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statement of

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Institutional Investors (MIT Press, 2001)

before the

Committee on Banking, Housing and Urban Affairs
United States Senate

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Examining Soft-Dollar Practices

Thank you Chairman Shelby, Ranking Member Sarbanes and members of the Committee for the opportunity to present to you this morning my views on the practice of soft-dollar trading, its significance to American investors, and why it should be eliminated.

Soft dollars are a subset of an industry-wide practice known as "commission bundling." Commission bundling involves fund managers using their clients' assets to finance the outsourcing of research, computer systems, and other support services to brokers. Technically, soft dollars refer only to bundling arrangements that are part of *an explicit, prior commitment* from a fund manager to a broker to pay that broker a minimum amount in trading commissions over a given period in return for services unrelated to trading. Such services may be provided by the broker itself, or sub-contracted to a third party.

For simplicity, I will use the term "soft dollars" to refer to the wider concept of commission bundling.

The central question before us is *why* fund managers should choose to buy research, computer systems, and other support services indirectly, as a bundle, through trading commissions, rather than directly, by agreeing a price for each product with the research purveyors, computer system purveyors, etc, and writing checks to each of them. After all, that is how normal businesses pay for their consulting, computers, etc. That is how you and I pay for such services. We do not, for example, pay for a computer by agreeing to buy $3000 worth of telephone calls from a telephone company.

The answer to this question is simple. The fund managers are trying to finance as much of their operating costs as possible *using their clients' assets*, rather than their own. And the only way that they can do this *legally*, other than through the management fee, is through trading commissions. It would, for example, be illegal for them to buy computers through bills paid to a telephone company out of the clients' assets. But it *is* legal for them to do so through brokerage commissions. This is the significance of the Section 28(e) loophole in the Securities Exchange Act, which has given rise to a vast, industry-wide kickback scheme through which fund managers use institutional brokers to transfer fundholder assets to themselves, in a manner invisible to fundholders.

The mutual funds will tell you – indeed, legally *must* tell you - that they use soft dollars to buy "research." This is true, but also very misleading. As Mark Twain observed, Mr. Chairman, "Almost all lies are *acts* and speech has no part in them."

Let me illustrate. As you will see from the attached figure number 1, mutual funds actually pay trading commissions to brokerage firms, using their clients' money, to buy such diverse items as newspapers, magazines, online services, conference registrations, accounting services, proxy services, office administration, computers, monitors, printers, modems, cables, software, network support and maintenance agreements. And in one of the ultimate ironies, fund managers even pay inflated trading commissions to brokers in return for third-party trading cost measurement services which invariably tell them that brokers cost too much.

How significant is this problem? Let me provide just a few examples for you.

- As you will see in the attached figure 2, the average institutional broker kicks back $1 in products and services to the fund manager for every $1.60 it receives in trading commissions. That is, most of the standard institutional trading commission represents payment for items that have nothing to do with trading. As you will see in figure 3, the percentage of institutional trading commissions allocated specifically to pay for "research," rather than good trade executions, actually rose from 29% in 2001 to 39% in 2003.

- Figure 4 will show you that the average fund manager cannot possibly be seeking "best execution" for the client, as the trading desks, according to the funds themselves, only control between 21 and 29% of the commission payments. The bulk of these payments are determined in advance by others who never actually initiate trades themselves.

- How much does this practice of soft-dollar trading actually cost investors? In my attached paper on "The Economics of Soft Dollar Trading," I estimate that the true, *effective* management fee that a fundholder pays is about 70 basis points higher than the headline fee which the fundholder sees in the prospectus. This 70 basis point premium is accounted for by bad trading: commissions which are about 2.5 times higher than they would be if the fund manager were seeking best execution, even after stripping out the value of the kickback services, and implicit (or "market impact") costs about 3 times higher.

If the Committee accepts that soft-dollar trading is indeed a problem, how then should this problem be addressed? There are 3 basic approaches:

- One approach is to require increased "disclosure" of trading costs to fundholders. More information is always preferable to less, but this is not, in my view, sufficient. Since the largest component of trading costs, so-called implicit costs, is not actually captured in visible commission fees, we must ultimately look for a solution that encourages fund managers to trade as efficiently as possible *in their own self-interest*. More fundamentally, if the practice does truly represent an abuse of fundholder assets, surely the remedy must be more robust. After all, we do not merely "regulate" fiduciary abuses by obliging fiduciaries to publish a costed inventory of client property improperly used.

- A second approach is to eliminate the 28(e) loophole entirely. In other words, fund managers would only be allowed to use trading commissions to pay for trading. This would be a big step forward, although I suspect that funds will try to continue to pay inflated commissions in return for kickback services that will simply be less visible to regulators.
- A third approach would be to oblige fund managers to pay trading commissions out of their own assets – as recommended in the March 2001 Myners Report, prepared for the UK Treasury. This would dramatically re-align fund managers' interests with those of their clients. They would immediately unbundle commissions and seek best execution *because it would be in their self-interest*, as well as the interest of their clients. It would, in fact, lead to a dramatic improvement in US market structure, with an expansion of low-cost, direct electronic trading at the expense of brokers whose only value-added is in facilitating the soft-dollar kickback system. As I show in my paper on "The Economics of Soft Dollar Trading," a typical fund management firm could cover the cost of bearing trading commissions by raising its management fee by about 18 basis points, *and this would still leave the fundholder better off by about 50 basis points*. The only losers in this unbundling process over the long run are brokers who earn their living facilitating soft-dollar kickbacks. American investors would be far better off if these brokers found another way to employ their capital.

