textsuperscript{117} His argument rests on the contention that traditional agency critiques of soft dollar arrangements overlook an equally important dimension of

\textsuperscript{116}Principal trades as opposed to agency trades entail an added element of risk for dealers. In principal trades, the dealer trades against its customer and thus the dealer's mark-up (in contrast to a commission) and trading spread must reflect the possibility that the customer with whom the dealer is trading has better information than the dealer.

\textsuperscript{117}Johnsen, \textit{supra} note 4, at 91-104.
the agency relationship, the potential of investment managers to shirk on investments in research (that is, invest less than what clients rationally would spend if acting on their own behalf). According to Professor Johnsen, soft dollar arrangements offer a low-cost mechanism for advisory clients to overcome this underinvestment problem. By subsidizing an investment manager’s use of research, soft dollar arrangements compensate for the tendency of manager’s to otherwise underinvest in research, thereby serving to align more closely the interests of advisory clients and advisers. Professor Johnsen dubs his theory as the “incentive alignment hypothesis.”

The incentive alignment hypothesis, while underscoring the fact that soft dollar arrangements potentially may benefit advisory clients indirectly, is not very plausible. In most soft dollar arrangements, the investment adviser reserves the right to use such arrangements without committing to their use. The advisory client seldom, if ever, actually directs or even encourages use of soft dollar arrangements. Under the incentive alignment hypothesis, one should expect the contrary, namely that clients would either mandate the use of or seek out advisers that employ soft dollar arrangements.

The incentive alignment hypothesis also rests on the premise that investment advisers have an incentive to underinvest systematically in research. Systematic

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118 Id. at 95-96.
119 Id. at 97-98.
120 Id. at 78-79, 91-92.
121 This underinvestment theory is directed at the issue of optimal investments in research by private actors rather than socially optimal investments in research. There is a considerable body of economic theory which suggests from society’s perspective, rules that encourage private investment in securities research do not enhance social welfare, even if individuals may privately gain from such activity, because it leads to overinvestment in such activities for society collectively. See Jack Hirshleifer, The Private and the Social Value of Information and the Reward to Inventive Activity, 61 AM. ECON. REV. 561 (1971) (exposition of the basic problems of overinvestment and underinvestment); John C. Coffee, Jr., Market Failure and the Economic Case for a Mandatory Disclosure System, 70 VA. L. REV. 717 (1984) (application to securities
underinvestment is a particular risk where clients face significant costs in monitoring the conduct of advisers. If the costs of monitoring performance were negligible, an investment adviser would make the appropriate investments in research, even though costly, since it would otherwise risk losing advisory clients that are vigilant.\textsuperscript{122}

While investors may face significant costs in evaluating a particular investment adviser's actual expenditures on research, there are low-cost proxies for monitoring investments in research as discussed above.\textsuperscript{122} Indeed the

\textsuperscript{law}. This concept forms the basis for Pozen's critique of section 28(e) in Pozen, supra note 3.

From society's perspective, securities research entails both productive and wasteful activities. It is productive to the extent that it improves asset pricing in capital markets so that new capital is directed to its most productive use. See generally Marcel Kahan, Securities Laws and the Social Costs of "Inaccurate" Stock Prices, 41 DUKE L.J. 977 (1992). It is wasteful, however, in that it involves a great deal of largely duplicative effort to produce securities research on the part of market participants and investors as they scour markets for underpriced investment opportunities. Although securities research may result in private gains among market participants and investors, it does not necessarily lead to corresponding improvements in the precision of prices in capital markets. There is a considerable body of opinion that argues that singling out securities research for subsidization is unwise social policy. Thus, assuming a social welfare perspective, it might well be the case that society should adopt rules that discourage subsidization of private securities research, such as the soft dollar safe harbor, even if investment advisers are prone to underinvesting in research from the perspective of their own clients. However, in analyzing Professor Johnsen's argument, I will focus exclusively on private incentives and evaluate whether investment advisers are likely to underinvest in research from the perspective of advisory clients.

\textsuperscript{122} If monitoring of performance is sufficient to induce optimal levels of investment in research, subsidization of securities research through soft dollar arrangements may lead to overinvestment in research from a purely private investment perspective — that is private investment in securities research would be greater than what fully informed clients and investment advisers would choose with costless bargaining and monitoring. If soft dollar arrangements subsidize research, and advisers are already equating the marginal costs and marginal benefits of securities research, permitting soft dollar arrangements would induce even greater investments in research — research in excess of optimal levels from a private bargaining perspective.

\textsuperscript{123} These include mandatory disclosure regarding performance in some cases, standardized performance measures and third-party rating
underinvestment theory itself presupposes a discernible relationship between private investment returns from securities research and research expenditures. If, as one would hope, superior research translates into superior investment performance, then investment performance should provide a useful proxy for investment in research. Thus, clients may have the ability to monitor investments by advisers in research indirectly by monitoring investment performance of portfolio managers and accounts. If underinvestment leads to inferior reported services. See text and notes accompanying notes 105-06. Empirical studies of mutual fund investor behavior support the view the advisory clients are sensitive to investment performance, although these studies also reveal that investor behavior does not follow a simple pattern and is affected by other factors as well. See, e.g., Erik R. Sirri & Peter Tufano, Costly Search and Mutual Fund Flows, 53 J. Fin. 1589 (1998) (empirical analysis suggesting that investors appear to give disproportionately greater weight to superior past performance in purchasing mutual funds than to inferior past performance in determining whether to sell their fund investments and that search cost factors tend to exaggerate this asymmetrical behavioral response); cf. Lu Zheng, Is money smart? A study of mutual fund investors' fund selection ability, 54 J. Fin. 901 n.1 (1999) ("It is well-documented that investors chase past positive performance and that performance persists on a short term basis." [collecting citations]) (presenting statistical evidence of short-term "smart money" effect in which investors move their own funds to mutual funds that will outperform in the short-run).

Other factors also serve to address the risk of systematic underinvestment in research. Institutional money managers will generally have to compete for business from large pension funds by demonstrating that they are capable of managing the client's money. Such a demonstration invariably will involve descriptions of the qualifications of their portfolio managers and analysts as well as other resources employed in managing assets. This process frequently involves evaluation by outside investment management consultants as well. To some extent, retail advisory clients may be able to free ride on this research by using funds whose advisers also advise pension funds.

124 If such a relationship did not exist, it would be impossible to conclude that an adviser was underinvesting in research. In other words, underinvesting in research necessarily presupposes that additional investments in research will yield positive private economic returns. One early critic's advocacy of repeal of section 28(e) and criticism of soft dollar arrangements in general was premised on the view that private securities research did not yield positive economic returns for clients and thus that payment of research out of client funds should give rise to a presumption of a breach of fiduciary duty, unless the adviser could actually show that the research economically benefited the client. See Pozen, supra note 3, at 927, 932-33, 934-35.
investment performance, performance disclosure will in turn discourage shirking on investment expenditures.¹²⁵

Even if there were pervasive underinvestment in research by investment advisers, it does not follow that soft dollar arrangements would provide an efficient means of addressing the problem. Professor Johnsen reaches a different conclusion by arguing that soft dollar arrangements subsidize research, encouraging marginal investments in research which absent the subsidy would not be undertaken.¹²⁶ This argument, however, assumes that soft dollar rebates are used to purchase additional units of research or in other words that the soft dollar subsidy affects an adviser's decision-making at the margin. Not only need this not be the case, but it actually seems unlikely in many cases. The reason is that many advisers frequently will substitute soft dollar credits to accomplish research expenditures that they would have

¹²⁵ Expenses are themselves reasonably transparent and have a direct effect on reported performance. It is therefore reasonable to ask why, if reported performance is sufficient to deter an adviser from underinvesting in research, it does not create similar incentives for advisers to allocate soft dollars toward reduction of the expenses of the managed account and thereby boost reported performance. One explanation might be that investors are less sensitive to modest differences in performance attributable to variations in expenses than to potentially significant variations in performance based on investment decisions. See Erik Sirri, Mutual Fund Fees and Expenses, Investment Company Institute, Conference on Economic Developments & Issues in the Mutual Fund Industry, New York, N.Y. (Nov. 16, 1998) (audiotape available from the Investment Company Institute) (discussing (i) observation that investors have difficulty in evaluating the effect of fund expenses on investment performance because over short periods the random noise effects on investment performance figures frequently outweigh the relatively small-order magnitude effects of expenses and (ii) illustration using reasonable assumptions to show that a 75 basis point difference in annual expenses between two funds with common investment objectives would likely not be apparent to an investor that solely studied net performance figures alone for a decade or two and that a 10 basis point difference might not be apparent for more than 100 years). In contrast, it appears anecdotally that investors are extremely sensitive to the effect of expenses on performance in the case of money market funds and broad-based index funds, funds where control of expenses rather than investment decisions have a decisive effect on relative fund performance.

¹²⁶ See Johnsen, supra note 4, at 95-100.
made in any event. In other words, the rebate will not necessarily subsidize research at the margin and could just as easily be used to subsidize either fixed costs associated with research or so-called inframarginal units of research — research inputs that would have been purchased in any event. In either case — subsidization of fixed research costs or of research that would have been procured in any event — the rebate obtained from soft dollar arrangements would not actually increase total investment in research because the rebate would not affect marginal costs in the range relevant for determining the level of investment in research.\footnote{Diagrammatically, Professor Johnsen’s subsidization argument boils down to this: subsidization of research based on commissions derived from portfolio executions will essentially result in a parallel downward shift in the adviser’s marginal cost function relative to marginal costs in the absence of a soft dollar arrangement. If costs and returns are graphed as a function of research inputs (as Professor Johnsen does in his article, supra note 4, at 113), it might well turn out that the rebates do not affect marginal costs but only the fixed costs of research or alternatively the costs of specific research inputs. In the former case, the rebate would reduce average costs (for example, the adviser is able to buy a personal computer) but not marginal costs. In the latter case, the shape of the marginal cost curve may be affected over a particular range of inputs, but may not affect the marginal cost function continuously (i.e., soft dollar rebates may result in a kinked marginal cost curve but not necessarily a downward parallel shift in the curve). As a result, there is no assurance that soft dollar rebates will in any way effect the adviser’s decision making since it may not change the point where marginal costs equal marginal benefits (i.e., the subsidy will not affect the level of research).}

From an agency law perspective, it does not appear that soft dollar arrangements will necessarily be the most or even a particularly efficient way to subsidize research as opposed to other methods. For example, the client could enter into an explicit agreement with the investment adviser to subsidize some portion of the adviser’s research directly.\footnote{See Pozen, supra note 3, at 964-66 (discussing likelihood of alternative compensation arrangements for advisers in event that section 28(e) were repealed).} Soft dollar arrangements, at best, are a crude metering device for remedying any systematic underinvestment in research. There is no reason to believe that the amount of the subsidy, based as it is on a
relationship between portfolio executions and research, is calibrated in an economic sense to bring about optimal levels of research from the perspective of advisory clients.  

Moreover, there is no guarantee under the safe harbor that rebates resulting from commissions paid by one client result in research specifically calculated to aid that client. One client’s subsidy may actually contribute to an investment adviser providing additional research to another client. The relationship between portfolio executions and systematic underinvestment in research thus appears too attenuated to conclude plausibly that soft dollar arrangements provide an efficient remedy for any systematic underinvestment in research.

Only limited empirical evidence is available and although it weighs against the incentive alignment hypothesis, it is not decisive. Agency analyses assume that informed bargaining by a principal and agent will lead to arrangements that enhance the efficiency of the agency relationship. Accordingly, if the incentive hypothesis were correct and soft dollar arrangements promoted efficient agency relationships, advisory clients would opt for more efficient rebate arrangements if given a choice. The rise of customer directed arrangements, however, provides powerful evidence of the preference of certain advisory clients for customer directed rebate arrangements over

129 Professor Johnsen argues that the fixed relationship between the rebate and commissions is likely to curb excessive research since the inducement is tied to portfolio executions. See Johnsen, supra note 4, at 98-99. This fixed relationship exists, however, only in the case of third-party arrangements. Moreover, while undoubtedly portfolio turnover constrains the size of the subsidy received by the adviser, its effect at the margin is likely to be entirely fortuitous.

130 The adviser has no obligation to account for the benefits resulting from one account as long as the benefit is reasonable in relation to the value derived by all accounts under management. In other words, soft dollar rebates earned from trading in one account can and frequently are used to subsidize research benefits to other accounts. The use of soft dollar arrangements to effect cross-subsidies among accounts casts further doubt on their use as a means to redress underinvestment concerns.
soft dollar arrangements. In other words, at least some advisory clients prefer to capture brokerage commission rebates directly (either in hard cash or in the form of expense reimbursement) in lieu of subsidizing investment adviser research through soft dollar arrangements negotiated by the adviser.

This fact is particularly striking since the use of customer directed brokerage arrangements tends to be concentrated among a limited segment of advisory clients: clients who possess unusual bargaining power such as pension plans. The bargaining power derives both from the inherent attractiveness of clients with large asset bases and from the ability of such clients to absorb the transaction costs of independently negotiating such arrangements. The prevalence of customer directed brokerage arrangements to facilitate commission or expense recapture in the private pension segment of the investment management industry stands in contrast to the prevalence of soft dollar arrangements in the predominantly retail segment of the industry (mutual funds and management of non-institutional client accounts). That larger institutional clients negotiate rebate arrangements that are fundamentally different from the rebate arrangements that prevail in the retail segment of the industry suggests that the absence of bargaining power and choice, rather than systematic underinvestment in research, is the driving factor in many soft dollar arrangements.

The fact that small investment advisers which service retail accounts use soft dollar arrangements more extensively than advisers that service institutional accounts is further evidence against the incentive

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131 Professor Johnsen recognizes the potential significance of advisory client preference for commission recapture arrangements. See Johnsen, supra note 4, at 106. He suggests that differences in utilization of soft dollars between managers of defined benefit and defined contribution plans might provide a test of the incentive alignment hypothesis.

132 The larger asset-base of certain institutional clients enables those clients to take advantage of economies of scale and spread the costs associated with negotiation and monitoring.
alignment hypothesis. While not necessarily inconsistent with the incentive alignment hypothesis, these results fit more naturally with the view that, absent the ability to monitor adviser conduct closely, soft dollar arrangements are more likely to influence an adviser's exercise of discretion in ways that do not advance the interests of clients. Once again, client bargaining power and transaction costs, rather than systematic underinvestment in research, seem to be more important in explaining the different rates of utilization of soft dollar arrangements.\(^{133}\)

There is, however, one piece of evidence that provides support for the basic thrust of the incentive alignment hypothesis namely that soft dollar arrangements have spurred new forms and greater use of more diversified research products. The proliferation of third-party research vendors since introduction of the soft dollar safe harbor in 1975 has been nothing short of staggering.\(^{134}\) Before deregulation of commissions, it is probably fair to say that full-service firms dominated the supply of research products to the investment management industry and in many ways effectively dictated the form of research available. While full-service firms continue to be a major source of research to the investment management industry, third-party vendors are now a significant alternative source of research not only in terms of amount but also in terms of variety.

3. Other Theories

The incentive alignment hypothesis reflects the view that advisory clients must subsidize research by investment advisers in order to ensure adequate levels of investment research. As such it is merely one of several possible

\(^{133}\) For variation in use of soft dollar arrangements by investment adviser size, see supra note 88. Of course, it is possible to reconcile these results with the incentive alignment hypothesis by postulating that small adviser cost functions are far more sensitive to changes in the marginal costs of research and that expected marginal returns from research for small advisers is greater than for larger firms and that these differences account for the huge disparities in utilization rates.

\(^{134}\) See supra note 91.
theories that seek to justify rebate, and implicitly bundling, arrangements. At least three other objectives have been offered to justify rebate or bundling arrangements: (i) facilitating joint production of brokerage and research services and high quality brokerage execution by full-service firms; (ii) promoting greater competition among full-service and third-party firms; and (iii) protecting small investment advisers.

Full-service firms, by bundling execution services and research, seek to exploit economies of scope from their different lines of business. The bundled services, as noted, embody an implicit rebate arrangement. Section 28(e) makes regulatory allowance for such implicit rebate arrangements, thereby enabling the firm to exploit strengths and efficiencies in research derived from its other lines of business. In effect, the regulatory policy behind section 28(e) permits the full-service firm to spread the cost of its research operations among its different lines of business.

