Howell E. Jackson, John Rady & Jeffery Y. Zhang,
“Nobody is Proud of Soft Dollars”:
A Critical Review of Excess Brokerage Commissions in the United States and
the Impact of MiFID II Reforms of Unbundling in the European Union
Professor Howell E. Jackson

3CL Seminar at Cambridge Law Faculty
Moot Court Room (G28)
October 21, 2019

Outline of Remarks

- Introduction: Global & Consumer Protection
  - Soft-Dollar Practices in the United States
  - Developments Under MiFID II
  - Cross-Border Implications & Reactions
  - Current State of Affairs & Open Questions
Mechanisms of International Coordination

- Harmonization
  - Treaties & Collective Agreements
  - Soft Harmonization
    - Regulatory Alignment
    - Market Convergence

- Market Access Conditioned on Comparability
  - In-Bound Substituted Compliance
  - Out-Bound Substantial Equivalence Tests

- Consumer/Investor Led Convergence

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CHAPTER THREE

The Trilateral Dilemma in Financial Regulation
Howell E. Jackson

Introduction

Consumers face numerous challenges in keeping their financial house in order. How to invest one’s retirement savings? What asset policies to purchase? How to finance a home or educate one’s children? These are all complicated decisions balancing numerous factors and weighing the risks to consumers. Thus they may use recommendations as to specific courses of action—narrow down the range of possibilities to a manageable number. Consumer education programs often recommend the use of such “financial planners.” Sometimes these advisors will be family friends or relatives, but mostly consumers will turn to members of the financial sector for advice and direction.

This reliance on recommendations of the financial sector creates a potential problem for consumers. By gaining some aspects of a consumer’s financial decision-making process, a financial advisor may be tempted to steer the consumer’s decision in a manner that serves the interest of the advisor and not the client. Often times, the temptation will involve the selection of a financial product or service that produces collateral benefits for the advisor—either a direct cash payment or the provision of some ancillary service for the advisor. These collateral benefits can result in the consumer being steered towards a financial product or service that is not in their best interest.

The tripartite dilemma can be represented as follows:

- **Financial Product**
- **Financial Professional (Intermediary)**
- **Consumer**

A kick-back system is illustrated, where the financial professional (intermediary) receives a kick-back from the financial product provider in exchange for steering the consumer towards the product that provides substantial benefits to the advisor.
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The Structure of Bundled Commissions

- Proprietary Research
- Advisory Contract (fee for service)
- Order flow with Bundled Commission on Trades (covering both execution and research services)
- Mutual Fund (UCIT)
- Investors
- Brok-Dealer (executing trades of portfolio securities)
- Trading Markets
Section 28(e) of the Securities Exchange Act of 1934

(1) No person . . . in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law . . . solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion. This subsection is exclusive and plenary insofar as conduct is covered by the foregoing, unless otherwise expressly provided by contract: Provided, however, That nothing in this subsection shall be construed to impair or limit the power of the Commission under any other provision of this chapter or otherwise.

(2) A person exercising investment discretion with respect to an account shall make such disclosure of his policies and practices with respect to commissions that will be paid for effecting securities transactions, at such times and in such manner, as the appropriate regulatory agency, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Own Funds versus Bundled Commissions

“I won’t pretend that we monitor soft dollars the same way we monitor other expenses.”

Personnel (e.g., Portfolio managers, analysts, support staff)

Other Expenses (e.g., computers & other support and direct costs, including hard dollar research)

Other External Research (from major & independent firms plus data and corporate access)

Execution Services (including, high-touch & electronic)

Bundled Commissions (deducted from Client Funds)
The SEC’s Uneasy Relationship to Soft Dollars (Coupled with Strong Industry Resistance to Changes)

Scope of Coverage:
- Limit to Proprietary Research Directly from Broker Dealers
- Allow for Third Party Research
- Promote Third Party Research with CSAs

Attention to Boundary Problems
- What About Mixed-Use Products?
- Defining Research (e.g., trips to Caribbean and nice office accoutrements)

Scope of Disclosure Duties
- No Requirement to “Unbundle” Soft Dollar Costs (perhaps impractical)
- Largely Boilerplate & Not Directed to Investors

Several Failed Forays at Reform
- Proposals for More Explicit Disclosures of Soft Dollar Payments (1994)
- Chairman Cox’s Trial Balloon for Repeal of Section 28(e) (2007)

