

30 March 2004

The Honorable William H. Donaldson
Chairman
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Donaldson:

Perceived scandals in America's mutual fund industry have brought renewed attention from Congress and the SEC to conflicts of interest in fund management thought to threaten investor welfare. Various reports have appeared in the financial press calling for further regulation in the name of investor protection.

Among the business practices thought to raise conflicts of interest are soft dollar brokerage arrangements. With soft dollars, fund managers receive research from the broker bundled together with execution for a single commission that exceeds the lowest available rate. Because fund investors indirectly pay brokerage commissions, soft dollars have been subject to criticism on the following grounds: 1) they allow the manager to unjustly enrich himself by secretly shifting his research bill to investors, 2) by implicitly subsidizing research they encourage the manager to use too much of it, 3) they tempt the manager to do too much trading and to pay excessively high commissions to generate the soft dollar credits to pay his inflated research bill, and 4) they might lead the manager to be excessively loyal to brokers who provide soft dollar research credits but whose execution quality falls below expectations. To avoid these conflicts, some have called for either restriction or outright elimination of the safe harbor protection under Section 28(e) of the Securities Exchange Act (1934) for managers who use soft dollars.

Having lectured, conducted extensive scholarly research, and published widely on the subject of soft dollar brokerage over the past decade, we believe it is an innovative business practice that actually helps to avoid conflicts of interest in mutual fund management by providing managers and their brokers with incentives to act in the best interest of fund investors. Any restriction on soft dollar use would very likely injure investors by compromising best execution and reducing fund returns. Both theoretical and empirical support for our position can be found in our attached working paper entitled *Does Soft Dollar Brokerage Benefit Portfolio Investors: Agency Problem or Solution?* According to our analysis, managers who pay more in total brokerage commissions per dollar of assets earn higher risk-adjusted returns, suggesting soft dollars

benefit investors. What is more, we find that managers who pay more in total brokerage commissions per dollar of assets do not earn lower management fees, suggesting soft dollars do not result in unjust enrichment.

We submit our paper for your consideration on behalf of the Alliance in Support of Independent Research. We also call your attention to Professor Johnsen's recent Editorial Commentary in BARRONS summarizing our analysis (D. Bruce Johnsen, *Hard Facts on Soft Dollars*, BARRONS, March 15, 2004). Our substantive analysis is our own and strongly supports the following findings and policy implications:

Perceived Conflicts of Interest Alone do Not Justify Federal Regulation

Absent demonstrable evidence of harm to investors, calls for federal regulation in response to perceived conflicts of interest are inappropriate. In an advanced market economy, principal-agent conflicts are an inevitable consequence of specialization, and informed principals routinely consent to them because the benefits outweigh the potential losses. In the field of investment management, all conflicts of interest could be avoided if investors were to manage their own portfolios and trade for their own accounts. Yet it is undeniable that this would dramatically reduce the size of the economic pie due to the lost benefits from specialization.

More importantly, much of the recent concern over conflicts of interest fails to recognize that actual disloyalty by agents seldom occurs. As a general matter, market participants faced with competition routinely enter into private arrangements to limit opportunities for their own and others' disloyalty because doing so allows them to increase their principals' and their own profits. These arrangements sometimes appear puzzling or improper to outsiders and have been summarily condemned without adequate investigation merely because they create a perceived conflict of interest.

In 2001, for example, Richard A. Brealey and Anthony Neuberger of the London Business School responded to a hasty recommendation by Britain's Treasury to prevent conflicts of interest in pension management by mandating advisory contracts that require the manager to cover his own research and execution costs in exchange for an "all-in-one" (concededly higher) management fee. This mandate would have effectively prohibited soft dollar brokerage ("soft commissions" in England). Although a mandatory all-in-one management fee might sharpen managers' incentives in one area, Brealey and Neuberger concluded it would likely weaken their incentives in other areas so much that the proposed restriction on contract choice is unwarranted (See Richard A. Brealey and Anthony Neuberger, *The Treatment of Investment Management Fees and Commission Payments: An Examination of the Recommendations Contained in the Myners Report* (2001)).

Perceived Conflicts Apply to All Bundling

Widespread criticisms of soft dollar brokerage fail clearly to define the practice or the nature of any unique conflicts of interest it creates. A precise definition of soft dollar brokerage is elusive. To most critics, it refers exclusively to situations in which a broker who lacks comprehensive in-house research capacity provides a manager with third-party research generated by independent vendors and formally meters the arrangement through a soft dollar account. Yet, from the standpoint of conflicts of interest this type of bundling is almost indistinguishable from the large quantity of proprietary in-house research full-service brokers have traditionally provided managers on an informal, or *relational*, basis. Indeed, all the alleged conflicts of interest said to surround soft dollar brokerage are misplaced criticisms of any arrangement in which the broker provides execution bundled with research, regardless of who generates the research.

The unique attributes of bundled independent research are that the parties formally meter the flow of research, execution, and brokerage commissions, so that research and execution can be supplied by entirely separate, specialized firms. Specialization is unassailable as a driving force for economic progress, and criticisms of bundled independent research as a form of “hidden” transaction are simply mistaken. It would be completely anomalous to restrict the bundling of independent third-party research because it formally meters what is entirely hidden from view with proprietary in-house research. Moreover, any such restriction would negate the recent *Global Settlement’s* goal of fostering independent research as an unbiased competitive alternative to in-house research. To be consistent, any restriction on bundling to prevent perceived conflicts of interest should apply equally to independent and in-house research.