Brokerage rebate arrangements, by permitting full-service firms to better compete for order flow, also tend to promote continued supply of high quality execution services to the marketplace. It may be that services such as block positioning that are required to deliver the highest quality executions would become prohibitively expensive and would disappear if full-service firms were required to compete with execution-only brokers on the basis of commissions alone. Indeed, full-service firms in the earlier part of the decade strenuously challenged third-party soft dollar arrangements on grounds that such arrangements impaired the ability of full-service firms to use order flow from low cost executions to cross-subsidize high quality execution services (block positioning).

A second justification for bundling relates to the ability of third-party brokers to compete with full-service firms. A

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135 See supra notes 109-111 and accompanying text.
136 See Sillen Testimony, supra note 71, at 713-15; Statement of Paul G. Haaga, Jr., 1993 House Soft Dollar Oversight Hearings, supra note 64, at 740, 766-68 ("Haaga Statement").
frequent refrain from critics of brokerage rebate arrangements is a proposal to compel unbundling of execution and research services.\textsuperscript{137} Compulsory unbundling would have dramatic implications for competition involving full-service and third-party brokers depending on how the proposal is actually framed. One proposal would be for unbundling by all firms, full-service and third-party firms, thus requiring full-service and third-party firms to price their research services separately from execution services. Such an unbundling proposal, of course, is essentially another way of advocating repeal of section 28(e). Indeed, compulsory unbundling would not only eliminate the protection afforded by the safe harbor, but would also prohibit bundling altogether.

Another form of compulsory unbundling proposal — and what is typically meant when compulsory unbundling is discussed — is directed specifically at third-party arrangements. Under the proposal, third-party providers would be required to separate the pricing of execution and research. This would effectively eliminate safe harbor protection for third-party arrangements. The third-party broker is clearly capable of pricing the services separately since it provides execution services internally and only procures externally research services for distribution to clients. However, requiring compulsory unbundling of execution and research by third-party firms would adversely affect the ability of third-party firms to compete with full-service firms since advisers only could obtain soft dollar benefits from the latter and would be required to purchase third-party research from their own, rather than client, funds.

It is important to distinguish between the policy effects of permitting bundling and prohibiting bundling. Permitting bundling allows full-service firms to take

\footnote{\textsuperscript{137} See 1999 SEC ROUNDTABLE, \textit{supra} note 65, at 168 (SEC official posing question regarding desirability of SEC initiatives to encourage unbundling); Keith P. Ambachtsheer, \textit{The Soft Dollar Question: What is the Answer}, 49 FIN. ANALYSTS J. 8 (Jan.-Feb. 1993) (urging consideration of compulsory unbundling as means of eliminating efficiencies introduced by brokerage rebate arrangements).}
advantage of economies of scope and to price their services in a way that they perceive to be advantageous. Allowing other firms, such as third-party firms, to bundle services enables such firms to compete more effectively with full-service firms. Prohibiting bundling only by third-party firms, in contrast, blocks competition and has the effect of protecting full-service firms.\footnote{138 From a policy perspective, the issue raised by such limited compulsory unbundling proposals is whether advisory clients are better off if (i) the third-party and full-service firms compete with one another in providing soft dollar rebate arrangements (thereby bringing about a greater range of choice in research products and greater competition for full-service firms) or (ii) only full-service firms are permitted to offer soft dollar arrangements (thereby potentially reducing use of soft dollar arrangements and sharpening price competition between full-service and other brokers).

Initiatives other than compulsory unbundling proposals also may have differing effects for full-service and third-party firms. For example, several years ago as part of the 1993 Soft Dollar Oversight Hearing, full-service firms urged significantly enhanced disclosure in connection with soft dollar arrangements. See Silfen Testimony, supra note 71, at 719-722. Many believed that the purpose of the proposal was to disadvantage third-party firms competitively relative to full-service firms.}

A final form of subsidization is reflected in the view that permissive attitudes toward soft dollars enable small investment advisers to compete with large advisers. Although permissive in character, such a rationale is problematic too because it fails to explain what advantages advisory clients obtain from policies which promote the ability of small advisers to compete with larger advisers. If small advisers promote more competitive markets, there of course would be an advantage. But adopting policies solely for the sake of enabling a competitor to survive, without any corresponding efficiency justification, seems dubious. If small advisers are in fact more dependent on soft dollar arrangements and, as a result, are more susceptible to influence in their brokerage allocation decisions, this suggests a cause for concern rather than a rationale that supports permissive attitudes toward soft dollar arrangements.
The use of brokerage rebate arrangements has also shaped competition in the securities industry in terms of competition among investment advisers, among brokers and among providers of research and ancillary brokerage services. Competition has been affected in three areas: (i) competition with respect to commission rates; (ii) competition among investment advisers; and (iii) competition on rebate arrangements.

Brokerage rebate arrangements directly affect the way in which brokers compete with one another on the basis of commissions. An oft-repeated criticism of soft dollar arrangements is that such rebates discourage direct competition on the basis of commission rates. In contrast, there appears to be vigorous competition in terms of soft dollar and directed rebate arrangements (that is, the amount of rebate provided for a given level of commission and usually referred to as the conversion ratio).

Rebate competition undoubtedly substitutes in some respects for vigorous competition on commission rates. That competition as to rebates may substitute for competition on commission rates is not to say, however, that rebate competition is as desirable in the eyes of advisory clients as commission competition. Quite clearly, it depends on whether advisory clients place a greater value on reduced commissions or enhanced soft dollar rebates (including indirect benefits generated by such rebates) and whether competition in one area is likely to be more vigorous than in another. The overriding issue is whether fully-informed advisory clients, if given a choice, would opt for a regime of soft dollar and directed brokerage

\footnote{For the argument that soft dollar arrangements discourage price competition, see supra note 99 and infra note 160 showing relative stability in institutional brokerage commission rates at full-service firms over the last decade and simultaneous decline in retail commission rates to rates roughly comparable to those for institutional investors. Concerning competition in terms of soft dollar and directed rebate arrangements, see 1997 ASIR SOFT DOLLAR PAPER, supra note 4, at 9.}
rebate arrangements (and the benefits and detriments that may entail) rather than reduced commission rates.\textsuperscript{140}

The agency problem inherent in the typical rebate context lends credence to the concern that soft dollar competition is an imperfect substitute for commission rate competition. The investment adviser may push more aggressively for greater soft dollar benefits (which directly benefit the adviser) by pursuing a less aggressive posture on commission rates (which shifts to the advisory client the costs of the rebate).\textsuperscript{141} Such a dynamic would in fact lead to the type of market behavior observed — fairly stable commission rates and intensive negotiation regarding soft dollar benefits.

The client may be especially vulnerable to less than diligent bargaining by the investment adviser with respect to commission rates because of the client’s limited ability to monitor the trade-offs relating to the soft dollar arrangement.\textsuperscript{142} As the rebate level becomes larger and

\textsuperscript{140} The former might well be the case if Professor Johnsen’s hypothesis is right and soft dollar arrangements lead to a more efficient agency relationship between the adviser and the advisory client. If soft dollar competition is a perfect substitute for commission competition, one would expect that the economic costs of the advisory relation for clients would be roughly the same in return for the same investment performance.

\textsuperscript{141} That is not to say of course that the adviser is entirely indifferent to commission rates. Advisers will be sensitive to commission rates to the extent that clients are able to monitor and evaluate the effects of soft dollars on commission costs. As discussed in Section IV.A., however, the underlying premise of any agency theory of soft dollar arrangements presupposes that clients are not unusually sensitive to the effect of soft dollar arrangements on reported expenses.

\textsuperscript{142} The client does not even observe directly the commissions paid (although they are reflected in investment performance), and will generally be unaware of the underlying soft dollar conversion ratio or the amount of the soft dollar benefit obtained by the adviser. In other words, the soft dollar arrangement lacks transparency from the client’s perspective. Thus, even if it appears the commission paid corresponds to a prevailing market rate, the commission may reflect radically different underlying soft dollar rebate levels. Moreover, evaluating investment performance on a short-term or intermediate-term basis may be difficult due to random market factors that affect investment performance. See Mark Hulbert, “Why Top Returns Are Not in the Stars,” N.Y. TIMES, April 4, 1999, at 36 (Money and Business Section) (discussing predictive deficiencies of rankings prepared by rating
larger as a percentage of the commission, approaching as noted above nearly 50% of the commission rate, rebates are more likely to appear to be affecting the terms of competition with the adviser and broker merely allocating among themselves the benefits of artificially high commissions at the clients’ expense.

Another issue is the effect of rebate arrangements on competition among investment advisers, especially in terms of the advisory fees paid by clients. One possibility is that, to the extent that advisers are receiving excess compensation in the form of soft dollar rebates due to excessive commissions, the compensation premium enjoyed by advisers (or as economists say, economic rents) will be eroded by other forms of competition that arise as advisers compete to earn the premium. For example, advisers may reduce their investment advisory fees. This result, however, presupposes that the pricing of investment advisory fees is competitive, that is, that clients are price sensitive and advisory fees reflect significant price elasticity.

services) “The problem with the popular rating systems is that they do a poor job of distinguishing between adviser skill and mere luck”. Id. In addition, the adviser may use discretion to allocate research benefits in a way that tends to mask their impact — for example, allocating a higher priority to research resources for underperforming funds.

143 See Johnsen, supra note 4, at 91; 1999 SEC ROUNDTABLE, supra note 65, at 212 (fund director noting that soft dollar benefits obtained by adviser are evaluated in connection with reviewing the advisory fee). But see, Livingston & O’Neal, supra note 71 (presenting empirical results casting doubt on whether higher soft dollar commissions substitute for lower expense ratios in the form of reduced management fees) (the study does not control for market impact costs).

144 While investment advisory fees may be affected by competitive forces, there are reasons to doubt whether broad segments of the investment management market could be described as perfectly price competitive with respect to fees. These reasons include: (i) differentiated products that are difficult to compare except over an extended time horizon; (ii) the existence of widely different investment advisory fees charged by different providers for products that seem similar and use of different investment advisory fee schedules by the same provider for different clients; (iii) industry practices involving long-term affiliated advisory relationships (as in the case of fund families with an affiliated adviser); and (iv) well-established fiduciary principles that defer to the discretion of investment company boards in considering factors other
If, on the other hand, it appears that the market for investment management services does not exhibit the characteristics of a perfectly competitive market and investment advisers obtain excessive benefits from soft dollar arrangements, the excess costs to a client incurred in connection with the rebate arrangement will not be offset by diminished investment advisory fees. Moreover, even if rebate arrangements encourage advisers to reduce their advisory fees to offset any compensation premium earned, it does not follow that advisory clients will be indifferent to payment of excessive commissions. The reason is that reductions in advisory fees to compensate for above-normal advisory profits earned from soft dollar benefits will not generate the same economic consequences for advisory clients as lower portfolio expenses. In sum, there is no reason to believe that competitive forces with respect to investment advisory fees will return excessive benefits earned on client portfolio transactions to clients in a way that will leave advisory clients as well-off as reduced fees.

Finally, there is an issue of competition in structuring rebate arrangements, that is the way brokers package their services to investment advisers and their clients. There is little direct evidence bearing on advisory clients' preferences as between soft dollar and directed brokerage arrangements and that fact is of potential concern since an overriding issue should be what would clients choose if they were fully informed and bargaining costs were minimal.145

than investment advisory fees in approving an investment advisory contract.

One area where there does appear to be significant price competition is in the area of money market funds and broad-market index funds, where the product and services are largely homogenous. Investment advisory fees and expenses are the principal distinguishing factor among competing funds. But the very reasons that make money market and index funds so competitive on fees and expenses go a long way to explaining why fees associated with other investment accounts may be less price competitive.

145 See Johnsen, supra note 4, at 91 & n. 78.
Under the current regulatory scheme, the only significant competition to soft dollar rebate arrangements is from directed brokerage arrangements. One possible explanation for such limited rebate competition, of course, is that soft dollar arrangements are perceived as more attractive in the marketplace than other potential arrangements. In other words, soft dollar arrangements have vanquished competing alternatives. However, there is another explanation for the pervasiveness of soft dollar arrangements. Soft dollar arrangements survive because of legal and practical obstacles that effectively block competing rebate arrangements that might be more attractive to investors.

Greater competition with respect to rebate alternatives could give clients more influence over the rebate arrangements employed by investment advisers. At the very least, a greater range of alternatives would provide a more meaningful opportunity for clients to reveal their preferences as to such arrangements. Offering clients a greater range of choices regarding rebate arrangements effectively accomplishes the same objective as enhancing bargaining power: clients in effect will bargain by voting with their feet.
V. THE UNSATISFACTORY STATE OF THE SOFT DOLLAR SAFE HARBOR

The core of section 28(e) is its safe harbor. Section 28(e)(1) establishes an exception to agency and fiduciary law principles as applied to investment advisers: it permits an adviser while acting as agent for a client to retain rebates in the form of research or brokerage services derived from commissions paid by the client, provided the commissions paid by the client are not unreasonably excessive. Not surprisingly, the safe harbor's conditions as construed by the SEC effectively dictate the way in which most soft dollar arrangements are currently structured. The safe harbor consists principally of two distinct conditions, each of which must be satisfied: (i) an adviser is permitted to retain a rebate only if the rebate consists of research and brokerage services (the "benefit retention" principle) and (ii) the adviser may have its client pay higher commissions in connection with such soft dollar arrangements only if the excess commission is reasonable under the circumstances (the "reasonableness" principle).

Although the fundamental guideposts of the safe harbor are fixed by statute, the SEC performs an integral role in construing the bounds of the safe harbor. The SEC's interpretive approach has been shaped largely by pragmatic concerns rather than policy. Because the safe harbor was the product of a legislative compromise to secure passage of the 1975 Securities Acts Amendments, the SEC generally has construed the provision narrowly, giving literal effect to the language of the compromise, without necessarily rationalizing its contours in terms of a consistent policy. The staff's approach undoubtedly reflects uneasiness in permitting conduct that would otherwise be viewed as violative of basic agency and fiduciary law principles, but also is tempered by sensitivity

to issues of commercial and administrative feasibility. The SEC, however, has been less successful in articulating how overarching policy objectives, such as efficiency, fairness or the interests of advisory clients, are served by its interpretive positions.

It is appropriate to question whether the safe harbor as construed embodies a coherent rebate policy. This section discusses the principal features of the safe harbor and why, despite the scrupulous efforts of regulators to apply it in a consistent fashion, the safe harbor has failed to produce a regime of efficient rebate arrangements.

A. **The Reasonableness Principle and the Paying up Paradox**

Soft dollar arrangements, absent the safe harbor’s reasonableness principle, would arguably violate the investment adviser’s best execution obligations if an adviser caused its client to pay a higher commission to execute a transaction in connection with a soft dollar arrangement than the advisory client would have paid absent the arrangement. 147 Section 28(e)(1), however, expressly authorizes the adviser to pay a higher commission with its client’s funds to obtain research and brokerage services, but imposes constraints on how much of a commission the adviser can cause its client to pay. The excess amount paid relative to “the amount of commission another ... broker ... would have charged for effecting [the] transaction” may not exceed the reasonable value of the research and brokerage services obtained by accounts under the adviser’s management. 148 When an adviser

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147 See discussion in Section II.B. regarding the specific legal violations.

148 Specifically, section 28(e)(1) provides: an adviser may pay a commission in excess of the amount of the commission another ... broker ... would have charged ... [if the adviser] ... determine[s] in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided ... viewed in terms of either that particular transaction or his overall
causes its client to pay a higher commission, the adviser is commonly described as “paying up.”

In theory, the reasonableness standard would appear easy to apply. Suppose an investment adviser uses a broker that charges a commission of $.06 per share and directs to the broker transactions involving approximately 100,000 shares. Another broker provides brokerage services of comparable quality on an execution-only basis and charges $.03 a share. Under the reasonableness standard of section 28(e), the adviser must receive research that provides at least $3,000 worth of value to the managed accounts.

This illustration suggests that the reasonableness standard is a quantifiable standard that lends itself to routine and mechanical application. The standard, however, is difficult for regulators to enforce strictly since it presupposes knowledge of the amount by which the investment adviser is paying up, or equivalently, knowledge of a benchmark commission rate, namely the commission another broker would have charged for executing the transaction on terms affording the client comparable execution quality. For example, in the illustration above, we assumed that the benchmark commission rate was $.03. In practice, however, knowledge of the benchmark commission is at best difficult to discern.

Presumably when Congress referred to the amount of commission another broker would have charged for effecting the transaction, it intended that the reference point for a benchmark commission rate be the lowest available commission absent the soft dollar responsibilities with respect to the accounts as to which he exercises investment discretion.