Hiatus in SEC Attention Post 2008

Figure 3
Trends in U.S. Equity Commissions

Summary of Academic Literature

- **Dominant Theoretical View**
  - Principal-Agent Problem (Haslam 2016)
  - Minority Perspective: Solution to Lemons Problem

- **Empirical Evidence:**
  - Mixed, But Generally Not Advantageous to Investors
  - Confounding Problem of Data
    - No Direct Measures of Soft Dollar Payments
    - Higher Commissions Could Pick up High Touch Trading
  - Also Possible Presence of Tainted Alpha
    - IPO Allocations
    - Corporate Access
Collective Action Problem
(to self help in Unbundling)

- **Investment Advisers**
  - May Be Penalized for Unilateral Reduction
  - Forces Higher Salient Expenses

- **Major Securities Firms**
  - Resist Efforts to Unbundle Commissions
  - Can Threaten Denial of High Touch Services
  - Withhold Other Opportunities: Corporate Access & IPO Allocations (maybe)

Public Goods Dimensions

- **Sources of Public Goods**
  - Information Necessary for Quality of Capital Markets
  - Liquidity Provision
  - [Preservation of Medium Sized Asset Managers]

- **Challenges in Line of Argument**
  - Would Disclosure of Costs Diminish Supply of Good?
    - Are Bundled Commissions Supporting These Goods
    - Might Unbundled Costs Produce Same or More?
    - Is it Credible that Securities Firms are Cross-Subsidizing these Public Goods?
  - [Are There Better Ways to Support these Public Goods?]
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Figure 6
Regulatory Timeline
Two Regimes in One Picture

An American Perspective: The Evolution of MiFID II

- Intensity of Supervisory Attention on “Inducements”
- Refinement of Permissible Research Services
  - Corporate Access Ban
  - Articulating Scope of “Substantive “Research
- Insights from Supervisory Reviews
  - Chronic Recidivism & Lax Industry Oversight
  - Benefits of Explicit Budgeting
- Key Elements of MiFID II Unbundling
  - Hard Dollar Payments & RPAs
  - Ex Ante and Ex Post Transparency of Costs
  - Explicit Budgeting with Limited Cross Subsidies
- The Impact of Unbundling on Best Execution
An American Perspective: MiFID II Implementation in 2018

• (Unsurprising) Decline in Research Costs & Shift to Internal Buy-Side Research and Alternatives
• Surprising Jump to P&L Usage But Interesting Insights from RPA Usage (Clients Confused) as well as Hybrid Models (RPA with P&L top-off)
• Greater Attention to Budgeting, Valuing Research and some Evidence of Improved Quality
• Lots of Transitional Effects on Research from Bulge Firms, Independent Providers, New Sources, Research Aggregators and New Entrants (“The Phony War.”)
• Much Discussion of Impact on SME Research Coverage, But Contested and Hard to See in Data

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Cross-Border Issues
(from Perspective of U.K. Asset Manager)

Does MiFID II Apply? [Yes per FCA]
U.S. Legal Issues:
- Advisers Act Registration
- NY State Sales Tax
Practical Questions:
How Will U.S. Firms Deal with MiFID II Asset Managers?

SEC No-Action Relief (Oct. 2017):
Firms Subject to MiFID Get Temporary Relief from US Law Thru Summer of 2020.
Evolving Practice in the U.S.

- Evolution in Asset Manager Practices:
  - A Few, Larger Firms Internalizing Soft Dollar Costs
  - Others Improving Disclosure Practices
- Sell-Side Firms:
  - Focused on Expiration of No-Action Relief
  - Still Resistant to Unbundling, Especially to Smaller Asset Managers with Less Market Power
- SEC Undecided on How to Proceed
  - For a Time Hesitant to Extend No-Action Relief
  - SEC Investor Advisory Committee & Various Buy-Side Groups Pushing for Greater Transparency
  - SEC Chair Deeply Concerned About Impact on SME’s (and decline of public companies)
  - Intense Interest in Developments in EU/UK, where there are divisions Across Regulatory Bodies

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A Wealth of Reports & Studies

• Industry Studies (e.g., CFA Institute & Bloomberg)
  – Surveys on Reduction in Sell-Side Analysts & Research Payments
  – Uncertainty over MiFID II’s Anti-inducement Requirements
  – Dire Warnings on Impact for SMEs