I thank you again for the opportunity to testify this morning, and I look forward to assisting your deliberations in any way possible.

What Do Soft Dollars Buy?

Research

General Company	13.5%
General Economic	7.7%
Industry/Sector	6.5%
Equity	6.4%
Pricing used for research	5.5%
On line news services	4.6%
Magazines/Journals	4.4%
Fixed-Income	4.2%
International	3.5%
Fundamental Analysis	3.4%
Technical Analysis	3.2%
Newspapers	2.5%
Performance Measurement	2.2%
Mutual Fund Data	1.8%
Portfolio Accounting/Management	1.4%
CPUs	1.3%
Modem phone lines	1.0%
Seminars/Conferences	1.0%
Consulting (General)	0.9%
Newsletters	0.8%
Asset Allocation	0.6%
Other Software	0.4%
Cables	0.4%
Commodities	0.4%
Daily faxes	0.3%
Real Estate	0.3%
Derivatives	0.3%
Proxy Services	0.2%
Network Support	0.2%
Upgrades (i.e.,-software, etc.)	0.2%
Maintenance Agreements	0.2%
Printers	0.1%
Market Timing	0.1%
Total Research	**79.7%**

Mixed-Use

Portfolio Accounting/Management	1.8%
Performance Measurement	0.8%
CPUs	0.7%
Pricing service used partly for research	0.6%
Trading Facilitation	0.4%
Network Support	0.4%
General Company	0.3%
Proxy Services	0.3%
Maintenance Agreements	0.3%
On-line services	0.2%
Consulting (General)	0.2%
General Economic	0.2%
Other Software	0.2%
Upgrades (i.e.,-software, etc.)	0.2%
Printers	0.2%
Mutual Fund Data (marketing uses)	0.1%
Seminars/Conferences	0.1%
Monitors	0.1%
Cables	0.1%
Total Mixed-Use	**7.9%**

Non-Research

Proxy Services	0.4%
Membership/License Fees	0.4%
Office Administration	0.3%
Compliance Information	0.2%
Pricing used solely to value portfolio for fee purposes	0.2%
Internet Access/Information	0.1%
Seminars/Conferences	0.1%
CFA Books/Review Course	0.1%
Total Non-Research	**2.2%**

Trade Assistance

Pricing Services used for execution	5.7%
Trading Facilitation	4.0%
Maintenance Agreements	0.1%
Total Trade Assistance	**10.2%**

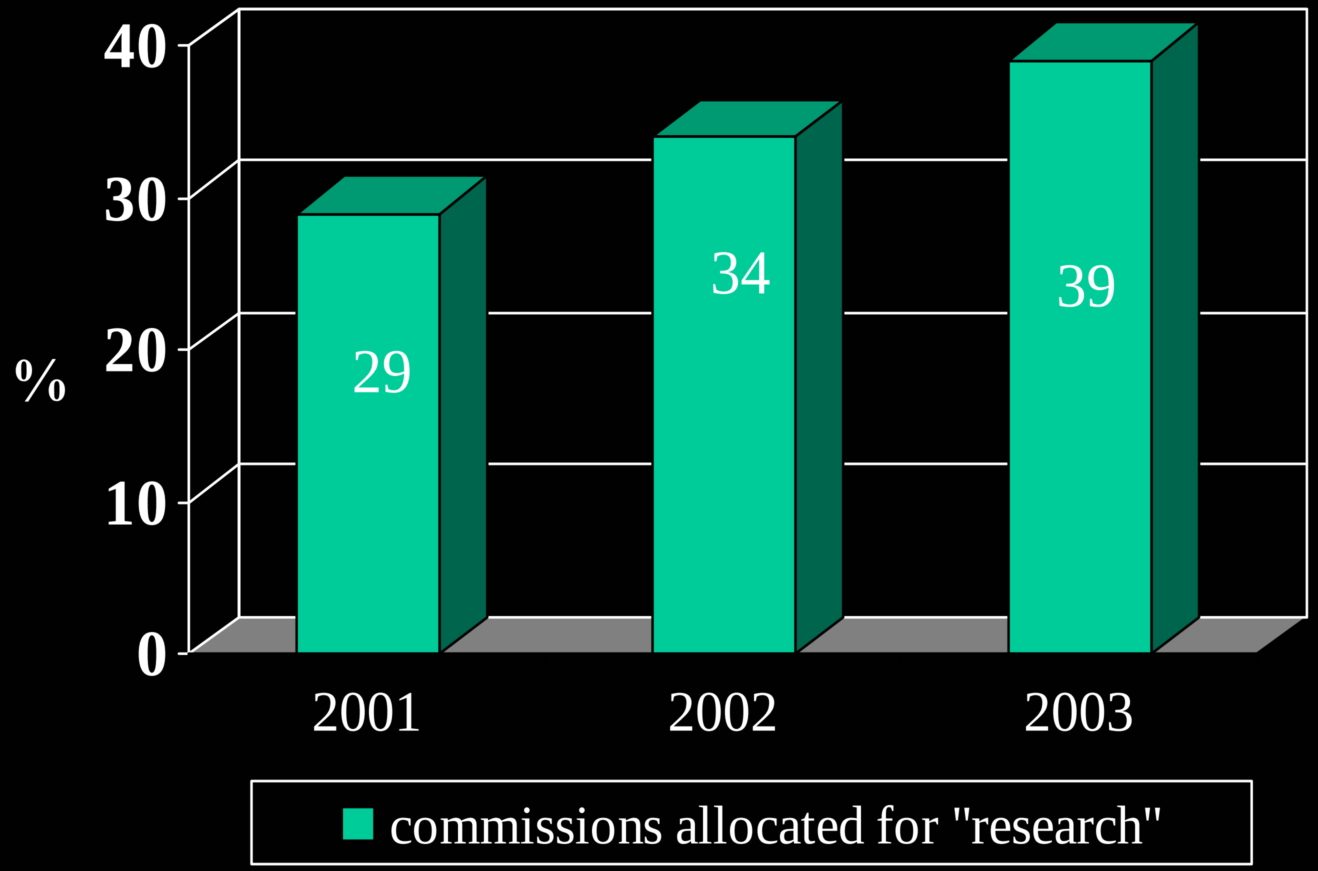
Source: SEC (1998)