The standard, tempered as it is by concepts such as “good faith” and “reasonable relation,” is generally permissive. Although permitted to pay a higher commission, the adviser is not permitted to compromise best execution in other respects. See 1986 SEC Soft Dollar Release, supra note 26, at 16011.
arrangement.\textsuperscript{149} Investment advisers will seldom be able to canvass the market for the lowest commission rate each time they seek to execute a trade on behalf of a client and thus as a practical matter any determination regarding the appropriate benchmark rate must be based on a discernible pattern regarding available commission rates.\textsuperscript{150} In addition, as discussed in a preceding section, execution quality may vary as a function of commission rates, that is, a broker who provides lower quality executions is more likely to charge lower commissions. What constitutes an execution of comparable quality is notoriously difficult to define, but assuming that problem is overcome, some adjustment should be made to the benchmark commission to reflect quality differences. In theory, then, the benchmark commission should be the lowest known commission rate for an execution of comparable quality.

\textsuperscript{149} The SEC has correctly insisted that paying up should be evaluated based on the established rates of the low-cost, rather than the average-

\textsuperscript{150} The SEC has long recognized that best execution need not be determined on an order-by-order basis, but rather may be determined based on a periodic review of execution quality. See 1986 Soft Dollar Report, supra note 26 at 16011. This fact merely underscores the illusory quality of the reasonableness standard since it appears to have presupposed a benchmark rate determined on an order-by-order basis.

There are other potential pitfalls faced by regulators in establishing a benchmark rate. For example, quoted commission rates may differ from commission rates that could be obtained through aggressive negotiation. But unless an adviser is inclined to use the broker, such negotiation will never take place.
The reasonableness standard modifies conventional notions of best execution in two respects. Section 28(e) treats research provided to investment managers as a factor that money managers may consider in discharging their best execution obligations.151 This approach, however, appears to be a product of industry custom rather than any necessary link between research and execution (that is, at most research is ancillary to execution services, but the two nevertheless remain separable).152 If brokerage execution and research are viewed as independent, then the safe harbor permits the investment adviser to balance certain adverse consequences to overall execution quality against receipt of research benefits. For example, in the illustration above, the adviser is able to cause its client to incur an extra $3,000 in execution costs because the execution costs generate $3,000 in research benefits to the adviser.

The paying up standard also departs from best execution principles in a less obvious way. It does not require strict tracing of benefits to the account that bears the commission costs.153 Instead, by permitting the

151 This statutory approach is echoed in the SEC's interpretive positions regarding best execution. As applied to an investment adviser's decision in directing brokerage for clients, the SEC has indicated that best execution also encompasses "the value of research provided...and the [broker's] responsiveness to the money manager." 1986 SEC Soft Dollar Release, supra note 26, at 16011.

152 See supra note 45.

153 Section 28(e)(1) expressly authorizes the adviser when paying more than the lowest available commission to consider the value of brokerage and research services "in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion." Abandonment of strict tracing is a practical necessity in order to have a workable standard. Trade-by-trade accounting would be impossible since research benefits may be shared by more than one account and the benefit to any particular account may not be quantifiable. The safe harbor, however, is unusually broad in its endorsement of the principle since in theory the standard does not require a showing of any benefit to a particular account, even if that account is the sole source of commissions for the soft dollars used to purchase the research. More sophisticated fund managers are, of course, free to impose stricter limits on use of brokerage to obtain research. See 1999 SEC ROUNDTABLE, supra note 65, at 163 (noting that in the rare instances in which officials from
investment adviser to weigh benefits to all accounts under management, the safe harbor implicitly endorses use of commissions from one account to cross-subsidize other accounts.\textsuperscript{154} Returning to the illustration above, the 100,000 shares in transactions may have come equally from two accounts, A and B. The research, however, may only benefit Account A. Thus, although Account B has incurred $1,500 in excess execution costs, the benefit flows only to the adviser and Account A.

From a policy perspective, the safe harbor's reasonableness standard is flawed. The safe harbor assumes that a valid benchmark rate can be ascertained. In many cases, however, the benchmark figure may overstate the commission that would have been charged by another broker to execute the transaction, thereby understating the actual amount paid up in connection with the soft dollar arrangement. First, collective use of soft dollar arrangements may in fact lead to inflated industry-wide commission rates. If the prevalence of soft dollar arrangements leads to inflated industry-wide benchmark commission rates,\textsuperscript{155} it is clear that the operational standard designed to measure the amount of paying up will actually underestimate the collective effect of soft dollar arrangements on client commissions.\textsuperscript{156}

Second, the reasonableness standard's benchmark requires a comparison of the soft dollar commission to

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\textsuperscript{154} See 1998 SEC STAFF SOFT DOLLAR REPORT, supra note 1, at 38.

\textsuperscript{155} Benchmark commission rates of brokers may be artificially inflated to the extent that an adviser is able to use an inappropriate benchmark. For example, an adviser could assert that brokers with lower commission rates would not offer comparable execution quality. Moreover, to the extent that advisers are successful in preventing execution-only brokers from competing for brokerage business from managed accounts, execution-only brokers are discouraged from competing aggressively on the basis of price.

\textsuperscript{156} In such circumstances, the true economic cost of paying up is as follows: the excess amount paid over the amount another broker would charge plus the amount by which the other broker's charge is inflated over what would be charged in the absence of soft dollars altogether.
what the investment adviser would pay in the absence of a soft dollar arrangement. But the soft dollar arrangement typically involves an informal commitment by the adviser to direct trades in a given volume (for example, $100,000 in commissions). The informal commitment thus affords a separate benefit to the broker which may warrant a lower commission. The correct comparison should not be to the commission that would be paid in the absence of the soft dollar arrangement but rather to the commission that would be paid if the adviser were willing to make a similar informal commitment without receipt of any soft dollar rebate.157

These defects are manifest in the frequently made assertion that no paying up in the statutory sense occurs in connection with many soft dollar arrangements, even though the broker provides a soft dollar rebate to the investment adviser.158 This result is paradoxical from an economic perspective unless the benchmark commission rate is inflated or involves comparison to an inappropriate benchmark commission rate. The broker's willingness to offer a rebate, whether explicit or implicit, signals that the commission rate if charged for execution alone would generate surplus profits — that is the broker would earn above-normal profits. Obviously no broker would willingly pay a rebate on commissions that yielded only a

157 This as a rule is not done since advisers generally do not negotiate cash rebate arrangements. However, some idea of the difference between the lowest available rate and the lowest effective rate in a cash rebate arrangement can be gleaned from commission recapture arrangements. The effective commission cost to the client in a recapture arrangement (the commission less the recaptured amount) may be less than the lowest available commission rate and if so, then, in theory at least, that effective rate rather than the lowest available commission rate should be employed to determine whether other commissions offering similar execution quality involve paying up.

158 See, e.g., In the Matter of Kingsley, Jennison, McNulty & Morse, Inc., Advisers Act Release No. 1396, 55 SEC Dkt. 2064 (Dec. 23, 1993) (holding that Investment Advisers Act was violated notwithstanding finding that adviser had not caused client to "pay up"); 1999 SEC ROUNDTABLE, supra note 65, at 164. (Vanguard Fund official noted that some sub-advisers for Vanguard managed funds do enter into soft dollar arrangements, but asserting that arrangements do not involve paying up).
competitive return (since payment of the rebate reduces the effective commission to an amount less than the competitive return). If, however, a broker charges a commission that yields surplus profits (assuming the broker provided trade execution and no more), the broker will offer rebates willingly to induce more business at that commission rate to garner greater surplus profits.\textsuperscript{159}

The reasonableness standard thus merely assures that the excess portion of any commission (as measured against an established benchmark commission rate) does not exceed the value of benefits conferred. It does not foster competition or implement policies that encourage reduced commissions or added value to the advisory client. It sets a floor for conduct and not much more. That floor may be extremely liberal from the perspective of advisers where there is no rigorous check on the benchmark commission rate.

Although there is little question that the deregulation of commission rates brought about a more competitive commission rate structure, the SEC generally has been content to rely on market forces to keep commission rates low.\textsuperscript{160} Thus, it is perhaps not surprising that the SEC has seldom challenged the reasonableness of commission rates in connection with research soft dollar arrangements. While conduct regulation as practiced by the SEC is effective in attacking clearly abusive situations, it seems less well-suited as a strategy for promoting enhanced competition among brokers.

\textsuperscript{159} See Haaga Statement, supra note 136, at 760-63 ("Brokerage firms can be expected to understand their cost structures and to act rationally and in what they perceive to be their economic best interests.").

\textsuperscript{160} See Schwartz Statement, supra note 64, at 636 (noting decline from 11.5 cents to 6.2 cents in commission rates from shortly after deregulation in 1977 to early 1993). Recently, however, the SEC staff indicated that it intends to probe more deeply into the relatively high brokerage commissions of advisers, and especially into whether adviser order routing decisions serve to minimize client costs and provide clients with best execution. See supra note 99.
B. THE BENEFIT RETENTION PRINCIPLE

The other significant condition imposed by the section 28(e) safe harbor is that it permits investment advisers to retain research and brokerage service rebates. Whether a particular arrangement comes within the safe harbor turns in large measure on the meaning of research and brokerage services; an arrangement that involves rebates for services other than research or brokerage services is not eligible for safe harbor treatment. SEC positions regarding permissible products and services under the safe harbor illustrate the practical problems for regulators in trying to oversee rebate arrangements and the tension between rebate arrangements that are permissible and rebate arrangements that are efficient.

Shortly after section 28(e) was enacted, the SEC issued its first of two interpretive statements regarding the safe harbor. The first statement embraced an unusually narrow definition of research: research for purposes of section 28(e) did not include so-called generic research services — "readily and customarily available and offered to the general public on a commercial basis" — such as subscriptions to financial newspapers of general circulation. In the SEC's view generic research, in contrast to specialized research, was not the type of research Congress had intended to protect in permitting receipt of research services.

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162 The SEC relied on language in the Conference Report (supra note 63) that at best is ambiguous to infer that Congress had not intended to extend the safe harbor to arrangements involving generic research. The report language, however, did not expressly distinguish between generic and specialized research. ("[T]here appear to have been an increasing number of arrangements under which fiduciaries have been procuring, among other things, newspapers, magazines and periodicals, directories, computer facilities and software . . . The Commission does not believe that Section 28(e) would apply to arrangements of this type." Id.)
The SEC's interpretive approach evidenced its predilection for strict construction of the safe harbor. The safe harbor should be used, under this view, to address the specific types of research concerns that had been identified at the time of the safe harbor's enactment. It should not be used to shelter soft dollar arrangements designed merely to reimburse an investment adviser for expenses it likely would have incurred in the ordinary course of its business.

The SEC recognized in time, however, that this narrow original interpretation was untenable. Such a restrictive approach could not be reconciled with the safe harbor's statutory language since the safe harbor does not distinguish between generic and specialized research.163 In addition, industry lacked reliable means of distinguishing between generic and specialized research and as a result the staff was inundated with requests for interpretive guidance.164

Perhaps more importantly, distinguishing between generic and specialized research does not advance any meaningful policy goals, other than construing the safe harbor restrictively. Although there is some intuitive appeal to the assumption that an investment adviser is more likely to obtain something in the case of specialized research that it would not have purchased but for the brokerage arrangement, this generalization is not a reliable foundation for policy. There is no reason to believe that generic research is any more or less beneficial for clients than specialized forms of research, since the adviser has an incentive to be cost-effective in purchasing research, regardless of whether it is generic or specialized. In short, it is difficult to see how the interests of investors or clients of investment advisers would be advanced by a policy that distinguished between rebates involving specialized as opposed to generic research.

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164 Id.
To its credit, the SEC adopted a new, more workable standard: research is whatever “provides lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibility.” The standard is noteworthy because, unlike the discarded distinction between generic and specialized research, it cedes a larger measure of discretion to soft dollar participants to devise advantageous arrangements, subject to the minimum requirements of the safe harbor. Such an approach is more hospitable to the view that regulatory objectives may best be served in some instances by giving participants greater latitude in establishing the terms of rebate arrangements.

The SEC approach to treatment of mixed-use products further illustrates the virtues of a flexible approach. Mixed-use products are those that might serve both a research and non-research function. To the extent that such products are obtained in connection with a soft dollar arrangement a problem arises: when is receipt of such products permitted under the safe harbor?

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165 Id. The AIMR Soft Dollar Guidelines contain an arguably more restrictive definition of research: “services and/or products provided by a Broker, the primary use of which must directly assist the Investment Manager in its Investment Decision-making Process.” 1997 AIMR SOFT DOLLAR GUIDELINES, supra note 1, at 8 (emphasis supplied) (capitalized words are terms defined in the AIMR guidelines). Unlike the more generally phrased SEC standard, the AIMR Guidelines underscore the need for a direct nexus between the service or product and investment decision-making by the manager. The SEC, however, in applying its own “lawful and appropriate assistance” standard through the examination process, is able to ensure that the relationship between the service or product obtained and the manager's investment decision-making is not too attenuated. The recently completed SEC staff report provides a wealth of detail regarding the types of products made available to clients under this standard. See 1998 SEC STAFF SOFT DOLLAR REPORT, supra note 1, at 29-32, Appendices C and D. Occasionally, it has been suggested that the SEC provide a list of approved products. See 1997 ERISA ADVISORY COUNSEL REPORT, supra note 3, at 9 (recommendations to the SEC). The proposals — so-called “Un-American Activities lists” — have received a cool reception from the SEC and industry sources. See Vineeta Anand, Good, Bad News on Soft Dollars, PENSIONS & INVESTMENTS, Dec. 22, 1997.
The answer given by the SEC is relatively straightforward: it all depends on the purpose the product serves in the hands of the investment adviser. If the product or service serves more than one purpose (such as a personal computer), the adviser must allocate the product's cost between permitted research and brokerage services and non-permissible uses. Soft dollar credits can be used to fund only that portion of the product's cost actually used for research or brokerage services. Admittedly the SEC's approach involves some practical difficulties. There is no way to allocate a mixed-use product between research and non-research functions with complete precision, but it is possible to use reasonable methodologies in making such allocations. Not surprisingly, the SEC's recently completed sweep report, which involved extensive examination of adviser soft dollar practices, identified mixed-use products as an area of chronic deficiency in terms of recordkeeping. What is significant about the SEC's flexible approach, however, is that it encourages an adviser to put rebate credits to their best use and thus enhances the potential efficiency of the soft dollar arrangement for both the adviser and its client.

C. TRANSACTIONAL LIMITATIONS ON STRUCTURING REBATE ARRANGEMENTS

The evolution of soft dollar commercial practices has also engendered close scrutiny regarding the manner in which soft dollar arrangements are structured. SEC positions evidence both flexible and formalistic interpretive approaches. As I will argue, those SEC

166 1986 SEC Soft Dollar Release, supra note 26, at 16,006. Mixed-use allocation presupposes that the product is properly classified in the first instance as research at least for some purposes. A product that is not itself research at least for some purposes should not be subject to a mixed-use allocation even though the product may be linked indirectly with facilitating the research process, for example a word processor. See 1997 AIMR SOFT DOLLAR GUIDELINES 19 (Appendix B — Soft Dollars Permissible Research Guidance).

167 See 1998 SEC STAFF SOFT DOLLAR REPORT, supra note 1, at 24, 32-35.
positions evidencing a flexible interpretive approach are more desirable generally since they tend to promote more efficient rebate arrangements. In contrast, formalistic approaches are largely problematic since they do not tend to advance a coherent economic objective.

1. Third-Party Research Arrangements

The SEC's relatively accommodating position with respect to soft dollar arrangements involving research provided by third parties exemplifies sound administrative practice. As discussed previously, third-party arrangements refer to rebate arrangements in which the executing broker procures research services provided to the investment adviser, but does not produce the research itself. Thus, in a third-party research arrangement, the broker applies the soft dollar rebate to purchase research for the adviser from a third-party research provider.

Although third-party arrangements existed when section 28(e) was enacted, such arrangements were not a motivating consideration for section 28(e) and their status was uncertain in the wake of the new safe harbor. The safe harbor itself does not explicitly address third-party arrangements and questions arose whether and under what circumstances such arrangements were consistent with the safe harbor.