• Official Sector Responses:
  – French & German Authorities: Undertaking Separate Studies (expected by end of 2019), with concerns about SMEs and Fixed Income Coverage.
  – Potential Adjustments in Implementations of MiFID II and Possible Changes in 2023 +/-

• Academic Empirical Work
  – Confirms Decline of Sell-Side Budgets, But Preliminary Evidence Suggests Less Valuable Research Being Reduced
  – Potential Offsets on Buy-Side Research & Alternative Approaches to Providing Research
  – Evidence of Measureable Shift in Quality of SME Market Difficult to Detect

Figure 3: Median Bid-Ask Spread Normalized to January 3, 2018

- FTSESmallCap
- FTSE100
One View on Unbundling

The U.S. Legal Ecosystem

Corporate Law Issues
- Charging for Corporate Access
- Informal IPO Allocations

SEC Options
- Examination of Advisors/Boards
- Better SAI Disclosures
- Incorporate Soft Dollars Into Total Costs
- Align Rights of US Investors

Mutual Fund Independent Boards
- Get and Evaluate Full Range of Options on Soft Dollars
- Analyze Soft Dollars as Fall-Out Benefits/Enhanced Profitability
- Overseeing Best Execution with Clean and Granular Data

Pension Plan Sponsors
- Selecting Funds for 401(k)
- Supported by Consultants

Industry-Side Consultants
- Abel Noser/ITG
- Integrity Research
- Greenwich Associates
- Frost Consulting

Plaintiff-Side Law Firms
- Expand 36(b) litigation
- Focus on Board/Advisor Duties

Morningstar & Lipper
- Influential Rating
- Attention to Total Fees (with adjustment if soft dollars not disclosed?)
Mechanisms of International Coordination

- Harmonization
  - Treaties & Collective Agreements
  - Soft Harmonization
    - Regulatory Alignment
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List of Sources and Engagements


• MICHAEL S. BARR, HOWELL E. JACKSON, & MARGARET TAHYAR, FINANCIAL REGULATION: LAW AND POLICY (2nd ed. Foundation Press, 2018) (chapters 10.2 & 10.3)


• Various Engagements with Stakeholders (interviews with FCA Staff (Summer 2016); Presentation at LSE Workshop (June 2017); HLS Roundtable (Sept. 2017); MFDF Panel (February 2018); UK Research Industry Conference (Nov. 2018); MFDF Webinar (April 2019); NYC Research Conference (June 2019).

• Independent Trustee, CREF & affiliated TIAA-CREF Mutual Funds.

Extra Slides for Q&A
A Digression on U.S. Disclosure

**Boilerplate**

In selecting or recommending a broker-dealer, we will consider the value of research and additional brokerage products and services a broker-dealer has provided or will provide to our clients and our firm. Receipt of these additional brokerage products and services are considered to have been paid for with 'soft dollars.' Because such services could be considered to provide a benefit to our firm, we may have a conflict of interest in directing your brokerage business. We could receive benefits by selecting a particular broker-dealer to execute your transactions, and the transaction compensation charged by that broker-dealer might not be the lowest compensation we might otherwise be able to negotiate. The products and services we receive from broker-dealers will generally be used in servicing all of our clients’ accounts. Our use of these products and services will not be limited to the accounts that paid commissions to the broker-dealer for such products and services.

In addition, we may not allocate soft dollar benefits to your accounts proportionately to the soft dollar credits the accounts generate. As part of our fiduciary duties to you, we endeavor at all times to put your interests first. You should be aware that the receipt of economic benefits by our firm is considered to create a conflict of interest.
Typical SAI Disclosure in US

<table>
<thead>
<tr>
<th>Fund</th>
<th>Total Commissions Paid for Execution and Soft Dollars (Col. 1)</th>
<th>Commissions Paid to Firms Providing Soft Dollars Services (Col. 2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fidelity Dividend Growth Fund</td>
<td>$4,272,475</td>
<td>$3,252,211</td>
</tr>
<tr>
<td>Fidelity Low Priced Stock Fund</td>
<td>$6,641,317</td>
<td>$4,336,677</td>
</tr>
<tr>
<td>Fidelity OTC Portfolio</td>
<td>$5,608,088</td>
<td>$3,779,004</td>
</tr>
</tbody>
</table>