Are Trading Commissions for Trading?

- 95% of US institutional brokers receive trading commissions for services wholly unrelated to trading (*ie*, “soft dollars”).
- The average US institutional broker “kicks back” $1 in products and services to the investment adviser for every $1.60 it receives in trading commissions.
- Half of all US investment advisers failed to disclose to clients the nature of non-trading services being financed through commissions charged against the clients’ assets.
- Cross-subsidization of accounts via trading commissions is the norm, whereas only 38% disclosed the practice to clients, as required.
- Over 1/3 of US institutional brokers have illegal (*ie*, not “research-related”) arrangements with investment advisers, none of which were revealed to clients.
- Almost 2/3 of soft dollar arrangements are undocumented.
- Institutions pay the soft dollar rate (6¢ per share in 1998) whether or not they receive soft credits.

Source: SEC (1998)

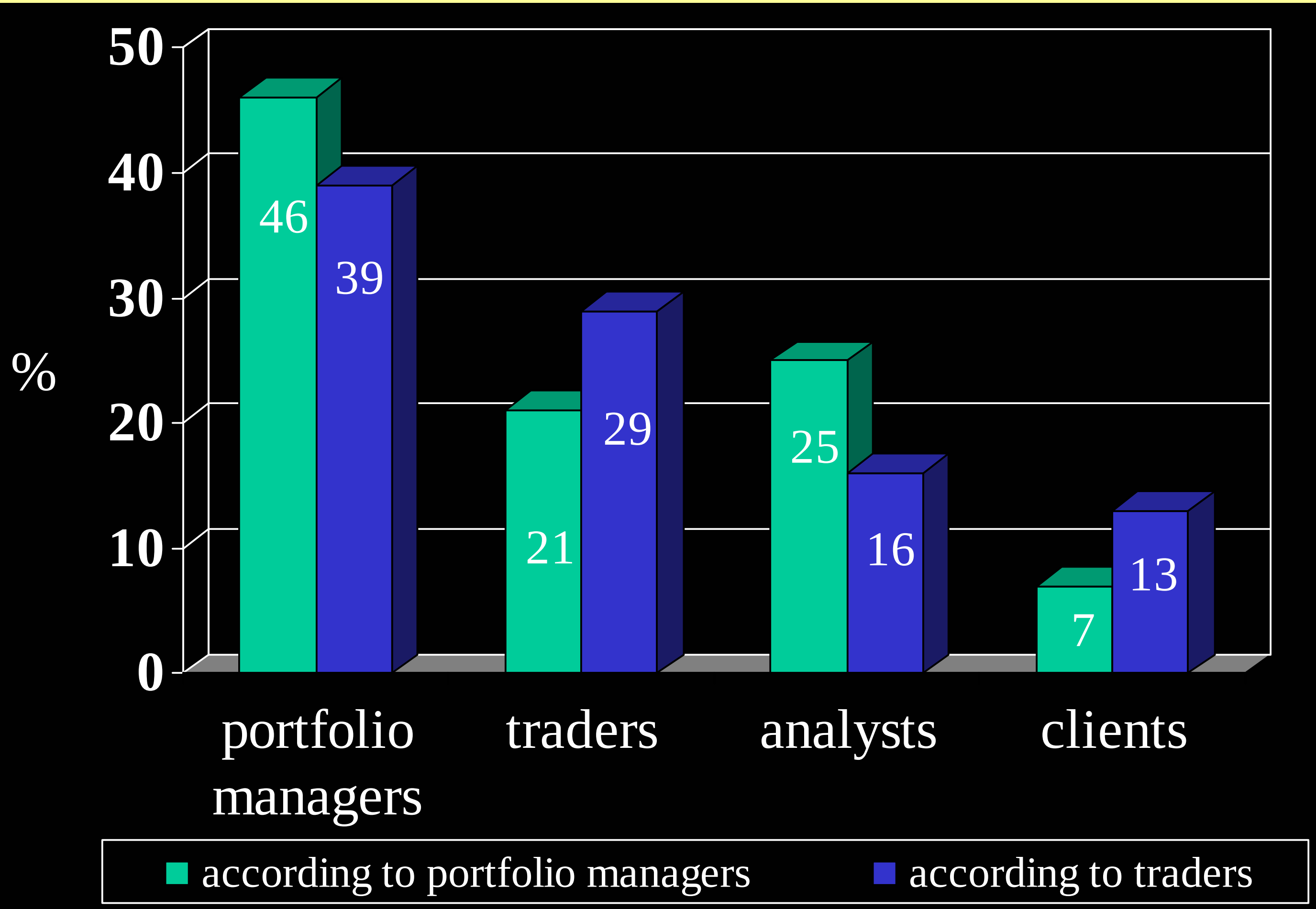
Are Trading Commissions for Trading?