The SEC took a permissive view and has consistently indicated that third-party research arrangements may come within the safe harbor, if the safe harbor's "provided

168 Compare 1986 SEC Soft Dollar Release, supra note 26, at 16,007 ("Prior to the elimination of fixed commission rates, a variety of techniques were employed that permitted money managers to purchase third party research with brokerage commissions.") with Schwartz Recapture Arrangement Statement, supra note 78, at 646 ("A new method of competition for institutional order flow began to emerge in the 1975-1976 period where some broker-dealers perceived that the provision of independent research under standards of high accountability would attract widespread acceptance in the financial community."); Hoch Reid & Perez Ehrich, Paying up for Services, 9 The Review of Securities Regulation 928, 930 (1976) (noting legal uncertainty about status of third-party arrangements after enactment of section 28(e)).
by” condition (discussed below) is also satisfied. As the SEC recognized, even though the safe harbor’s language could be read to exclude such arrangements, such a construction would not be desirable because of its competitive impact. If only research internally generated by broker-dealers were permissible, full-service firms would have an enormous advantage in competing against broker-dealers that did not generate proprietary research. Since enactment of the safe harbor, usage of third-party arrangements has increased dramatically, in large part due to the SEC’s accommodative position.

The strength of the SEC’s approach toward third-party research arrangements is that it is rooted in economic considerations regarding the benefits of competition. The SEC recognized that fostering competition among brokers argued for a more flexible interpretation of section 28(e) since section 28(e) itself had grown out of a broader initiative to encourage competition through deregulation of commission rates. Such an approach is desirable because it looks to the interests of advisory clients as the guiding policy consideration in evaluating specific rebate practices.

2. Brokerage Services and Third-Party Providers

The SEC has taken a less accommodating view with respect to permitting third-party brokers to provide brokerage services, such as custody, through a third-party

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171 See Julie Rohrer, Soft Dollars: The Boom in Third-Party Research, INSTITUTIONAL INVESTOR, Apr. 1984, at 73 (cover story); 1991 ASIR INDEPENDENT RESEARCH REPORT, supra note 64, at 68-75. The exact figures are open to some dispute, although there is general agreement that third-party arrangements grew dramatically throughout the 1980s. Compare Schwartz Statement, supra note 64, at 636, with Silfen Testimony, supra note 71, at 699.
provider, that is by someone other than the executing broker or a legitimate correspondent broker. The SEC has traditionally insisted that the safe harbor authorizes the investment adviser's receipt of brokerage services, in contrast to research services, only from a person acting as an executing broker. This result is not easily reconciled with the SEC's permissive policy toward third-party research arrangements. The statutory language does not distinguish between brokerage services and research services in a manner that supports a distinction between research and brokerage services provided by a third party.

The SEC's strict approach appears to rest on two considerations. The legislative history accompanying enactment of section 28(e) evinces Congress's emphatic rejection of give-up arrangements. Third-party custody arrangements appear to raise the specter of prohibited give-ups from the SEC's perspective more directly than third-party research arrangements. A related concern is


\[\text{[173]}\] A distinction between research and brokerage services has been made by regulatory authorities in one other context: the NASD's Papilsky Rule — NASD Conduct Rule 2740. See NASD Regulation Interpretive Letter to Lee A. Pickard Re: Interpretive Guidance Under NASD Rule 2740 and IM-2740 (Dec. 9, 1997) (generally prohibiting broker-dealers from participating in giving or obtaining selective discounts (not including bona fide research, but including bona fide brokerage services) in connection with fixed price offering except as consideration for services rendered in distribution). See Conference Report, supra note 63, at 71 ("The provisions [section 28(e)] have no application whatsoever to a situation in which payment is made by a money manager to one broker or dealer for services rendered by another broker or dealer.")
the SEC’s construction of the safe harbor’s provided by requirement. As discussed below, the SEC strictly requires that third-party services be provided by the broker-dealer meaning that the broker-dealer either be the source of the service or integral to its procurement. Third-party arrangements invariably involve broker-dealers providing services in the procuring sense. Procuring brokerage services, however, unlike procuring research, may raise questions from the SEC’s perspective about the broker-dealer’s capacity to provide best execution in the first place.

The distinction between third-party research and third-party custody arrangements is not very compelling from an economic perspective. The rationale for permitting third-party research arrangements is to favor constructions of section 28(e) that unambiguously advance advisory clients’ interests by promoting more efficient rebate arrangements. This argument should be no less persuasive in analyzing third-party custody arrangements than with respect to third-party research arrangements. If it is reasonable to conclude that the interests of clients may be better served when investment advisers use third-party research arrangements, the same logic dictates that third-party arrangements may create efficiencies in delivery of custodial services due to increased specialization that ultimately benefits the advisory client.

There does not appear to be any greater risk of abuse associated with a third-party custody arrangement than third-party research services. Indeed, to the extent that custody arrangements are used to reduce costs that clients would ultimately bear, they seem to involve a more advantageous form of rebate for clients than research arrangements. Even where the brokerage service rebate is used to reduce expenses that the investment adviser is contractually obligated to provide, the adviser should rationally want to select a third-party arrangement over a proprietary arrangement only if the service offered by the third-party provider is cost-effective in serving the needs of the adviser and the advisory client. Advisory clients do not
benefit from interpretations that require the adviser to use exclusively broker-dealers that are able to offer a full complement of brokerage services internally.

3. Provided By

As indicated above, the SEC has strictly construed the safe harbor in determining whether research and brokerage services are provided by the executing broker or merely paid for by the executing broker. According to the SEC, the safe harbor applies to arrangements in which the broker has a significant role in providing (as is the case with full-service firms) or procuring the service (as is the case of third-party firms) but excludes situations in which the broker merely pays for the services that the investment adviser independently has obligated itself to pay.\(^{175}\) Thus, section 28(e)(1) is not satisfied where an investment adviser procures research from a third party and merely forwards an invoice to the executing broker for payment. In the SEC's view, this latter situation involves discharging the adviser's own contractual commitments to obtain research services rather than the legitimate receipt of research services provided by a broker-dealer as permitted by the safe harbor. The practical effect of this interpretation is to require executing brokers to perform a primary, although as the SEC has made clear not an exclusive,\(^{176}\) role in the procurement of research as part of a third-party arrangement.


\(^{176}\) The SEC has made clear that the provided by requirement is not meant to exclude advisers from involvement in selecting research. 1986 SEC Soft Dollar Release, supra note 26, 16,007; Papilsky Rules Release, supra note 169. In addition, the broker's role in procurement need not include participation in delivery itself. Thus, the adviser may receive research directly from the third-party provider under section 28(e), provided the broker, and not the adviser, incurs the contractual obligation to pay for the research. See Gilder, Gagnon & Co., SEC No-Action Letter (pub. avail. July 4, 1987); Boston Institutional Services, Inc., SEC No-Action Letter (pub. avail. July 20, 1977).
From a policy perspective, the reasons for requiring that soft dollar arrangements be structured in this way appears to entail confusion regarding three different potential concerns: (i) use of soft dollars by an adviser to discharge an investment adviser's contractual commitments; (ii) the use of soft dollars to pay for ineligible products or services through give-ups; and (iii) the use of soft dollars to enable advisers to make independent discretionary purchases of research without substantial broker-dealer involvement in the procurement of research. Concerns as to possible abuses with respect to the first two situations appear warranted, while concerns regarding abuses in the third situation may be overstated.

Where an executing broker pays for services that the adviser is already contractually committed to purchase, a clear conflict of interest exists between the adviser and its client. The risk is that the adviser's judgment in directing brokerage is more easily compromised, thereby depriving advisory clients of best execution. In such situations, the adviser understandably may be tempted to put its own economic interests ahead of the interests of its clients. Thus, one function of the provided by requirement is to ensure that any contractual commitment relating to providing research runs from the broker to the provider and that the adviser is free of conflicts of interest owing to contractual commitments.

The second situation raises concerns arising out of the abuses associated with give-ups. If the investment adviser is able to direct payments to persons where the broker-dealer has no substantial involvement, there is a greater risk that payments may be used for an improper purpose — to obtain services other than research and brokerage services. The requisite involvement of the broker-dealer acts as a check against such abuses. Thus, another way of looking at the provided by requirement is that it drafts

\[\text{Fund Monitoring Services, Inc., supra note 175, at 81,149.}\]
broker-dealers to perform a gatekeeper function in ensuring adviser compliance with the safe harbor.\textsuperscript{178}

The third situation where the provided by requirement has been invoked — barring arrangements where investment advisers could use soft dollar credits to make independent discretionary purchases of research — is far more difficult to justify. This scenario is similar to one aspect presented in the SEC Investment Information Investigatory Report where the SEC indicated its view that such an arrangement was not eligible for safe harbor treatment.\textsuperscript{179} As described in the Report, a vendor of securities research services allowed advisers directing brokerage to any one of a number of brokers to earn soft dollar credits that could be used to purchase research services.\textsuperscript{180} The broker-dealers were otherwise uninvolved with the adviser’s selection of research services. The SEC concluded that the arrangement was not eligible for the safe harbor because “the brokers did not ‘provide’ services” as required by section 28(e).\textsuperscript{181}

Certain aspects of the arrangement were clearly troublesome under the principles discussed above. For example, investment advisers could run negative balances with the vendor and in effect create open-ended contractual commitments to direct brokerage to the participating brokers.\textsuperscript{182} But the SEC also seemed to indicate that such an arrangement would not meet section 28(e) even where the adviser ran only positive soft dollar credit balances (in other words, had already earned soft dollar credits) which the adviser sought to use without

\textsuperscript{178}This gatekeeping rationale is at the heart of the SEC’s repeated statements that broker-dealers may be liable for aiding and abetting securities law violations involving soft dollar arrangements. See Investment Information Investigatory Report, supra note 69, at 933-34; 1998 SEC STAFF SOFT DOLLAR REPORT, supra note 1, at 19.

\textsuperscript{179}See Investment Information Investigatory Report, supra note 69, at 930-32.

\textsuperscript{180}Id. at 927-28.

\textsuperscript{181}Id. at 932.

\textsuperscript{182}Id. at 928 n.7.
further involvement of the broker-dealer. This situation did not raise the contractual commitment problem found in the first situation nor the gatekeeping problem in the second situation since the vendor presumably could establish reasonable procedures ensuring that all purchases of research would be paid out of positive soft dollar balances and only permit purchases of research to be delivered prospectively.

One argument for prohibiting such "wholesale" soft dollar arrangements is that the arrangements fail to meet the formal requirements of section 28(e). But such a position misses the larger point that such a restriction is not good policy because it is inconsistent with the goal of promoting more efficient rebate practices. From an efficiency perspective, there is little reason to draw distinctions between services independently selected by the investment adviser that will be delivered prospectively and services selected through the collaborative efforts of the broker and the adviser that will be delivered prospectively. Construing the provided by standard to prohibit advisers from directly selecting research needlessly mandates a high degree of bundling in designing and structuring rebate arrangements. This bundling, however, has real costs. Mandating greater collaboration between the broker and adviser ensures higher negotiation costs in connection with the soft dollar arrangement and potentially distorts adviser decision-making. Although the broker may seek to provide advisers with low-cost high quality research options, there is no reason to believe that brokers will do a better job than advisers in selecting research options. Thus, while the provided by requirement serves to curb certain abusive practices described in the first two situations, it may also inadvertently serve to diminish the potential efficiency of soft dollar arrangements such as those described in the third situation.

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Id. at 928, 931-32.
4. Principal Transactions

The SEC has also resolutely declined to construe the safe harbor as encompassing soft dollar rebates on principal trades (as opposed to agency trades). Principal trades, unlike agency trades, generally involve payment of a mark up on the price of the security rather than receipt of a commission for the transaction. Congress did not explicitly consider the issue of principal trades in enacting the safe harbor. The safe harbor’s language refers to “commissions” paid but not to mark ups and commissions, as noted, are the hallmark of an agency trade. The statutory provision, however, was amended before enactment to refer to “dealers” as well as “brokers”, creating some ambiguity regarding the intent of Congress, since dealers almost invariably mark up or down a security without receipt of any commission.

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185 Although observers recognized the potential issue, the status of arrangements involving principal transactions was not directly addressed in the legislative history of section 28(e) since principal transactions mark ups were not altered by deregulation of commissions. See Reid & Ehrich, supra note 168, at 931.

186 See DOL (Charles Lerner), supra note 146, at 77,534.

While the SEC's position may be justified as a matter of statutory construction, it is not clear that the statutory language forecloses a contrary position. The different treatment of principal and agency trades, however, is troublesome from a policy perspective. Did Congress consciously consider the difference between soft dollar rebates on commissions as opposed to mark ups? Is there a greater risk of abuse on mark ups as opposed to commissions? Are there sound reasons why soft dollar arrangements should be permissible when trading IBM (an exchange-listed security) but not when trading Microsoft (a Nasdaq-listed security)?

While the SEC has alluded to the fundamental difference between agency and principal trades and more specifically commissions and mark ups, there is no clear economic explanation of why the difference between a principal trade and an agency trade supports treating rebates on agency trades differently from rebates on principal trades. Such distinctions only contribute to the complexity of administering rebate arrangements and offer little benefit to advisory clients, unless one believes that deterring soft dollar rebate arrangements in general is a desirable policy.

As soft dollar arrangements have continued to flourish and proliferate, the SEC's principal focus in construing the safe harbor has remained on rooting out potential abuses rather than rationalizing market practices or fostering principal transactions will typically require tracing of the soft dollar benefits on an account-by-account basis since cross-subsidization of research among accounts, absent section 28(e), may violate specific fiduciary prohibitions under ERISA or the Investment Company Act or would likely be viewed as a breach of the adviser's fiduciary obligations (unless the adviser obtains the prior consent of the affected advisory clients). See 1997 AIMR SOFT DOLLAR GUIDELINES, supra note 1, at 11.

The formulation overstates the situation slightly since failure to comply with section 28(e) is not itself a violation of the federal securities laws. But the underlying point remains valid, namely, is there any basis in policy for treating the one transaction as eligible for safe harbor treatment and the other as not?

In contrast, rebates on principal transactions are permitted in connection with directed brokerage arrangements.
more efficient rebate arrangements. Soft dollars and directed rebate arrangements have spawned a variety of intricate commercial practices. The complexity and variety of the practices seem driven only remotely by the underlying economic interests of advisory clients. Applicable legal requirements and interpretations appear as important, if not more so, in shaping the complex commercial practices observed. Although SEC safe harbor interpretations adhere to the original political compromise reached in 1975, they are too seldom tied to explicit policies aimed at advancing the interests of advisory clients. In part, this may reflect the inherent limits of statutory language, the drafters of which did not anticipate the way in which soft dollar practices would evolve, but it also may reflect a failure by the SEC to respond to the policy challenges posed by soft dollar arrangements.

VI. THE UNFULFILLED EXPECTATIONS OF REBATE DISCLOSURE POLICY

In addition to its role administering the safe harbor, the SEC possesses extensive authority regarding disclosure with respect to all rebate practices, including soft dollar practices. The requirements for an effective disclosure program with respect to rebate arrangements has been a subject of debate since section 28(e) was enacted.

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191 Shortly after section 28(e) was enacted, the SEC proposed a rule — rule 28e2-1 — that would have required advisers to provide clients with annual reports regarding soft dollar practices. See Disclosure of Brokerage Placement Practices By Investment Managers, Exchange Act Release No. 13,024, [1976 Transfer Binder] Fed. Sec. L. Rep. ¶ 80,185 (Nov. 30, 1976). That proposal was never adopted and the issue remained unresolved until 1979 when the SEC adopted separate rule proposals concerning adviser and investment company disclosure that incorporated scaled-down disclosure requirements relating to soft dollar practices.
Although disclosure has proven an effective tool in policing serious abuses by investment advisers, enhanced disclosure has had limited effect in actually promoting more efficient rebate practices. The SEC's many disclosure requirements have not led to either vigorous competition regarding brokerage arrangements or enhanced bargaining power for the vast majority of advisory clients.

Thinking about disclosure from a functional perspective provides some insight as to why enhanced transparency has not translated into significant competitive benefits for advisory clients. Disclosure regarding soft dollar arrangements serves two potentially beneficial functions for advisory clients: an investor protection function and a economic evaluative function. Disclosure promotes investor protection by facilitating the ability of clients to monitor the activities of an investment adviser and making clients aware of possible conflicts between their interests and the interests of their investment adviser. Disclosure of conflicts identifies areas where clients need to be more vigilant in assessing an adviser's conduct. Thus disclosure of a soft dollar arrangement should in theory put clients on notice of a need for monitoring with respect to brokerage expenses and rebates.

Disclosure requirements aimed at investor protection have principally taken the form of providing clients with qualitative information regarding the nature of rebate practices and the kinds of services obtained by investment advisers. Such information has only marginal effects on dollar practices. See Disclosure of Brokerage Placement Practices By Certain Registered Investment Companies And Certain Other Issuers, Investment Company Act Release No. 10,569, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,924, at 81,179 (Jan. 30, 1979).