Illustrative Enhanced Disclosure

Table 1: Deconstruction of Total Commissions and Soft Dollar Payments for Selected Fidelity Funds: 2015

<table>
<thead>
<tr>
<th>Fund</th>
<th>Total Commissions Paid for Execution and Soft Dollars (Col. 1)</th>
<th>Commissions Paid to Firms Providing Soft Dollars Services (Col. 2)</th>
<th>Commissions Allocated to Soft Dollar Services (Col. 3)</th>
<th>Soft Dollars as % of Total Commissions (Col. 4)</th>
<th>% of Commissions Paid to Soft Dollar Firms (Col. 5)</th>
<th>Portfolio Turnover in 2015 (Col. 6)</th>
<th>Average Net Assets ($ millions) (Col. 7)</th>
<th>Basis Cost of Soft Dollar Payments (Col. 8) (Col. 3 x Col. 6 &amp; adjusted)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fidelity Dividend Growth Fund</td>
<td>$4,272,475</td>
<td>$3,252,211</td>
<td>$1,360,269</td>
<td>31%</td>
<td>42%</td>
<td>64%</td>
<td>$6,679</td>
<td>2.1</td>
</tr>
<tr>
<td>Fidelity Low Priced Stock Fund</td>
<td>$6,641,317</td>
<td>$4,336,677</td>
<td>$1,892,318</td>
<td>24%</td>
<td>44%</td>
<td>9%</td>
<td>$30,163</td>
<td>6.6</td>
</tr>
<tr>
<td>Fidelity OTC Portfolio</td>
<td>$5,608,088</td>
<td>$3,779,004</td>
<td>$1,545,485</td>
<td>21%</td>
<td>41%</td>
<td>66%</td>
<td>$8,780</td>
<td>1.8</td>
</tr>
</tbody>
</table>

Sources: SEC filings.
The Board and Advisors have agreed to an annual aggregate maximum amount the actively managed equity funds will pay for research in soft dollars, which was implemented on January 1, 2017. Each of these funds pays for a portion of this maximum amount based upon a formula that takes into account their relative assets under management. Previously, each Fund paid for research in soft dollars using a trading-based methodology. Advisors will compensate these Funds for any soft dollars utilized above the aggregate maximum amount. Changes to the soft dollar maximum can only be made with Board approval. Additionally, Advisors will report to the Board, or a designated Committee of the Board, at least annually regarding soft dollar usage by the Funds, including soft dollars attributable to each Fund.

For the Funds that utilized soft dollars during the fiscal year ended October 31, 2018, the table below shows the total amount of soft dollars paid by each Fund in dollars and in basis points for that year (excluding any amounts compensated by Advisors).

<table>
<thead>
<tr>
<th>Fund</th>
<th>Soft dollars paid</th>
<th>Soft dollars as a percent of average net assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Emerging Markets Equity Fund</td>
<td>$348,663</td>
<td>0.04%</td>
</tr>
<tr>
<td>Growth &amp; Income Fund</td>
<td>$1,398,200</td>
<td>0.35%</td>
</tr>
<tr>
<td>International Equity Fund</td>
<td>988,004</td>
<td>0.02%</td>
</tr>
<tr>
<td>International Opportunities Fund</td>
<td>339,448</td>
<td>0.06%</td>
</tr>
<tr>
<td>Large Cap Growth Fund</td>
<td>976,116</td>
<td>0.11%</td>
</tr>
<tr>
<td>Large Cap Value Fund</td>
<td>1,740,808</td>
<td>0.35%</td>
</tr>
<tr>
<td>Mid Cap Growth Fund</td>
<td>327,104</td>
<td>0.02%</td>
</tr>
<tr>
<td>Mid Cap Value Fund</td>
<td>663,009</td>
<td>0.12%</td>
</tr>
</tbody>
</table>

The table below shows the aggregate amount of brokerage commissions paid by the following actively managed equity Funds to firms that provided research services during the fiscal period ended March 31, 2018 (except as otherwise noted). Note that the provision of research services was not necessarily a factor in the placement of all this business with these firms.