Source: Greenwich Associates (2003)

Figure 4

Who Controls US Institutional Commission Payments?



Source: Greenwich Associates (2002)

Appendix

The Economics of Soft Dollar Trading

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The Economics of Soft Dollar Trading

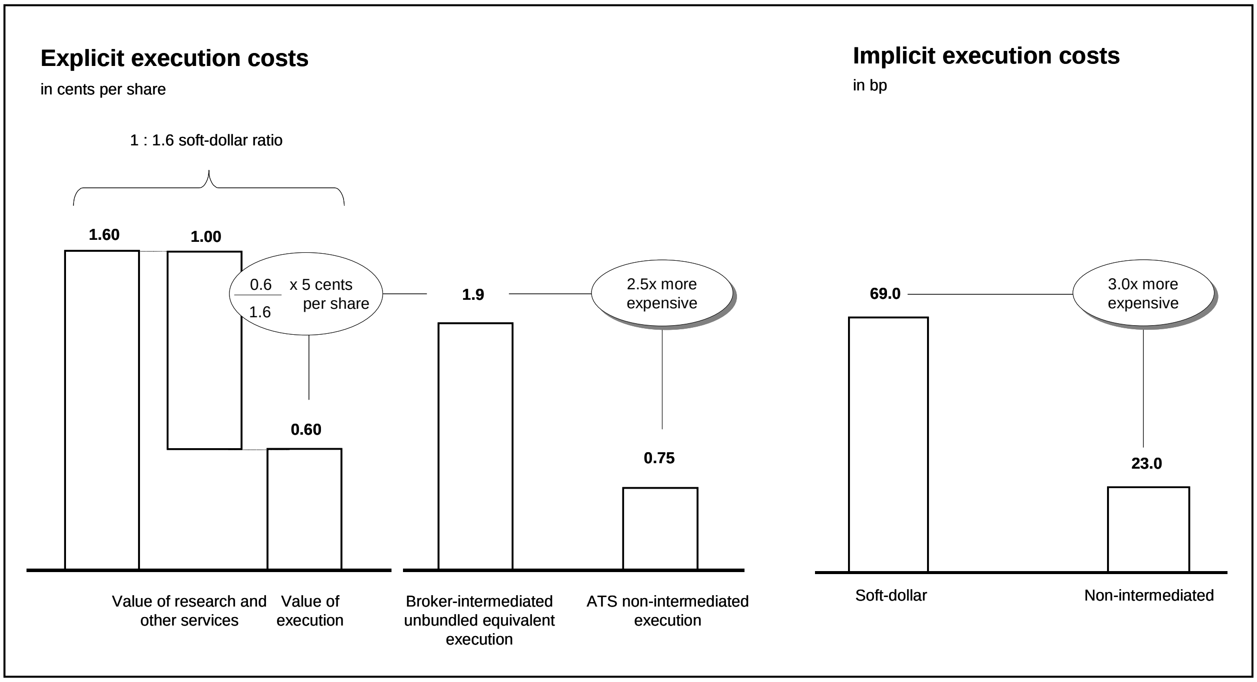
So much has been written and said about the practice of "soft dollar" trading, but so little is understood about what it actually means for fundholders and fund managers.

This quantitative example is intended to clarify how a soft-dollar world, in which fund management firms purchase research and third-party analytics using fundholder assets channeled to brokers through trading commissions, differs from a hard-dollar world, in which the firms finance such purchases themselves. Using real-world brokerage pricing and trading-cost data, we estimate that the effective management fee of a typical mutual fund using soft-dollar services is approximately 70 basis points higher than the headline fee which the fundholder sees in the prospectus.

We reach the surprising conclusion that both fundholders *and* fund managers can ultimately benefit from the unbundling of trading commissions – that is, from fund managers paying for non-trade execution services with hard dollars. The clear losers from unbundling would be the traditional full-service institutional brokers.

We begin by comparing the cost of soft-dollar trading with hard-dollar trading. Figure 1 shows that after stripping out the non-trade execution service component of the standard institutional commission, explicit costs (commissions) and implicit costs (market impact) on soft-dollar trades are 2.5-3.0 times those on electronic, non-intermediated, execution-only trades.