192 The principal qualitative disclosure requirement for advisers concerning soft dollars is Item 12 of Part II of the adviser's Form ADV. The Form as it relates to brokerage arrangements principally requires advisers to describe the product and services provided to the adviser if receipt of such products or services is a factor in selecting brokers and in determining the reasonableness of commissions. An adviser must also disclose whether services so obtained are used to benefit all accounts or only those that were the source of the commissions used to obtain the services. Under the brochure rule (Investment Advisers Act
competition since it does not provide the kinds of quantitative information necessary for comparisons. These disclosure requirements (and the related task of recordkeeping) also serve an investor protection function by aiding in the enforcement of conduct requirements. Allegations of disclosure violations relating to rebate practices are common in enforcement actions involving soft dollars.\textsuperscript{193}

Disclosure serves an equally important economic evaluative function by providing investors with information relevant to selection of and negotiation with investment advisers. Certain types of disclosure may facilitate evaluation and comparison of advisers by clients and thus sharpen competition among investment advisers. If soft dollar arrangements are perceived as economically disadvantageous for clients, clients may take their business elsewhere. Disclosure may also improve the ability of clients to bargain with advisers. A client, for example, should in theory seek some form of offsetting benefit (such as a slightly reduced advisory fee) in return

for consenting to the adviser's use of soft dollar arrangements.

Two types of information are potentially useful to advisory clients for purposes of engaging in evaluating use of soft dollar arrangements by investment advisers: accounting information reflecting the effects of soft dollar arrangements on overall performance and expenses, and transactional information relating to an adviser's use of such arrangements. Soft dollar and other brokerage arrangements will affect reported performance and expenses for managed accounts in several ways. Mutual fund accounting provides an illustration of these effects.\textsuperscript{194}

Commissions paid by each fund are reflected in the cost basis of the fund's investments.\textsuperscript{195} Soft dollar rebates do not alter the accounting for commissions, that is, no adjustment is made to the cost basis of the investments. In addition, soft dollar rebates in the form of research services will not reduce reported total expenses or even net expenses, since the beneficiary is the adviser rather than the advisory client.\textsuperscript{196}

\textsuperscript{194} In addition to generating annual financial statements, a mutual fund must have accounting systems in place which enable the company to redeem securities at current net asset value — the market value of the mutual fund's shares calculated at the close of business each day by taking the market value of all the securities owned plus all other assets, subtracting all liabilities and then dividing by the number of shares outstanding. \textit{See} 15 U.S.C. § 80a-22(a)(1) (1999) and 17 C.F.R. § 270.22c-1 (1999).


\textsuperscript{196} Under recently adopted rule amendments (rule 6-07 of Regulation S-X, 17 C.F.R. § 210.6-07 (1998)), mutual funds are required to include the expenses paid under brokerage/service and expense offset arrangements in total expenses reported in the statement of operations. The total expenses are then reduced by the total amount paid under such arrangements and the remainder is the net expenses. If the mutual fund directly negotiates with the broker, the cost of the services is the amount negotiated, or if a mutual fund cannot readily determine the cost of the services, the mutual fund must make a good faith estimate of the amount it would have paid if it had contracted for the
Accounting for commission recapture brokerage arrangements differs slightly from the accounting treatment for soft dollar arrangements. Where an advisory client negotiates and receives a rebate, the cash rebates will be reflected as a reduction in the cost basis of the managed account's investments and thus offset the effect on portfolio investments of the higher commissions that may have been paid. Expense reimbursement arrangements are treated differently. The expense reimbursement rebate does not result in an adjustment to the cost basis of the portfolio's investments. The reimbursement, however, will reduce reported net expenses, that is total expense net of credits. Because the reimbursement does not affect cost-basis or total expenses it does not alter a firm's reported expense ratios (since the reimbursed expenses must still be included in total expenses) nor reported yield since yield is calculated using total expenses.¹⁹⁷

Investment companies that are identical in all respects, except that one company uses soft dollar arrangements in its portfolio transactions and the other uses an expense reimbursement arrangement in its portfolio transactions will not differ in reported expense ratios or yield. This result is puzzling since it would appear that clients are unambiguously better off with the expense reimbursement arrangement, assuming execution quality is not otherwise affected.¹⁹⁸ Investment companies that employ commission recapture arrangements as opposed to

¹⁹⁷ See Instruction 7 to Item 21(b)(2) of Form N-1A.
¹⁹⁸ One celebrated critic of mutual funds expenses describes commissions paid on portfolio transactions — because they are capitalized costs — as "invisible costs." See John C. Bogle, BOGLE ON MUTUAL FUNDS: NEW PERSPECTIVES FOR THE INTELLIGENT INVESTOR, 201-06 (1994). If anything, the accounting treatment for soft dollar arrangements ensures that the costs of such arrangements are even more hidden. See 1997 ERISA ADVISORY COUNCIL REPORT, supra note 3, at 32-33 (summary of testimony of Steven H. Wallman, Commissioner, U.S. Sec. and Exch. Comm'n) (criticizing existing accounting treatment of soft dollar arrangements).
expense reimbursement arrangements will actually be able to report a slightly higher yield since the cost basis of the portfolio will be less than the cost basis of either the portfolio that uses soft dollar arrangements or the portfolio that employs expense reimbursement arrangements. These results underscore the potential significance of accounting conventions in influencing indirectly choice of brokerage arrangements.

The other kind of economically relevant information for advisory clients is transactional information relating to brokerage arrangements. Such information differs from the accounting information discussed above in that it focuses solely on economic information relevant to brokerage arrangements themselves rather than the economic effects of the arrangements on the managed account’s overall reported performance and expenses. Transactional information in theory can be either client-specific or firm-wide (that is, reflecting an investment adviser’s experience with respect to all of its managed accounts). Client-specific information might consist of average commissions paid for brokerage depending on the type of rebate arrangement or the value of the soft dollar benefits obtained by the adviser with respect to the client’s brokerage. Firm-wide transactional information might provide the client with information as to how its brokerage arrangements compare with other of the firm’s clients. Thus, it might include whether one client’s average commissions are greater than another, and soft dollar arrangements are more common for some clients than others. To some extent, the significance of either form of disclosure — transactional information or accounting information — depends on what kind of information is most relevant to clients in ultimately selecting brokers.

Interestingly, with respect to disclosure designed to facilitate economic evaluation by advisory clients, the SEC has relied principally on requirements regarding

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199 This follows since the amount of recapture will be applied to reduce the cost of investments.
disclosure of accounting information rather than transactional information. Indeed, even modest efforts to introduce transactional information have largely floundered. In 1995, the SEC issued an ambitious rule-making proposal that would have imposed significant transactional disclosure requirements on investment advisers with respect to soft dollar arrangements. Among the types of information that would have been required of advisers was an extensive breakdown of each adviser’s brokerage allocation by broker and category of brokerage arrangement (execution-only, full-service and customer directed). Detailed firm-wide information regarding adviser practices would have enabled individual clients to monitor more precisely their treatment by a particular adviser relative to the treatment of other clients and would also have facilitated comparisons across advisers regarding brokerage arrangements.

The SEC ultimately declined without comment to adopt the rule proposal, in part reflecting intense industry opposition. Giving clients ready access to detailed quantified firm-wide information regarding brokerage arrangements would undoubtedly have carried the potential advantage of engendering competition among investment advisers since advisers would realize that

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200 In 1995, the SEC introduced a requirement pursuant to which funds were required to disclose average commissions in the financial highlights table. See 1995 Investment Company Brokerage Arrangement Accounting Release, supra note 80, at 38,921-22. That requirement was eliminated in 1998 as part of the SEC’s disclosure simplification initiative for investment companies. See 1998 Adopting Release for Form N1-A, supra note 104, at 13,936.

201 See Disclosure by Investment Advisers Regarding Soft Dollar Practices, Investment Advisers Act Release No. 1469, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,488, at 86,218 (Feb. 14, 1995). The rule proposal was in part the outcome of fierce lobbying efforts by competing groups of broker-dealers providing soft dollar services — proprietary research firms and third-party research firms. Proprietary research firms felt that adviser disclosure regarding brokerage allocation practices at the firm-wide level would reveal the economic effects of third-party arrangements. The rule proposal was crafted to avoid tilting disclosure toward one camp over another but was unprecedented in terms of the level of detail that would be required of advisers using soft dollar services.
clients would be able to evaluate the adviser’s brokerage practices at very low cost. Detailed disclosure, however, also entailed significant disadvantages over and above the significant costs that would have been borne by firms in providing such disclosure. Mandated disclosure could well have actually discouraged price competition since competitors would be privy to significant information regarding other competitors’ brokerage practices. Extensive disclosure regarding commission and rebate levels could well have had the counterproductive effect of diminishing the incentive to cut commissions or increase rebates if advisers and brokers knew that such information would be disclosed. Similarly advisers might seek to become price followers rather than leaders, if it were clear that price advantages, once disclosed, would be quickly available to all. Thus, although the SEC’s proposal might have spurred genuine competitive benefits for advisory clients, it also risked significant competitive harms.

Given the various approaches toward disclosure policy, why has disclosure proven relatively ineffective in regulating rebate practices? Two related reasons may offer an answer. The first is that clients have difficulty using accounting information that they receive to differentiate meaningfully among investment advisers on the basis of brokerage expenses and managerial performance. The accounting treatment of soft dollar arrangements is perhaps most relevant to its effect on the bottom line, something clients monitor much more closely than expenses. The overall effect of rebate arrangements on reported performance, however, appears to be fairly small.

Moreover, the addition of extensive transactional disclosure requirements, even if adopted by the SEC, would not remedy this problem. It is reasonable to question whether such information in the hands of a large segment of advisory clients would enable those clients to bargain more effectively with their investment advisers.

202 See supra notes 107 & 142.
The relationship between detailed transactional information and overall account performance may be too attenuated to permit clients to use such information in a cost-effective manner.

The second explanation for why current disclosure may not be effective in bringing about more efficient rebate arrangements is that advisory clients do not perceive significant differences among the alternative rebate arrangements in terms of their choice of investment adviser. The lack of strong client sentiment regarding current brokerage arrangements diminishes the significance of disclosure. As discussed below, clients may perceive pass-through cash rebate arrangements, accompanied by modest disclosure requirements, as materially different and therefore permitting such arrangements may engender more meaningful negotiation between adviser and client.

VII. AN ALTERNATE REGULATORY APPROACH: COLLECTIVE CASH PASS-THROUGH REBATES

Congress and the SEC envisioned an environment in which commission rates would be set through negotiation and the interaction of market forces. Soft dollar arrangements were not intended to alter that vision, but to exist within it. Although soft dollar arrangements and other brokerage rebate arrangements have not foreclosed competition, they do appear to have altered the dynamics of competition. In particular, soft dollar arrangements, which are not very transparent and which entail significant monitoring costs for advisory clients, have become the dominant form of rebate arrangement. This development has also pushed competition with respect to institutional brokerage toward service competition and away from price competition. The sole meaningful rebate alternative — customer directed rebate arrangements — is feasible only for a limited range of clients. While the current regulatory approach toward brokerage rebate arrangements has curtailed abusive rebate practices, it has been notably unsuccessful in promoting vigorous competition.
competition as a means of controlling brokerage expenses of managed accounts.

The problem of brokerage rebates, viewed from the perspective of clients, is not merely one of potential misconduct by an investment adviser or even inadequate disclosure. An equally important issue is the absence of alternative brokerage rebate arrangements to compete with soft dollar arrangements. Policies aimed at encouraging brokerage rebate alternatives could lead to more efficient rebate practices and promote competition. In this section, one such alternative rebate practice — a collective cash pass-through rebate arrangement — is described. Permitting use of collective pass-through rebates would face some regulatory and practical obstacles which are addressed in this section. The following section explains the policy rationale that makes such an approach desirable.

A. DESIGNING A COLLECTIVE CASH PASS-THROUGH REBATE ALTERNATIVE

In a cash pass-through arrangement, the investment adviser or an account established by the adviser would be used as a conduit for cash rebates from brokers to advisory clients.²⁰³ A pass-through rebate arrangement in

²⁰³ The image of the adviser acting as a conduit is intended conceptually rather than literally. Generally advisers do not act as custodians for their clients’ funds. Thus, one of the practical issues described below is how to structure a conduit mechanism so that the adviser itself never actually is in possession of client funds.

this sense closely resembles a commission recapture arrangement. In a cash pass-through arrangement, as in a commission recapture arrangement, the advisory client is

Report to the NASD Board of Governors (1991) (commonly referred to as the "Ruder Report"). Such practices were the source of considerable controversy in the early part of the decade, but have diminished in importance somewhat as minimum quotation variations in auction markets, and bid-offer spreads in dealer markets, have narrowed. See Michael Barclay, William G. Christie, Jeffrey H. Harris, Eugene Kandel & Paul Schultz, The Effects of Market Reform on Trading Costs and Depths of Nasdaq Securities, 54 J. Fin. 1 (Feb. 1999) finding that quoted and effective spreads in Nasdaq market have fallen dramatically in wake of recent reforms to market trading practices).

One proposal with respect to the payment for order flow would have required broker-dealers to make mandatory the duty of the order routing broker to pass-through to their customers any payments for directing order flow. See Petition for Rulemaking of Midwest Stock Exchange Re: Payment for Order Flow Practices (May 21, 1990) (petitioning for rule amendments that would require broker-dealers receiving payment for order flow from market makers to remit payments to customers). withdrawn, Letter from J. Craig Long, Vice President, General Counsel and Secretary, MSE (currently the Chicago Stock Exchange (CHX)), to Jonathan G. Katz, Secretary, U.S. Sec. and Exch. Comm'n, (Oct. 29, 1991) (withdrawing petition). The SEC considered a proposal to require mandatory pass-through of payments to customers but subsequently rejected that approach in favor of a disclosure rule-making initiative. See Payment for Order Flow Proposing Release, supra at 52,941 (seeking comment on pass-through alternative); Payment for Order Flow Adopting Release, supra at 55,011 n.42 (rejecting pass-through alternative).

Although the pass-through proposal in the context of payment for order flow is analogous to what is proposed here, there are obvious differences as well. In the payment for order flow context, the pass-through proposal would have redirected existing cash rebates from order routing broker-dealers to their customers. In the soft dollar situation, the pass-through proposal would enable advisory clients to obtain a cash rebate in lieu of a soft dollar rebate to advisers. Second, the pass-through proposal in the payment for order flow context would have been mandatory, while the pass-through arrangement proposed here would be entirely voluntary and would rely on competition among advisers for implementation. Third, one reason why a pass-through proposal was not adopted in the order flow context was the difficulty of allocating the rebate back to individual customers. A pass-through solution was not feasible both because such arrangements were not negotiated on a per share basis and because of the absence of systems for making such allocations. Many soft dollar arrangements, especially those involving third-party providers, in contrast, would lend themselves to allocation because of the way transactions have been structured and general familiarity with allocation issues in the investment management industry.
the rebate recipient. The pass-through arrangement clearly contrasts with a soft dollar arrangement wherein the adviser receives and retains non-cash benefits in the form of research or brokerage services.

The pass-through arrangement, however, also differs from a directed brokerage arrangement in that the investment adviser serves as a conduit for rebate payments from brokers to advisory clients. This distinction is of modest significance in the case of a pass-through arrangement administered on an account-by-account basis. In the commission recapture arrangement, the broker sends the rebate directly to the advisory client, while in the pass-through arrangement it must go through an intermediate account before being forwarded to the advisory client. The main difference is that in a pass-through arrangement the adviser, rather than the advisory client, is responsible for finding the broker to whom the trades are directed whereas in most commission recapture arrangements the client directs order flow to the recapture broker, albeit in consultation with the adviser.

The investment adviser’s conduit status, however, is particularly significant when the pass-through arrangement is administered collectively on behalf of clients. A collective pass-through arrangement would be structured analogously to an individual pass-through arrangement, except in one important detail: the pass-through rebate would be based on trading coming from any or all accounts under management and thus would be administered on a collective rather than an account-by-account basis. The basic structure of the arrangement is shown in Diagram 3. In the collective pass-through arrangement, the adviser would route orders from several different managed accounts to the same pass-through broker which then would distribute a cash rebate back to a pass-through account established by the adviser. The proceeds from the pass-through account are then allocated back to the several managed accounts.
The pass-through arrangement relieves the pass-through broker of the significant recordkeeping associated with servicing the account. Although the investment adviser assumes additional recordkeeping obligations, the adviser has strong incentives to structure a pass-through arrangement on behalf of its own clients. The collective pass-through arrangement allows the adviser to retain control of the order allocation process, which is surrendered in whole or in part in a recapture arrangement. More importantly, in a collective pass-through arrangement on behalf of all or a large group of clients, the adviser can avoid the problem of having to break up similar client orders and routing them to different brokers. In other words, in a collective pass-through arrangement, the adviser can bunch orders without compromising the ability of individual clients to receive a cash rebate.