<table>
<thead>
<tr>
<th>Fund</th>
<th>Soft dollars paid</th>
<th>Soft dollars as a percent of average net assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Estate Securities Fund</td>
<td>$436,390</td>
<td>0.03%</td>
</tr>
</tbody>
</table>

Table 2

Summary of Survey of Soft Dollar Practices of 32 Major US Financial Services Firms (not including 19 firms that reported no restrictions beyond legal requirements)

<table>
<thead>
<tr>
<th>Uses Soft Dollars</th>
<th>Restrictions Beyond Those Imposed by Legal Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm A</td>
<td>Does not use for corporate access</td>
</tr>
<tr>
<td>Firm C</td>
<td>Does not use for market data</td>
</tr>
<tr>
<td>Firm D</td>
<td>Some limits for market data</td>
</tr>
<tr>
<td>Firm E</td>
<td>Does not use for market data or corporate access</td>
</tr>
<tr>
<td>Firm F</td>
<td>Does not use for market data or corporate access</td>
</tr>
<tr>
<td>Firm G</td>
<td>Soft dollars limited to 30 percent of total research</td>
</tr>
<tr>
<td>Firm H</td>
<td>Does not use for corporate access or third party research</td>
</tr>
<tr>
<td>Firm I</td>
<td>No soft dollars on UK accounts</td>
</tr>
<tr>
<td>Firm J</td>
<td>Does not use for third party research</td>
</tr>
<tr>
<td>Firm K</td>
<td>Does no use for market data, index data, or software</td>
</tr>
<tr>
<td>Firm L</td>
<td>Limits soft dollars to 75 percent of total equity commissions</td>
</tr>
<tr>
<td>Firm M</td>
<td>Does not use for corporate access; associates ratios (presumably 60 percent of equity commissions)</td>
</tr>
<tr>
<td>Firm N</td>
<td>Does not use for corporate access; thirty-party research capped at Greenwich</td>
</tr>
<tr>
<td>Firm O</td>
<td>Did not use for market data or any research services commercially available for cash (SEC standard of 1976)</td>
</tr>
<tr>
<td>Firm P</td>
<td>Board-imposed soft dollar budget allocated to funds based on net assets; overages reimbursed by investment adviser; does not use for market data; does not use for index funds or funds employing quantitative trading strategies</td>
</tr>
</tbody>
</table>

Sources: SEC filings and 2016 survey conducted by Integrity Research Associates LLC.
Figure 2

**Soft Dollar Payments for Proprietary Research**

Investment Adviser

1. **Proprietary Research**
   - Research, Market Data, etc.
   - Advisory Contract (fee for service)

2. **CSA Pools**
   - $\$, $\$, $\$

3. **Corporate Access**
   - Independent Research Providers
   - $\$, $\$, $\$

4. **IPO Allocations**
   - Investors

Trading Markets

Order flow with Excess Brokerage Commission on Trades (covering both execution and research services)

Figure 5

**Three Components of Total Commissions**

1. **Number of Shares Traded with High-Touch Trades & Bundled Commissions**
   - Bundled Commission
   - Soft Dollar Payments (Proprietary or CSA)
   - High-Touch Execution Costs

2. **Number of Shares Traded in Pure Execution Trades**
   - Pure Execution Cost
   - Pure Execution Costs

3. **Number of Shares Traded in Pure Execution Trades With CSA Payments**
   - Pure Execution Cost Plus CSA Add-On
   - CSA Payments
   - Pure Execution Costs
Preliminary Thoughts on an SEC Agenda

• Board & Adviser Responsibilities
  – Consideration of Soft Dollar Options (c.f. pre-1975 Litigation)
  – Distinguish Research Costs from Execution Costs
  – Greater Focus on Allocation Models: Trade Based versus Asset-based
  – Greater Differentiation in Types of Execution for both Commissions and Market Impact

• Improved Disclosure of Soft Dollar Practices
  – Qualitative Disclosures in Form ADV & SAI
  – Mandate Soft Dollar Break-Out in SAI Disclosure
  – Incorporate Soft Dollar Costs into Expense Ratio Disclosures (RPA approach)

• No Action Letters
  – Focus Should Be on Aligning Rights of US Investors
  – Public Acknowledgement SIFMA Letter Has No Limit on Contract Commitments to abide by MiFID II
  – Consider Narrow Exemptive Relief from Section 206(3) of the Advisers Act for Certain Principal Transactions similar to Rule 206(3)-3T.