Figure 1: The Cost of Soft Dollar Trading



Data Sources: Conrad et al (2001); interviews with fund managers

The explicit cost differential is measured as follows. We take the standard full-service institutional commission rate of 5¢ per share and strip out the portion which is typically devoted to non-execution services: $1 out of every $1.60 paid in commissions. This leaves 1.9 cents per share that is paid specifically for execution. This figure is 2.5 times the 0.75¢ per share commission rate which is widely available to institutions trading over execution-only electronic brokerage services. We will refer to these below as ATSs (alternative trading systems) for simplicity.

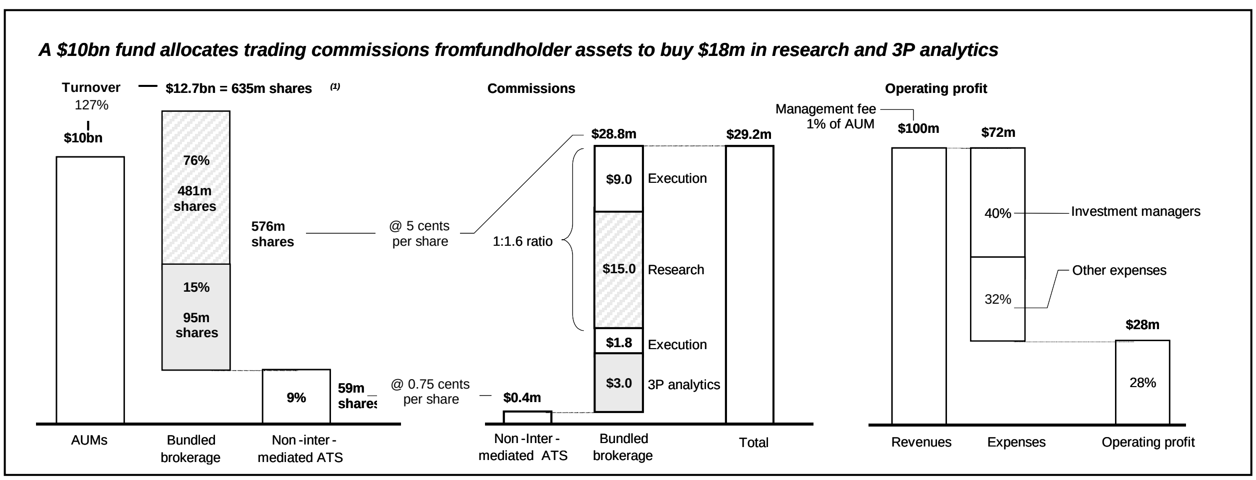
The implicit cost differential is estimated by Conrad *et al* (2001) using trading data from Plexus' proprietary database of institutional trades. They calculate that implicit costs on soft-dollar trades are 3 times higher than those on hard-dollar trades.

We can now consider how fund-manager profitability is affected by moving from a soft-dollar world to a hard-dollar world.

We assume a typical large fund manager operating a $10bn fund needing to purchase $15m in research and $3m in third-party analytics. Bundled commission rates are again presumed to be at the current industry standard of 5¢ per share, and non-bundled ATS rates at 0.75¢ per share.

The fund manager charges fundholders a management fee of 1% of assets under management (AUM). In a soft-dollar world, shown in Figure 2, this fund manager must direct 76% of its commissions to traditional brokers to pay for its research and 15% to soft-dollar brokers to pay for third-party analytics, leaving the remainder, 9%, which can be channeled to low-cost non-intermediated ATSs. This fund manager earns an operating profit of 28%.

Figure 2: Fund Manager Profitability in a Soft-Dollar World



Data Source: interviews with fund managers

(1) In September 2002, the NYSE and Nasdaq average share prices were $25.77 and $13.88, respectively, resulting in a weighted-average share price of $20.00. Data source: Nasdaq web site.

Let us now consider a hard-dollar world, in which the fund management firm is obliged to bear the cost of research and analytics from its own assets. This firm directs all its order flow through ATSs in order to minimize trading costs, as there is no longer any economic incentive for the firm to pay the higher bundled brokerage charges. Assuming no change in its management fee, the fund manager's operating profit falls to 10%, as shown in Figure 3.