On its face, a cash pass-through rebate administered on an account-by-account basis would not appear to present any legal problems. The SEC has indicated that such an arrangement is presumptively permissible under the federal securities laws, assuming the rebate goes from the broker to the customer.²⁰⁴ Cash rebates, however, are not particularly attractive to market participants from a business perspective for two reasons. A pass-through rebate transfers potential benefits from the adviser's pocket to the client's pocket. Self-interested advisers understandably prefer soft dollar arrangements to pass-through arrangements, all else being equal. In addition, administration of a cash pass-through on an individual client basis would be extremely expensive for all but the most substantial institutional client. The adviser and

²⁰⁴ See Investment Information Investigative Report, supra note 69, at 928 n.5 ("there [is] no legal impediment to the recapture of cash for the beneficial owners of securities.").
broker would need to track with precision which trades from which accounts were entitled to a rebate.205

A collective pass-through arrangement is designed principally to address the potential expense issue associated with a pass-through arrangement. A collective pass-through arrangement would be far easier to administer at the advisory level than a pass-through arrangement administered on a client-by-client basis because of the greatly diminished tracking burden at the adviser level. Moreover, a collective arrangement represents a more attractive brokerage vehicle from the perspective of brokers in terms of potential order flow. If such arrangements were permissible, some advisers might perceive an advantage to offering such an option (perhaps as an alternative to clients that have sought out directed brokerage arrangements). Other advisers might be persuaded to offer such an option by clients.

There are a number of issues relating to the design of a cash pass-through arrangement. Advisers that provide clients a pass-through rebate option would still be subject to best execution obligations. As a result, some standard analogous to the reasonableness standard applied in connection with soft dollar arrangements would also be required in the case of a pass-through arrangement. The reasonableness standard, however, should be modified in two respects when applied to pass-through arrangements. First, an adviser should be able to pay up — pay a greater commission — only if the cash rebate equals or exceeds the commission by which the commission with the pass-through rebate exceeds the commission that would otherwise have been paid by the adviser. This test can be applied with greater precision than the reasonableness test used for soft dollar arrangements because the actual value of the rebate — its cash value — will be known.206

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205 A pass-through arrangement on an individual basis is essentially equivalent to an adviser entering into a directed brokerage arrangement on behalf of its clients and directing the benefit to the client.

206 In third-party arrangements, advisers generally know the cost of the research since brokers generally "charge their customers the same
Second, the modified reasonableness standard should be applied on an account-by-account basis. In other words, any determination regarding the reasonableness of a pass-through arrangement must be made in terms of the cost and expected benefit to each participating account. Specifically, the investment adviser should be required to make a reasonable determination that any "paying up" by a particular account does not exceed the value of the pass-through rebate obtained by that account. Such an approach differs from the reasonableness standard applied in the soft dollar context where the benefit from any rebate is measured on the basis of the aggregate benefit to all accounts under management rather than on an account-by-account basis.

Inherent in the concept of a pass-through arrangement and the reasonableness test described above is the need for equitable procedures in apportioning cash rebates back to managed accounts. More than one set of apportionment principles is conceivable and it would be necessary to develop a consensus on principles governing fair and equitable methods of allocating rebates. The most obvious allocation scheme would be to allocate the pass-through benefit in accordance with each client's proportionate contribution of commissions toward the rebate.

Such an allocation method, however, is not the only conceivable fair and equitable method. Other factors might affect the method of allocating the rebate. For example, suppose a particular client could participate in a directed brokerage arrangement on more favorable terms than participating in a collective pass-through arrangement

prices for products/services as they were charged by the vendor" and only rarely engage in "bumping," that is charge a premium for the third-party product or service over its cost from the vendor. See 1998 SEC STAFF SOFT DOLLAR REPORT, supra note 1, at 25. But knowing the cost of a third-party product or service is different from the value "in terms of that particular transaction or [the adviser's] overall responsibilities with respect to the accounts as to which he exercise investment discretion," as required by section 28(e). In the pass-through arrangement, there is no need to ascertain the true value of a rebate since it is in cash.
with other clients. In order to induce the favored client to participate in the collective pass-through arrangement, it may be necessary to allow that client to receive a slightly greater proportion of the rebate under the collective arrangement. Similarly, the costs of executing securities trades may and probably do vary depending on types of security traded, a security’s issuer and transaction size. Thus, a portfolio that generates low-cost trades — trades in highly liquid issues where the trade is not unduly large — might be a more valuable source of commissions than a portfolio consisting of more thinly traded issues.\textsuperscript{207}

Fair and equitable allocation schemes should be viewed as falling within a range of acceptable practices but need not generate a single industry-wide model. Investment advisers should have some discretion in establishing and negotiating appropriate ones, provided they can offer a justification regarding the fairness and equity of the scheme employed. In any event, any allocation scheme should be appropriately disclosed to advisory clients.

Assuming an investment adviser arrives at a fair and equitable apportionment standard, there will be problems in applying the standard in practice. Payment of commissions would seldom be synchronous with payment and allocation of rebates. For example, broker-dealers frequently provide soft dollar rebates in advance of expected brokerage transactions while commission recapture arrangements typically involve post-transaction rebates. Presumably a collective pass-through arrangement would be structured in a similar manner to a commission recapture arrangement, that is the rebate would follow the brokerage transactions giving rise to the rebate.

\textsuperscript{207} Arguably the fairest method of apportioning the rebate would somehow reflect the marginal value the broker-dealer attaches to the order flow from each account. But such information will seldom, if ever, be available to the investment adviser and indeed the broker-dealer may only have a rough idea of the relative value of different order flow streams.
The investment adviser may encounter difficulties in apportioning the rebate among accounts. For example, a client may terminate its relationship with an investment adviser after commissions are incurred but before the broker pays the rebate (assuming it is paid after brokerage commissions have been incurred). The potential lack of synchronicity between the adviser's receipt of the rebate and the payment of the commissions that resulted in the rebate may complicate the calculation of the net asset value of the client's account, but the calculation issues raised by a pass-through arrangement are not more intractable than other types of accounting estimation issues that arise regularly in managing investment accounts.²⁰⁸

The mechanics of the pass-through arrangement represent another issue wholly distinct from the apportionment principle employed in connection with the pass-through arrangement. The apportionment principle determines how the rebate proceeds will be allocated among advisory clients. The mechanics of the pass-through arrangement concern how rebate proceeds are

²⁰⁸ Section 22(c) of the Investment Company Act establishes a rigorous methodology for the pricing of redeemable securities, i.e., computing net asset value, of investment companies. Although applicable only to registered investment companies, the accounting procedures are analogous to the types of accounting procedures that would be required to value virtually any managed account. See 15 U.S.C. § 80a-22(c) (1999).

A mutual fund's net asset value is the market value of the mutual fund's assets, less the value of its liabilities, divided by the number of shares outstanding. See INVESTMENT COMPANY INSTITUTE ("ICI"), 1997 MUTUAL FUND FACT BOOK 110 (37th ed. 1997). The SEC requires funds to calculate "current net asset value" daily which includes "calculations, whether or not recorded in the books of account, made substantially in accordance with [SEC requirements], with estimates used where necessary and appropriate." Rule 2a-4(a), 17 C.F.R. § 270.2a-4(a) (1998) (emphasis added). Expenses and income "need not be reflected if, cumulatively, when netted, they do not amount to one cent or more per outstanding share." Rule 2a-4(b), 17 C.F.R. § 270.2a-4(b) (1998). Mutual funds account for miscellaneous expenses that vary year to year by estimating expenses and accruing the estimated expenses over the relevant account period. The estimated accruals are then reconciled against the actual expenses incurred. See AICPA Exposure Draft, supra note 195, at 158.
paid to clients. Investment advisers typically do not exercise custody over client funds because of the significant regulatory burdens to which they are subject in the event that they do provide custody. Since an adviser's receipt of rebate payments as a conduit for its clients would constitute custody of client funds, the pass-through would need to be structured to avoid actual custody. One possibility would be for the broker to distribute to managed accounts participating in the collective pass-through arrangement their proportionate share of the rebate proceeds. Another, and perhaps more realistic scenario, would be for the adviser to advise the custodian of its clients' accounts regarding allocation of rebate proceeds delivered by a broker to the custodian.

The tax and accounting treatment of the pass-through amounts will also affect the feasibility of pass-through arrangements. Commissions typically are treated as capital expenses and thus affect basis or net proceeds, but not current expenses. If clients actually receive the rebates in the form of discrete payments, there is a risk that the pass-through payments might be deemed income to the client with possible tax ramifications. However, rebates effectively reduce capital expenses associated with the purchase and sale of securities. Because rebates reduce the costs paid to acquire securities, the better view would appear to be that they should be treated similarly to commissions and therefore capitalized.

B. ELIMINATING LEGAL OBSTACLES TO COLLECTIVE PASS-THROUGH REBATE ARRANGEMENTS

As indicated above, pass-through brokerage rebate arrangements are not employed frequently in the marketplace. While commercial considerations may have


210 In addition, the investment adviser will incur costs in connection with administering the pass-through arrangement. This issue is dealt with below in the text and notes accompanying note 226, infra.
much to do with this, restrictions under federal and state law also serve to discourage pass-through rebate arrangements administered on a collective basis. Section 28(e), of course, does not apply to collective pass-through arrangements. In the absence of any safe harbor protection, the collective pass-through arrangement must avoid triggering any of the federal or state law restrictions regarding brokerage rebates discussed earlier as well as restrictions on joint transactions.\textsuperscript{211} As a result there is some basis for uncertainty about the legal status of such arrangements and that uncertainty may well discourage use of collective pass-through arrangements commercially.

There are two areas that potentially could present legal obstacles to collective pass-through arrangements under current law: (i) restrictions on joint transactions and (ii) general fiduciary obligations.

1. Joint Transaction Restrictions

Both the Investment Company Act, which is applicable to registered investment companies, and ERISA, which is generally applicable to employer-sponsored benefit plans, contain specific restrictions relating to joint transactions, that is transactions involving participation by more than one managed account of a money manager. A collective pass-through arrangement, to the extent that it involves directing brokerage from several different managed accounts, could be characterized as a joint transaction. In the pass-through arrangement, the investment adviser manages advisory clients’ interests collectively. Such pooling carries at least the possibility of benefiting some clients at the expense of others.

Section 17(d) of the Investment Company Act and rule 17d-1 thereunder prohibit joint transactions among affiliates of an investment adviser except as permitted by the SEC.\textsuperscript{212} The owners of accounts managed by a common

\textsuperscript{211}See textual discussion in Section II.B. supra.
investment adviser may be deemed affiliates of affiliates for purposes of section 17 of the Investment Company Act, even if the funds and accounts are otherwise unaffiliated. If investment companies participate in transactions jointly (in this case brokerage is directed jointly) with other managed accounts in connection with the pass-through rebate arrangement, the rebate arrangement could be characterized as a joint transaction which, absent SEC approval, would violate section 17(d) and rule 17d-1 thereunder.

In considering whether to grant exemptive relief, by rule or order, permitting otherwise prohibited joint transactions, the SEC evaluates whether such arrangements are consistent with the provisions, policies and purposes of the Investment Company Act and whether the participation of the investment company "is on a basis different or less advantageous than that of other participants." Cash pass-through arrangements involving investment companies thus may overcome the restrictions created by section 17(d) and rule 17d-1 in one of two ways. A determination could be made that the pass-through arrangement is not a joint transaction for purposes of rule 17d-1 or, if it is, that the SEC should nevertheless authorize such joint transactions because they are consistent with the policies and purposes of the Act.

Although the SEC has traditionally taken a broad view of what constitutes a joint transaction, it has exhibited a


214 Rule 17d-1(b), 17 C.F.R. § 270.17d-1(b) (1998).

215 The SEC has been subjected to heated criticism with respect to rule 17d-1's overbreadth and the absence of clear standards. See R. James Gormley, On the Same Side of the Table: Is Investment Company Act Rule 17d-1 Partly Invalid?, 20 SEC. REG. L.J. 115 (1992); Joseph W. Bartlett & Stephen P. Dowd, Section 17 of the Investment Company Act — An Example of Regulation by Exemption, 8 DEL. J. CORP. L. 449 (1989). The SEC's Division of Investment Management evidenced sensitivity to these concerns in its comprehensive 1992 report. See Div.
more cautious view in the context of aggregated orders (commonly referred to as bunching of orders).216 A pass-through arrangement is analogous to brokerage arrangements involving bunching of orders. As with bunched orders which are aggregated to secure the best execution for orders collectively, the pass-through arrangement would permit aggregation of orders for routing purposes to secure the most favorable brokerage arrangements. Accordingly, the staff could well take the view that section 17(d) is not applicable to the pass-through arrangement, provided any investment companies participate on terms no less advantageous than those of any other participant. The pass-through arrangement, however, might be distinguished from bunching of orders. Aggregating or bunching of similar orders — the sale of the same issuer’s shares by several accounts — is employed to ensure that orders are executed on the same basis. Although the pass-through arrangement ensures that the cost of executing different orders will be on the same basis, there is no guarantee that the broker offering the most favorable brokerage arrangement in terms of execution costs will be equally suited to afford best execution to orders involving securities of different issuers.

In other words, the no-action letters regarding bunching of orders merely state that there is no rule 17d-1 problem when 500,000 shares of Stock A from five different managed accounts are sent to a broker at one time as

216 See SMC Capital, supra note 213 ("agree[ing] that the mere aggregation of orders for advisory clients, including a registered investment company, would not violate section 17(d), provided that the investment company participates on terms no less advantageous than those of any other participant."); accord Pretzel & Stouffer Chartered, SEC No-Action Letter (pub. avail. Dec. 1, 1996); Banque Indosuez Luxembourg, SEC No-Action Letter (pub. avail. Dec. 10, 1996) (discussing aggregation in connection with fund cloning procedures).
opposed to five separate 100,000 share orders from the different managed accounts. The pass-through arrangement differs from this situation by sending a 500,000 share block consisting of 100,000 share blocks of Stocks A, B, C, D, and E. In the former situation, the investment adviser should not route the order to a broker unless it is sure that it will offer best execution for the 500,000 share block in total and indeed the five clients are likely to be treated more fairly by bunching their orders into a single order. The latter situation, however, poses a much greater concern regarding best execution of the individual order since the adviser must assure itself that the broker can offer best execution for each individual order. In such circumstances, the risk that the interests of a particular client may be compromised are arguably greater, which could cause the SEC to regard the arrangement as a joint transaction.\textsuperscript{217} If so, investment advisers providing such arrangements for their investment company clients would need to receive exemptive relief from the prohibitions in section 17(d) and rule 17d-1. In order to grant the relief, the SEC would need to find that the pass-through cash rebate arrangement provided for participation by investment companies on an equal or no less advantageous basis than other participants.\textsuperscript{218}

Similar fiduciary and transaction restrictions might arise with respect to employee retirement plans under ERISA. ERISA governs potential conflicting fiduciary responsibilities in managing the assets of more than one

\textsuperscript{217} Even if the arrangement were characterized as a joint transaction, the adviser itself would not appear to be a participant since its role in the pass-through arrangement is as a servicing agent. Cf. The Flex-Fund, SEC No-Action Letter, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,178, at 76,733 (Nov. 22, 1985) (noting that affiliated person engaged in service arrangement with fund does not engage in joint arrangement where compensation is not based on revenue generated by arrangement).

\textsuperscript{218} See, e.g., In the Matter of State Street Bank and Trust Company, Investment Company Act Release No. 23,441, 68 SEC Dkt. 147 (Sept. 22, 1998) (granting application permitting investment company's participation in securities lending facility where revenues generated by facility and fees earned by investment company would comply with standards of rule 17d-1.)
client. An issue would arise whether cash pass-through arrangements compromise fiduciary obligations owed to individual plans that participate in such pass-through arrangements.\textsuperscript{219} Like the SEC, the DOL has rule-making authority to clarify circumstances under which such pass-through arrangement would not violate established federal law fiduciary standards under ERISA.\textsuperscript{220} If it is determined that existing class exemptions do not cover pass-through arrangements, coordinated exemptive relief with the SEC would be desirable.\textsuperscript{221}

Another affiliated transaction restriction for registered investment companies arises under section 17(e)(1) of the Investment Company Act.\textsuperscript{222} As noted,\textsuperscript{223} soft dollar rebate

\textsuperscript{219} Cf. SMC Capital, supra note 213, at 79,097 (Sept. 5, 1995) (noting that in addition to federal securities law restrictions relating to aggregation of orders, managed accounts subject to ERISA would need to address exclusive benefits requirements of section 404(a) of ERISA and prohibited transaction restrictions of ERISA section 406). See supra notes 27-31 and accompanying text.