Bundling Benefits Fund Investors by Ensuring Best Execution

Contrary to widespread criticisms, bundling actually helps to avoid conflicts of interest by providing managers and brokers with the incentive to achieve best execution. As explained in the U.S. Securities and Exchange Commission’s (SEC’s) recent Concept Release: *Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs*, the total cost of transacting portfolio securities includes both direct brokerage commissions and indirect costs such as market impact, which occurs when the price of a security moves against the manager as a result of the broker’s trading activity. The Concept Release reports that market impact costs can easily exceed commissions as a percent of assets under management.

The manager’s fiduciary duty of best execution requires him to balance direct commission costs against potential market impact costs when making brokerage allocation decisions. While it is true that bundling may require managers to pay more than the lowest available commission rate, it would not be an economically viable course of conduct for a manager to pay the lowest available rate for most trades because doing so would compromise execution quality and lead to excessive price impact.

In securities markets where prices are extremely noisy, it is difficult for a manager to accurately assess a broker's execution quality except over an extended series of trades. Absent some method of guaranteeing execution quality, damage to investors from poor execution and price impact can occur before the manager has a chance to respond. By formally accounting for the flow of research, execution, and brokerage, the bundling of independent third-party research allows the broker to front-end load the manager's receipt of research. The manager receives research up front in exchange for his (legally unenforceable) promise to send the broker future trades at commission rates that exceed the lowest available rate. If the manager later determines the broker's execution quality is inadequate, he can terminate the relationship and withhold the balance of the commission business he promised the broker at the outset. The threat of termination with the expected commissions remaining unpaid serves as a performance bond to guarantee the broker carefully executes the manager's trades (For a general analysis of quality assurance, see the pathbreaking article by Benjamin Klein and Keith B. Leffler, *The Role of Market Forces in Assuring Performance*, 89 *Journal of Political Economy* 615 (2001)).

Artful brokerage allocation lies at the heart of best execution and can have a significant effect on fund returns. In essence, the broker's provision of bundled research in advance of the promised commission business helps create a relationship of trust with the manager that ensures best execution and clearly benefits portfolio investors, as our empirical results confirm. Any manager who commits himself to paying only the lowest available commission rate would deprive his investors of these benefits. Since paying the lowest available commission is not an economically viable course of conduct, managers should be allowed to exercise their business judgment and receive the full protection of Section 28(e)'s safe harbor when making brokerage allocation decisions.

Bundling Benefits Investors by Encouraging Profitable Research

Claims that bundling creates a conflict of interest by encouraging managers to use too much research are simply mistaken. Reliable economic theory holds that managers would have too little incentive to engage in research if required to pay for it out of their own pockets because they receive only a small share of the returns from identifying profitable trades (See the pathbreaking article by Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 *JOURNAL OF FINANCIAL ECONOMICS* 305 (1976)). The not-so-active manager who hugs a market index while collecting a handsome fee for active management is one well-known case on point. By subsidizing research, bundling encourages the manager to identify profitable portfolio trades for the benefit of investors.

In virtually all agency relationships, principals subsidize their agents' use of productive inputs to give them proper incentives to be productive. Absent demonstrable evidence that managers are unjustly enriching themselves, there is no reason why the

research subsidy bundling provides should be presumed improper in the context of mutual fund management. Our evidence suggests bundling does not lead managers to engage in unjust enrichment because managers who pay more in brokerage commissions per dollar of assets do not earn lower management fees. If the receipt of a research subsidy truly allowed managers to engage in unjust enrichment, labor market competition would force those who pay more in brokerage commissions per dollar of assets to accept lower management fees.

Both mutual fund managers and private pension and trust managers are free to enter into contracts that preclude the receipt of bundled research. Indeed some do, but the vast majority do not because they believe it would be imprudent to do so. Together with our analysis, this raises a presumption that requiring managers to unbundle by paying the lowest-available commission for all trades would injure fund investors

Conclusion

Based on the foregoing findings, we believe proposals to restrict Section 28(e)'s safe harbor are ill-advised. Before taking action, we urge you and others considering regulatory restrictions on bundling to examine the full range of conflicts surrounding mutual fund management and institutional securities brokerage as well as the actual effects of moving to an alternative regulatory framework. To this end, Professor Johnsen has organized a scholarly panel at the upcoming annual meetings of the INTERNATIONAL SOCIETY FOR NEW INSTITUTIONAL ECONOMICS that will convene top scholars from economics, finance, and law to examine conflicts of interest that arise in the general context of third-party payments. This panel should shed considerable light on the competitive effects of soft dollar brokerage and related practices. In the meantime, we would be happy answer any questions you have regarding our research and its policy implications.

Respectfully yours,

D. Bruce Johnsen
Professor of Law
George Mason University School of Law



Stephen M. Horan
Associate Professor of Finance
St. Bonaventure University

The Honorable William H. Donaldson
March 30, 2004
Page 6

Enclosure

Cc:

The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid

Annette L. Nazareth, Director
Robert L.D. Colby, Deputy Director
Larry E. Bergmann, Associate Director
Division of Market Regulation

Paul F. Roye, Director
Division of Investment Management