Figure 3: Fund Manager Profitability in a Hard-Dollar World

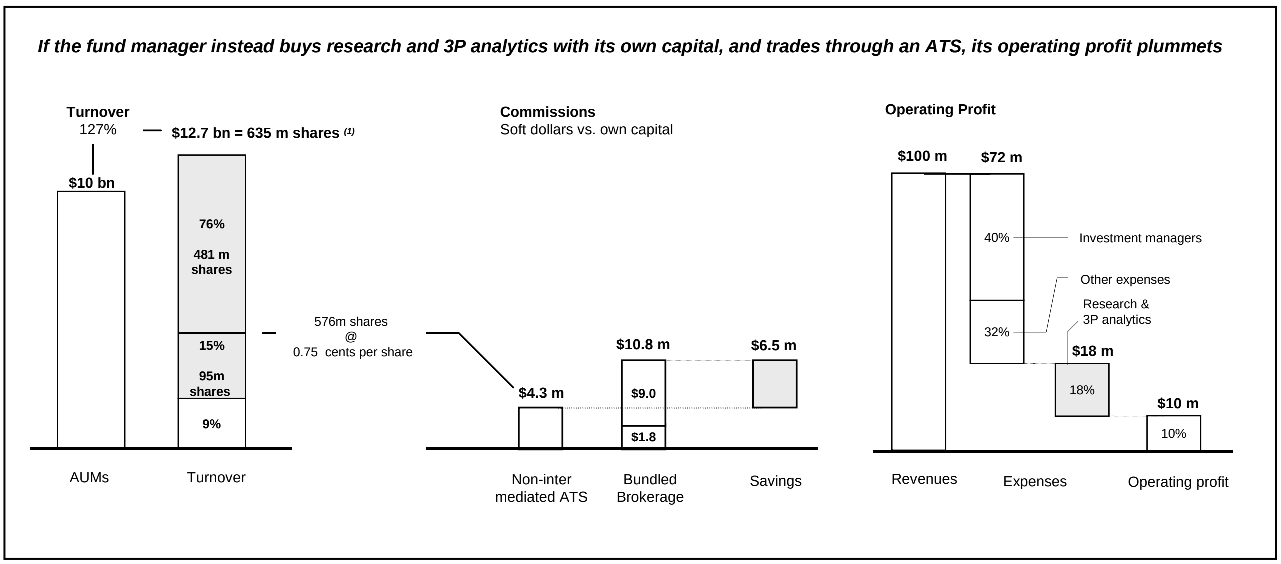
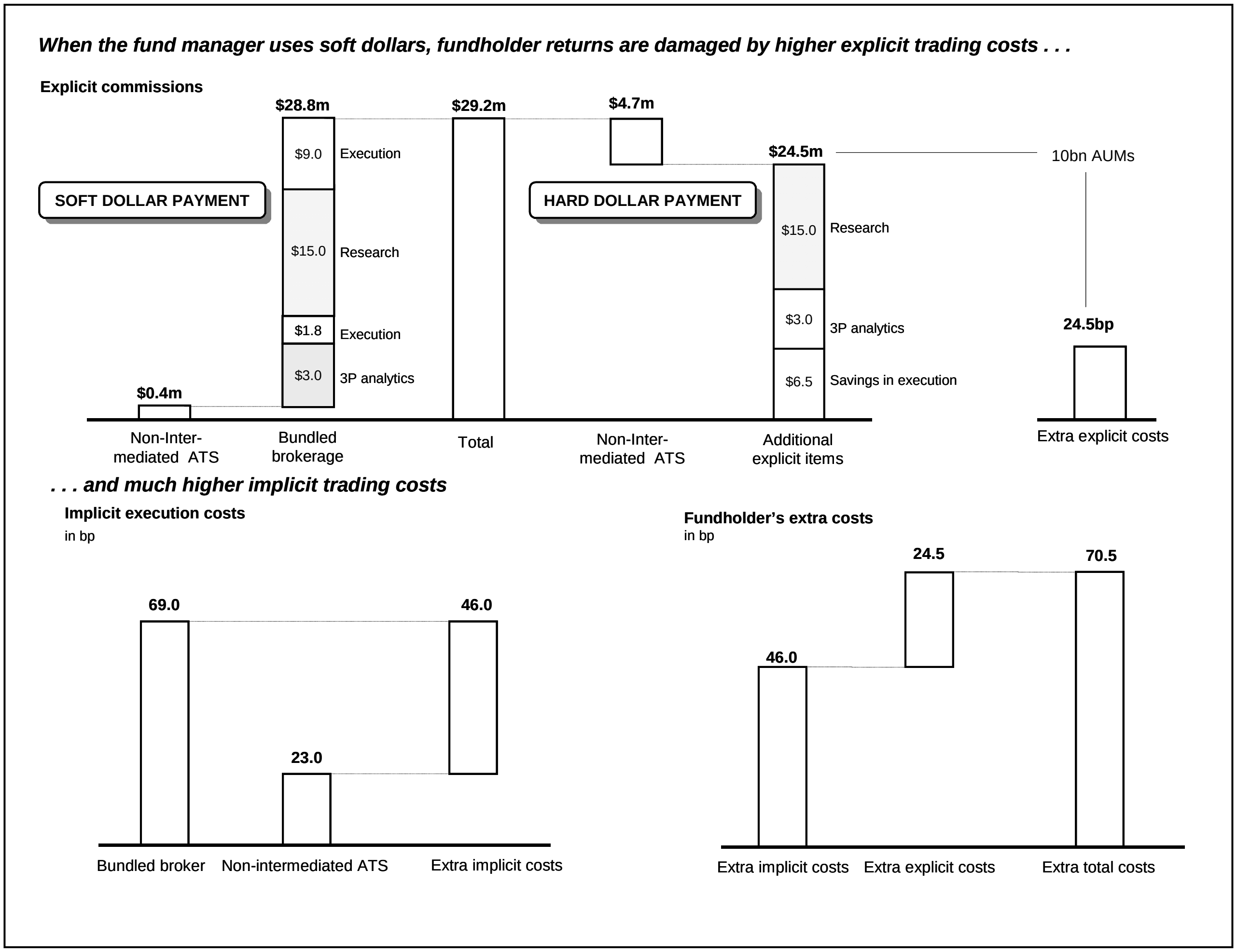