\textsuperscript{220} It is not entirely clear how the pass-through arrangement should be treated under the fiduciary provisions of ERISA. DOL has provided guidelines regarding permissible use of directed brokerage arrangements. See ERISA Technical Release No. 86-1, supra note 27, at 88, 155-56. The Department’s staff has also indicated that the fiduciary provisions of ERISA would not be violated where an investment manager uses brokerage commissions to procure goods and services for the plan that the plan would otherwise be obligated to pay. See DOL Information Letter to Capital Institutional Services, Inc. (Oct. 16, 1986). In addition, the Secretary has established a class exemption from the prohibited transaction restrictions that authorizes ERISA fiduciaries, including investment advisers, to direct brokerage transactions on behalf of pooled separate accounts that jointly benefit the accounts, provided the fiduciary satisfies certain procedural conditions. See Class Exemption for Securities Transactions Involving Employee Benefit Plans and Broker-Dealers, 51 Fed. Reg. 41,686 (1996).

\textsuperscript{221} Coordinated rule-making could be viewed as a commercial necessity. From an adviser’s perspective, collective pass-through arrangements may be attractive to advisers only to the extent that a number of clients are willing to participate in the rebate arrangement. Favorable action by the SEC on collective pass-through rebates, in the face of an adverse determination by DOL, would mean that investment company clients, but not pension plans, could participate in collective arrangements. This disparate treatment would pose some inconvenience to those advisers that service both types of clients.


\textsuperscript{223} See supra note 26.
arrangements involving assets of investment companies such as mutual funds violate, absent compliance with the safe harbor of section 28(e), section 17(e)(1) of the Investment Company Act which prohibits investment advisers from receiving direct or indirect compensation, in addition to their advisory fee, in connection with brokerage transactions. A pass-through rebate arrangement would not raise the same concerns because, unlike the soft dollar arrangement, the pass-through arrangement would not involve the receipt of compensation by the adviser. Although the adviser is a conduit for the cash rebates, the rebates are remitted to the adviser's clients. Where an investment adviser acts as a conduit for rebates that "directly and exclusively benefit the fund," the SEC has indicated that section 17(e)(1) is not violated.224

The investment adviser may bear additional accounting or recordkeeping costs in connection with the collective administration of a pass-through arrangement for which it might seek compensation from the participants. Such compensation would most likely be deemed compensation in connection with brokerage transactions since the compensation would derive from costs incurred in connection with the pass-through brokerage arrangement, and thus arguably violate section 17(e)(1). However, in analogous circumstances, the staff of the SEC has indicated that compensation for administrative services in connection with securities transactions is not always a sufficient nexus where such compensation would be "typical" of compensation that would be received if similar services were rendered in another context.225 If the staff is unconvinced by this position, the adviser may be required

225 See Norwest Bank Minnesota, N.A., SEC No-Action Letter (pub. avail. May 25, 1995) (holding that compensation to custodian for services provided by custodian in connection with securities lending program did not constitute compensation within scope of section 17(e)(1)).
to absorb the administrative costs of the pass-through arrangement as part of its advisory fees.226

2. General Fiduciary Obligations

Joint transaction restrictions are closely related to general fiduciary duty issues that arise under section 206 of the Investment Adviser Act,227 ERISA and state law. However, unlike the requirements of Investment Company Act section 17(d) and rule 17d-1thereunder which are mandatory absent an SEC exemption, general fiduciary obligations typically turn on a close analysis of the facts and circumstances in light of general fiduciary principles. An investment adviser’s use of a pass-through rebate arrangement on a fully disclosed basis, consistent with best execution principles, should satisfy fiduciary obligations imposed pursuant to section 206. In a pass-through arrangement, the adviser remits the cash rebate to the advisory client. Because the benefits from brokerage allocation arrangements are passed through to clients, there does not appear to be a potential conflict between the

226 The costs of administering the pass-through, however, need not be prohibitively expensive with the pervasive use of computer technology. It is possible that the more stringent the allocation standard, the more costly it will be to administer a pass-through arrangement. To conserve on administrative costs, it may be appropriate to seek allocation methodologies that balance benefits against costs of allocation. Thus, for example, trading volume may be a perfectly sound methodology for allocating rebates even though the commissions earned on trades from some accounts entail more profit for the broker-dealer than commissions earned on other trades. The administrative cost of evaluating each trade might well be prohibitive, making trading volume alone a satisfactory, albeit imperfect, allocation methodology. In any event, costs associated with administering a pass-through arrangement are likely to be less than the operating and management costs associated with directed brokerage arrangements. Directed brokerage arrangements require the adviser to track trades very precisely on an account-by-account basis and provide reports of those trades to the advisory client. Although a pass-through retains certain of the classification costs in processing trades, the adviser is able to do it on a group rather than individual basis. Thus, the adviser is less likely to have to break up similar trades from different accounts and retains a freer hand in making routing decisions to secure best execution for its clients.

interests of the adviser and its clients collectively. Employing such an arrangement on a fully-disclosed basis would further remove the taint of potential conflicts of interest.

Nor does the pooling of brokerage from more than one different managed account violate general fiduciary law principles if done on a fully disclosed basis. The staff of the SEC recently considered in an analogous context the permissibility under section 206 of an investment adviser aggregating orders from a group of managed accounts for execution purposes and internally allocating the trades among the participating accounts. The staff indicated that it would take no enforcement action provided the adviser adhered to procedures designed to ensure that no one advisory account would be favored over any other advisory account. In the staff's view, such fully-disclosed arrangements satisfied the requirements of Investment Advisers Act section 206 in treating clients fairly and providing full and fair disclosure of all material facts.228

A fully-disclosed pass-through arrangement poses no greater fiduciary concerns than those presented by aggregation of orders. The pass-through arrangement would require aggregation of orders. In addition, however, it would generate a benefit in the form of cash rebates. The pass-through arrangement would be fair to clients provided that the rebate proceeds are equitably apportioned among clients.229

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228 See SMC Capital, Inc., supra note 213; accord Pretzel & Stouffer Chartered, supra note 216.

229 The viability of pass-through arrangements would be enhanced by adoption of a regulatory safe-harbor that established minimum standards for pass-through arrangements to avoid liability under section 206. The SEC could use its interpretive or exemptive rule-making authority to establish such a safe harbor, including standards governing rebate apportionment schemes that are presumptively equitable and consistent with the adviser's fiduciary obligations. Cf. rule 206(3)-2, 17 C.F.R. § 275.206(3)-2 (1998) (exemptive provision for agency cross transactions for advisory clients).

It could be argued that pass-through arrangements pose conflict of interest issues besides those affecting advisory clients participating in the pass-through program. In particular, the SEC may need to consider...
Similar issues could arise under state fiduciary law principles. State law poses an additional challenge since the multiplicity of jurisdictions creates a possibility of divergent standards among different jurisdictions. Nevertheless the likelihood that any state would conclude that the pass-through rebate arrangement violates fiduciary law principles is fairly remote. The pass-through rebate would be fully disclosed to clients in advance. Moreover, states are likely to look to federal law in this area, even absent express or implied federal preemption, since section 206 and ERISA are themselves based on interpretations of common law fiduciary standards.

Conflicts that may exist between the interests of an adviser's participating and non-participating clients. To the extent that a pass-through arrangement represents an increasingly significant portion of an adviser's trades, the accounts of non-participating clients may be used increasingly and disproportionately as a source of soft dollar commissions. Thus, a potential by-product of a pass-through arrangement may be to increase the tendency to use soft dollars from the accounts of non-participating clients to cross-subsidize research that benefits the accounts of participating clients. The pass-through arrangement contrasts in this respect with order aggregation schemes; aggregating orders from some accounts does not adversely affect trading by other accounts in different securities.

There are several responses. Section 28(e)(1) explicitly authorizes cross-subsidization among accounts. Moreover, any adverse effects are the result of the decision by non-participating clients not to participate in the pass-through mechanism and therefore any adverse effect suffered by non-participating clients is a direct result of their own decision. Indeed, the pass-through mechanism does not raise an issue different from that presented by directed brokerage arrangements that have the same potential to increase the proportion of soft dollar commissions coming from accounts that do not direct brokerage. Finally, the SEC could consider disclosure initiatives aimed at reducing undisclosed indirect effects from pass-through or directed brokerage arrangements on other accounts. Such initiatives might include requiring advisers to disclose whether soft dollar commissions are drawn disproportionately from some managed accounts.

While a controlling federal regulatory law standard might give rise to preemption of an inconsistent state law fiduciary standard under the Supremacy Clause, enactment of section 28(e) ironically undercuts that argument in the context of rebate arrangements. Section 28(e) specifically delimited the scope of federal preemption of state law in the case of soft dollar arrangements, implicitly suggesting that federal agencies are precluded from further expanding preemption of state law fiduciary principles in the case of rebate arrangements.
C. PROMOTING COMPETITION BETWEEN CURRENT BROKERAGE REBATE ARRANGEMENTS AND COLLECTIVE PASS-THROUGH REBATE ARRANGEMENTS

A collective pass-through arrangement would appear to be reconcilable with existing federal and state law restrictions. Would steps aimed at easing this process be sufficient to guarantee either the success of such alternative arrangements or greater competition? The answer may well be no. Merely creating a legal climate favorable to a greater variety of practices may not alter the current competitive landscape; the pervasiveness of soft dollar arrangements and commercial inertia could well deter or retard the emergence of new forms of rebate arrangements such as a collective pass-through arrangement.

Ideally advisory clients should determine which brokerage rebate practices best serve their interests. If investors genuinely prefer soft dollar arrangements to pass-through rebate arrangements then investor choice rather than regulatory process should dictate the outcome. Certain regulatory measures, especially disclosure initiatives, might nevertheless serve to enhance competition between soft dollar arrangements and pass-through rebate arrangements. These requirements would not mandate a shift from soft dollar arrangements to collective pass-through arrangements, but merely ensure a more meaningful opportunity for advisory clients to be able to choose reconsideration of existing industry practices.

1. Disclosure and Pass-Through Arrangements

Regulators may wish to consider ways to refine existing disclosure policies with a view to enhancing the ability of clients to make comparisons among rebate arrangements in selecting investment advisers. Disclosure is a tool for enabling clients of advisers to make informed decisions. New disclosure proposals could be directed at ensuring that investors are aware of the availability of pass-through
arrangements as an alternative to soft dollar arrangements and the potential economic benefits of such arrangements.

Certain disclosure requirements currently applicable to soft dollar arrangements would also be applicable to pass-through cash rebates, such as requirements regarding consideration of brokerage arrangements as a factor affecting selection of brokers.\(^2\)\(^3\)\(^1\) Reported performance and expenses are another way in which clients may indirectly consider the effects of rebate arrangements.

Accounting requirements, however, may have to be reviewed to ensure that substantive differences between the two types of arrangements are adequately conveyed to clients in terms of performance and expense disclosure. Soft dollar and pass-through arrangements differ in their monetary effect on clients. Soft dollar arrangements that involve higher average commissions will adversely affect reported performance if the soft dollar rebate does not otherwise result in enhanced investment performance.\(^2\)\(^3\)\(^2\)

A pass-through arrangement, in contrast to the soft dollar arrangement, would cause reported performance with respect to the same investment portfolio to be higher because the rebate in effect reduces investment costs. Investment adviser performance figures, therefore, would reflect the direct benefits of a pass-through rebate in terms of reduced capital costs.\(^2\)\(^3\)\(^3\)

\(^{231}\) See supra note 192.
\(^{232}\) See text and notes accompanying notes 195-96.
\(^{233}\) It could be argued that the pass-through rebate should not be treated as reducing capital costs since the pass-through rebate is contingent on an adviser directing a certain volume of transactions to the broker. In connection with expense reimbursement caps pursuant to which the adviser agrees to temporarily reimburse a fund for expenses that exceed a prescribed ratio, the SEC has required more prominent disclosure of unreimbursed fees, although permitting funds in footnotes to allude to the reimbursement feature. Such an approach in the pass-through context is not warranted since there is nothing temporary about the rebate and incorporating the pass-through rebate into capital costs is likely to reflect a more accurate picture of the true effect of commissions on performance. The effective commission rate is the commission less any rebate received and that result is what would
This disclosure proposal could be made even more exacting by requiring investment advisers using soft dollar arrangements to disclose annually to their clients whether such arrangements were used in lieu of pass-through rebates, and if so, why, and whether pass-through arrangements were used in brokerage directed on behalf of other of the adviser's clients and, if so, why such arrangements were not used for the client. In addition, an adviser could be required to disclose on a pro forma basis the monetary effect of failing to use pass-through arrangements where such a rebate arrangement is available. In theory, of course, advisory clients would like to obtain information more broadly regarding the monetary effect of an adviser's various brokerage arrangements. Past efforts to develop meaningful disclosure in this regard, however, have proven frustrating.

Another possibility would be to require investment advisers to disclose the average pass-through rebate obtained with respect to all managed accounts and the percentage of transactions for all accounts under management on which a pass-through rebate was obtained. Admittedly these average figures may not be illustrative of arrangements that could be obtained for a particular account. To that extent, advisers should be able to qualify any such disclosure by describing how the figures may not in fact be comparable and do not reflect, for example, indirect benefits obtained by the client under the soft dollar arrangement.

be reflected in performance figures calculated by reducing capital costs by the amount of any rebate received.

234 One of the recommendations of the recently completed SEC Staff Soft Dollar Report is instructive in this regard. In addition to urging that clients receive more detailed disclosure about advisory firm brokerage practices, the staff recommends requiring clients to disclose the availability of commission recapture and commission reimbursement arrangements. 1998 SEC STAFF SOFT DOLLAR REPORT, supra note 1, at 51. This recommendation is notable in recognizing that disclosure regarding the availability of alternative rebate arrangements (rather than access to information about soft dollar practices alone) may be particularly significant in advancing the interests of advisory clients.
The obvious benefit from such disclosure is that it gives the client more information that may be relevant to selecting or negotiating with an investment adviser. Such disclosure, however, may also be potentially burdensome for the adviser. Nevertheless, the disclosure burden that would be imposed under the pro forma disclosure urged here would be significantly less than the disclosure burden that would have resulted from the 1995 Adviser Disclosure Release, a proposal subsequently abandoned by the SEC.235

2. Collective Pass-Through Arrangements and Paying Up

An incidental benefit of collective pass-through arrangements is that such arrangements might provide a more reliable benchmark from which to evaluate whether an investment adviser was paying up for research. The effective commission rate in a collective pass-through arrangement (the commission after netting out the rebate) could be viewed as the relevant benchmark in determining what another broker would have charged for effecting the transaction. If the effective commission in a pass-through arrangement is less than the commission charged by an execution-only broker, then both advisers and regulators should use the former rate in determining whether paying up exists and whether the amount paid up is excessive in relation to the benefit received.

3. Fiduciary Obligations to Consider Pass-Through Alternatives

Another area for heightened scrutiny concerns the conduct of pension fund trustees and boards of directors of investment companies. The boards of investment companies have an important role to play in reviewing and

235 See Disclosure by Investment Adviser Regarding Soft Dollar Practices, Exchange Act Release No. 35,375, 60 Fed. Reg. 9750 (Feb. 14, 1995) (requiring excessively detailed client-specific and firm-wide disclosure regarding brokerage arrangements). Not only would such information have been burdensome to collect and disseminate, but the effect of disseminating the information may well have led to conduct that deterred rather than fostered price competition.
monitoring policies and procedures of the fund with respect to portfolio execution and expenses.236 Such review encompasses practices relating to soft dollar and other rebate arrangements. In the absence of viable alternatives to soft dollar arrangements, however, mere reiteration of board responsibilities (or those of pension fund trustees) is likely to have little effect.