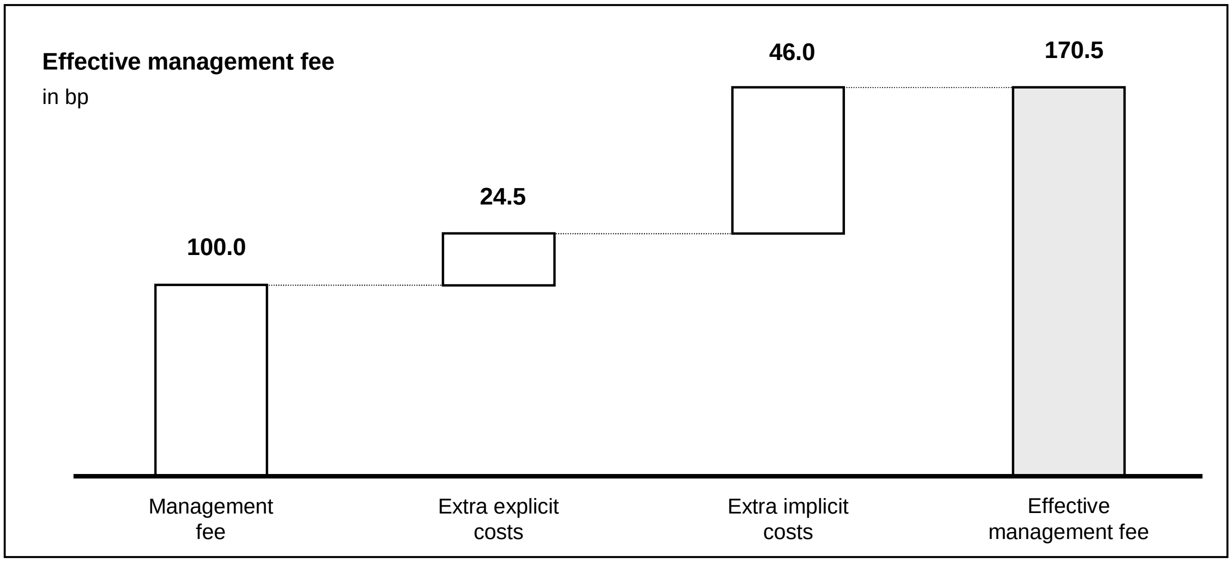
Figure 4 shows the effect on fundholders. When the fund manager uses soft dollars, the fundholder is made worse off by about 70 basis points (bp). This is comprised of 24.5bp excess explicit trading costs and 46bp excess implicit trading costs.

Figure 4: Impact of Soft Dollars on Fundholders



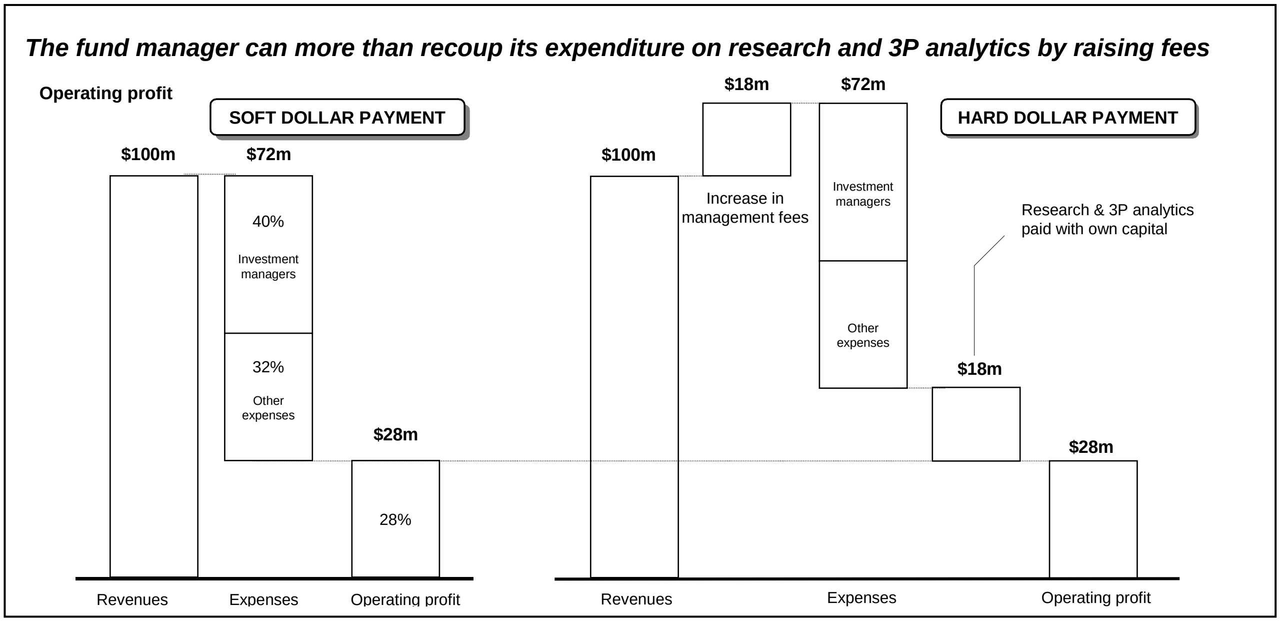
As figure 5 shows, the 1% management fee is effectively a 1.7% fee, after the effect of soft-dollar trading on the fundholder's assets is factored in.

Figure 5: Effective Management Fee



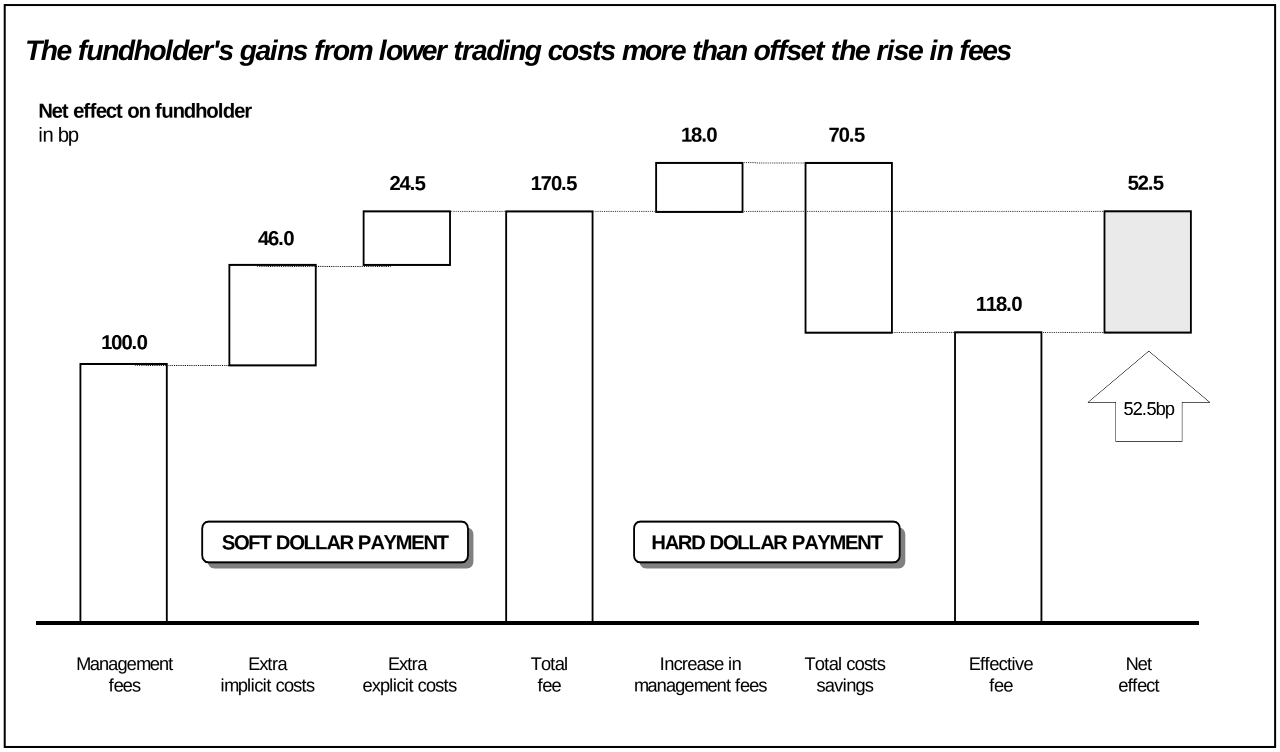
As Figure 6 shows, if the fund management firm wishes to restore its soft-dollar world operating profit of $28m, it must raise its management fee by 18%, to 1.18%. The fund manager is therefore indifferent between a soft-dollar world with a 1% management fee and a hard-dollar world with a 1.18% management fee, assuming no effect on assets under management.

Figure 6: Impact on Fund Manager of Moving to Hard Dollars and Raising Fees



As Figure 7 shows, since the fundholder is still better off by a substantial 52bp in a hard-dollar world with a 1.18% management fee than he or she would be in a soft-dollar world with a 1% fee, there is actually tremendous scope for both the fundholder *and* the fund manager to benefit from an elimination of soft-dollar trading practices.

Figure 7: Net Impact on Fundholder of Moving to Hard Dollars



Although many buy-side traders have long been proponents of eliminating soft dollars, upper management at their firms have been concerned that clients will react negatively to any rise in management fees necessary to offset the impact on the firms' bottom line. Thus client awareness of the significant hidden cost of soft-dollar trading will have to grow before market pressure brings an end to the practice. Regulatory reform in the US and UK, however, are likely to limit its scope. The only losers in this process will be the full-service institutional brokers, who in an age of automated trading provide no net added value beyond facilitating soft-dollar business.

References

Conrad, Jennifer S., Kevin M. Johnson, and Sunil Wahal S, "Institutional Trading and Soft Dollars", *Journal of Finance*, February 2001.