Proposals for increased vigilance and oversight with respect to fund expenses by investment company boards and pension trustees would take on added significance if such fiduciaries were able to evaluate the investment adviser's conduct in light of the availability of collective pass-through arrangements. SEC and DOL interpretive pronouncements should indicate that in evaluating brokerage expenses and policies, fiduciaries should consider the availability of pass-through rebate arrangements as an alternative to soft dollar and directed brokerage arrangements.237

VIII. COLLECTIVE CASH PASS-THROUGH REBATE ARRANGEMENTS AND PUBLIC POLICY

Assuming collective pass-through rebates are feasible both legally and commercially, it is also necessary to consider whether fostering such arrangements as an alternative to existing rebate arrangements is desirable public policy or likely to have any effect. The reasons why collective pass-through rebates should be viewed favorably from a policy perspective are discussed below.

236 See 1998 SEC STAFF SOFT DOLLAR REPORT, supra note 1, at 45-46.
237 There is some irony in this latter proposal in light of the history regarding brokerage rebate arrangements. The duty to at least consider a pass-through alternative where soft dollar arrangements are being used carries faint echoes of the duty to recapture debate from an earlier generation. See supra note 38 and accompanying text.
A. COLLECTIVE PASS-THROUGH ARRANGEMENTS VERSUS OTHER BROKERAGE ARRANGEMENTS

Collective pass-through rebates enjoy comparative advantages over either soft dollar arrangements or directed brokerage arrangements. Because a pass-through rebate goes back to the client, there is no conflict of interest related to receipt of the rebate. Thus, the agency concerns that characterize soft dollar rebate arrangements are largely nonexistent in pass-through rebate arrangements. In this respect, the collective pass-through is similar to a directed rebate arrangement. In addition, unlike soft dollar arrangements, a collective rebate arrangement allocates rebate benefits in accordance with each managed account's contribution of brokerage commissions. The research benefits generated by soft dollar arrangements in contrast may benefit some managed accounts disproportionately to others, measured against their respective brokerage commission contributions.

A collective pass-through rebate is also superior to directed commission arrangements that form the basis for commission recapture or expense reimbursement programs. A collective pass-through rebate, like the directed commission arrangement, benefits advisory clients directly. But, unlike the directed commission arrangement, the collective pass-through does not entail the same degree of disruption to the investment adviser's role in securing best execution on behalf of the client since the adviser, rather than the advisory client, retains responsibility for selecting brokers in connection with any pass-through arrangement.238 Moreover, by pooling

238 See earlier discussion regarding best execution supra notes 13 & 30. A collective pass-through rebate program should be more attractive from the perspective of advisers than directed rebate arrangements for another reason as well. Directed rebate arrangements are more expensive for the adviser to administer because the adviser must more carefully track execution of trades with respect to the particular account. Administration of a collective pass-through rebate program would be more analogous from the adviser's perspective to administration of a soft dollar program.
brokerage, an adviser may find it easier to satisfy its clients' rebate objectives, without sacrificing best execution. This fact underscores another benefit of the pass-through alternative relative to directed commission arrangements: it is likely to be available to a broader range of advisory clients and will be a more cost-effective rebate arrangement for clients generally. Many advisory clients lack the expertise and sophistication to establish a directed brokerage arrangement. In addition, many advisory clients may be precluded from establishing a directed brokerage arrangement by the size of their trading account.

A collective pass-through arrangement offers a means to overcome issues of scale and sophistication in connection with a directed brokerage arrangement. An investment adviser is more likely to generate the scale of trading that is necessary to support a cash rebate program because trades from different accounts would be pooled to earn a rebate from a broker-dealer. Advisers also possess significant advantages relative to many advisory clients in dealing with rebate issues by virtue of their business expertise and the regularity with which they deal with issues concerning allocation of brokerage.

A collectively administered pass-through rebate arrangement may also offer advisory clients with commission recapture arrangements the same benefits they currently enjoy, but with reduced transaction costs. A commission recapture program entails negotiation and administration costs that investment advisers may be more effective in internalizing because brokerage allocation is ancillary to the adviser's other business activities.

A cash pass-through rebate may similarly be more efficient than an expense reimbursement arrangement negotiated by an advisory client. An expense reimbursement arrangement may demand an even greater level of client sophistication or expertise than a commission recapture arrangement because it requires
the client to accept a rebate in the form of in-kind services rather than cash. In effect, the reimbursement arrangement is transformed into a barter transaction rather than two distinct transactions: one consisting of obtaining the best price for a brokerage execution of a given quality and the other consisting of obtaining the lowest possible price for services. The collective pass-through rebate enables the advisory client to keep these two issues distinct.239

B. ELIMINATING LEGAL AND ADMINISTRATIVE COMPLEXITY

A collective pass-through rebate conserves on regulatory burden and costs. Because a pass-through arrangement does not implicate issues of self-dealing by an investment adviser, it poses fewer regulatory concerns. Moreover, the structure of a pass-through arrangement is much simpler than that of a soft dollar arrangement. The conditions that exist under section 28(e) governing compliant soft dollar arrangements — issues such as the “provided by” standard, “mixed use” product allocations and utilization of third-party providers — are irrelevant in the pass-through context. Indeed, because cash pass-through arrangements do not raise conflict of interest issues, use of pass-through arrangements would be appropriate in principal transactions as well as agency transactions. As a result, use of a pass-through arrangement would not turn on any distinction between principal and agency transactions which otherwise contributes to the complexity of soft dollar brokerage allocation practices. Finally, a pass-through arrangement also raises fewer regulatory concerns regarding best execution relative to

239 Treating an expense reimbursement arrangement as two independent transactions has the effect of separately pricing services of each part of the transaction. Unbundling the pricing of such brokerage rebate arrangement offers advisory clients the same advantages that money and payment systems offer relative to any barter transaction, namely reduced transaction costs and greater efficiency in determining the terms on which goods and services shall be exchanged. See Alan S. Frankel, Monopoly and Competition in the Supply and Exchange of Money, 66 ANTITRUST L.J. 313, 315-16 (1998).
directed brokerage arrangements because the adviser retains principal control over decisions regarding selection of brokers.

Because they are more transparent, pass-through arrangements may also serve as a useful check on use of other types of brokerage rebate arrangements. The pass-through will make far clearer the tradeoffs between brokerage commissions with embedded research and brokerage services and cash commission rates. This would be important if the staff of the SEC sought to subject soft dollar practices to closer scrutiny in terms of best execution and paying up.

C. THE LOWER AVERAGE COMMISSION ALTERNATIVE

A cash pass-through arrangement closely approximates the more straightforward pricing strategy of simply charging a lower average commission. A broker could employ a graduated commission schedule that enables it to differentiate among customers in much the same way as a cash pass-through arrangement. Commissions would be based on the amount of brokerage an investment adviser was willing to direct to a broker. The functional similarity of a pass-through arrangement and charging lower average commissions raises the question, noted earlier, as to why a broker would ever opt for a more complicated rebate arrangement in lieu of charging a lower average commission.

Although there are clear similarities between a graduated commission schedule and the pass-through arrangement, there are also differences that may explain why pass-through arrangements may be commercially more attractive for brokers and investment advisers than the graduated commission schedule. A pass-through arrangement allows the broker to use multiple pricing strategies with respect to its customers rather than a single low average commission because the terms of the rebate may vary from customer to customer. In this way, rebates may be a more effective strategy of masking the
effective commission rate paid by different customers. A pass-through arrangement also permits the broker to retain the value of the rebate until it is returned to the customer. A lower commission rate eliminates the need to return the rebate since the customer never pays up in the first place.

Investment advisers may prefer the pass-through rebate arrangement to a graduated commission schedule because paying low average commissions in some cases may cause greater scrutiny of higher commission rates paid in connection with other brokerage arrangements, such as soft dollar research arrangements. A pass-through rebate undercuts this perception somewhat by tending to show similar commissions from different broker-dealers even though the effective commission after factoring in rebates and execution quality may be very different. Thus, advisers may prefer to pay uniformly high commissions to avoid having to justify higher commission rates paid to full-service brokers or third-party soft dollar brokers, while recognizing that use of such brokers is not always warranted.

The existence of commission recapture arrangements in the current environment attests to this perception issue. The functional similarity between a pass-through arrangement and graduated commission schedule providing lower average commissions is a similarity also shared with commission recapture arrangements. Notwithstanding the functional similarity of lower average commissions and commission recapture arrangements, it is clear that both brokers and advisory clients prefer in many situations to use commission recapture arrangements rather than a graduated commission schedule.

Use of collective pass-through arrangements is only one initiative aimed at promoting choice and competition in brokerage rebate arrangements. Other regulatory initiatives might seek to rationalize the bounds of the safe harbor with respect to soft dollar practices themselves.
Accordingly, as a corollary to any initiative regarding collective pass-through arrangements, it may be desirable for regulators to reexamine current interpretive limitations with respect to the section 28(e) safe harbor that do not appear to advance the interests of advisory clients. For example, as currently applied, the "provided by" standard precludes investment advisers from independently negotiating with research vendors for research products or using intermediary clearinghouses to obtain the most favorable economic terms with respect to research products. In addition, the SEC should consider whether use of soft dollar arrangements in connection with principal transactions should be liberalized. Finally, the SEC may wish to reconsider interpretive positions that permit third-party research arrangements but discourage third-party custodial arrangements.\textsuperscript{240}

Liberalization of existing positions with respect to soft dollar arrangements, however, should not be undertaken before the SEC has obtained some experience with collective pass-through arrangements. Collective pass-through arrangements could provide valuable evidence regarding the operation of market forces with respect to brokerage rebate arrangements. Use of collective pass-through arrangements on a commercially significant scale would attest to the viability of competition as a means of disciplining brokerage rebate practices, thereby arguing for greater liberalization with respect to soft dollar practices as well. However, if collective pass-through arrangements were unable to gain a commercial foothold, it would suggest that there were significant obstacles to meaningful competition. Such obstacles would argue against further liberalization with respect to permissible soft dollar practices until regulatory authorities have sufficient assurances that liberalized practices would have beneficial effects for advisory clients.

\textsuperscript{240} See supra Section V.C.
D. The Virtues of Choice and Competition in Brokerage Rebate Arrangements

Encouraging pass-through rebates as an alternative to soft dollar and directed commission arrangements is desirable for another reason: the pass-through arrangement, by introducing an alternative rebate arrangement, promotes competition among brokerage rebate arrangements and enhances the role of advisory clients in influencing brokerage rebate practices. Even if pass-through rebates were not affirmatively beneficial, it is clear that they do no harm since they do not create the problems of either soft dollar or directed brokerage arrangements. Presumably advisory clients will be in the best position to determine which type of rebate arrangement is most advantageous.

Even though pass-through arrangements are not clearly more advantageous for advisory clients than soft dollar arrangements, investment advisers should be permitted to compete with other advisers by offering such arrangements and clients should be able to consider the availability of pass-through arrangements in selecting an adviser. Because there is no basis for concluding that a pass-through arrangement is inevitably worse for investors, client self-interest should be given considerable deference in determining which type of rebate arrangement is most advantageous to the client. Affording clients a choice among a broader range of rebate arrangements will promote greater confidence that the rebate arrangement selected best serves the interests of advisory clients.

Pass-through rebates are also likely to engender greater competition than soft dollars by bringing a greater level of transparency to rebate arrangements. Bundling in soft dollar arrangements renders non-transparent the relationship between investment performance of a particular account and the research obtained under a soft dollar arrangement (research that is potentially shared by many accounts). As a result, client monitoring of the
benefits of soft dollar arrangements is not possible except in the largely perfunctory sense of recognizing that the investment adviser may be deriving unquantifiable benefits that improve the adviser’s ability to service clients generally. The lack of transparency associated with the benefits obtained from soft dollars diminishes the ability of customers to exercise discipline over portfolio brokerage costs.\textsuperscript{241}

Unbundling brokerage allocation and the purchase of research promotes greater competition in commission rates and in the pricing of research services. Since the pass-through rebate effectively frees up funds dedicated to purchase research either from or through the investment adviser, those proceeds can be put to their best use whether for obtaining the same or higher quality research services from the lowest cost provider or purchasing other investment services.\textsuperscript{242} In either case, the relevant purchaser of brokerage and research services is likely to be more discerning and selective in making its purchasing decision when using hard dollars rather than soft dollars.

**E. WILL INDUSTRY EVER ACCEPT COLLECTIVE PASS-THROUGH ARRANGEMENTS?**

Even if collective pass-through rebate arrangements represent an incremental improvement in public policy and are feasible, there is no assurance that they will be embraced by the investment management industry. Advisers may prefer to avoid using such arrangements in favor of soft dollar arrangements. Similarly, brokers may

\textsuperscript{241} This is not to say that competition in the soft dollar realm is absent. Competitive issues undoubtedly manifest themselves to investment advisers in terms of soft dollar ratios for converting some portion of a commission into a soft dollar rebate and the pricing of brokerage and research services purchased with soft dollars. However, because soft dollar arrangements are inherently less transparent than pass-through arrangements, there are higher transaction costs associated with oversight of brokerage expenses in a soft dollar environment by advisory clients.

\textsuperscript{242} If a client prefers bundling, of course, it can continue to opt for a bundled arrangement through its investment adviser.
decline to offer them if they believe that to do so would imperil their standing with investment advisers.

There is nevertheless good reason to believe that collective pass-through arrangements may gain a meaningful foothold if permitted. First, collective pass-through arrangements give investment advisers a way to discourage advisory clients from resorting to directed brokerage arrangements. Second, if collective pass-through arrangements gain some presence in the market, advisers will as a competitive matter be unable to ignore their use. An adviser which makes the option available to some clients will in all probability be forced to make it available to all clients. Moreover, if it is clear to clients that pass-through arrangements better serve their interests than soft dollar arrangements, they are likely to become more insistent that advisers use pass-through arrangements in at least some cases where an adviser might be more inclined to use a soft dollar brokerage arrangement. Finally, the combined effect of disclosure proposals and best execution interpretations could induce brokers to offer, and advisers to make use of, such arrangements.\footnote{The SEC could also consider more aggressive regulatory positions to encourage brokers to offer pass-through arrangements. For example, the SEC could conclude pursuant to rule-making that brokers who offer certain types of brokerage rebate arrangements, such as third-party research arrangements or directed brokerage arrangements, should also be required to offer customers the option of a collective pass-through arrangement. Such a requirement would rely on rule-making authority pursuant to section 15(c)(2)(D) of the Securities Exchange Act [15 U.S.C. § 78o(c)(2)(D) (1999)] which gives the SEC authority to adopt rules that are reasonably designed to prevent fraudulent conduct by brokers. Undoubtedly such an affirmative obligation would be extremely controversial and should be undertaken, if at all, only after examination of the competitive consequences for third-party and commission recapture brokers relative to full-service brokers.}

Does this mean that collective pass-through arrangements are ever likely to vanquish soft dollar and directed brokerage arrangements entirely? The answer is almost certainly no. Rather the best hope and most likely outcome is for collective pass-through arrangements to
alter the existing pattern of usage with respect to soft dollar and directed brokerage arrangements. Collective pass-through arrangements have a greater potential to displace commission recapture arrangements since collective pass-through arrangements might better serve the interests of both advisers and advisory clients. Collective pass-through arrangements may also erode usage of soft dollar arrangements. Nonetheless, advisers are likely to be resistant to surrendering the soft dollar benefits that they currently enjoy and, thus, it is unlikely that pass-through arrangements would entirely displace current soft dollar practices.

The relative significance of pass-through arrangements as a policy initiative, however, should ultimately be measured not in terms of its effect on the continued use of soft dollar arrangements but rather in terms of its ability to bring the benefits of enhanced competition to institutional brokerage. The benefits would include greater price competition among full-service and third-party brokers for institutional brokerage and greater price discipline in connection with the use of soft dollar arrangements.

**IX. CONCLUSION**

Soft dollar arrangements compliant with section 28(e), although entirely lawful, remain a controversial practice. Such arrangements are far less abusive of client interests than the reciprocal and give-up arrangements which they displaced, but it cannot be said with any degree of confidence that the interests of advisory clients are well-served by such arrangements. Directed brokerage arrangements are a direct market response to the prevalence of soft dollar arrangements, but they have met with only limited success and have introduced separate problems.

In view of this situation, regulators should seize the initiative, not by proscribing such practices but by removing obstacles to rebate practices that are more favorable to advisory clients. This article has discussed
one such alternative — a collective cash pass-through rebate. Advisory client choice rather than government mandate, however, should be the final arbiter respecting rebate arrangements. Thus, use of the collective cash pass-through arrangement proposed here should be voluntary. By permitting such arrangements and creating conditions that would enable them to compete with existing brokerage rebate arrangements, regulators can ensure that advisory client choice and competition play decisive roles in shaping brokerage rebate arrangements rather than regulatory fortuity or industry self-interest and inertia.