On Money Managers' Use of Client Commissions for Fixed Income Securities Research

D. Bruce Johnsen
ON MONEY MANAGERS’ USE OF CLIENT COMMISSIONS FOR FIXED INCOME SECURITIES RESEARCH

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Abstract

An increasingly important question is how money managers can best equip themselves with the investment research necessary to fulfill fiduciary obligations to their baby boom clients, who will inevitably shift from equities to fixed income securities as they near and enter retirement. Rather than reflecting a conflict of interest, this essay argues that managers’ use of client commissions to pay for investment research, including fixed income research, is both legally permissible and in their account holders’ best interest. For over three decades Section 28(e) of the Securities Exchange Act has given managers a safe harbor from fiduciary suits and other legal actions when they use client commissions to acquire research on equity agency trades. Starting in 2001, however, the SEC began interpreting the safe harbor to protect “certain riskless principal” trades by brokers that do not hold or trade fixed income securities for their own account — known as “non-positioning brokers” — and on which the mark-up or mark-down can be stated as a commission equivalent. It has since found that the safe harbor applies to research provided by non-positioning brokers in agency trades in fixed income securities disclosed through a trade reporting system adequate to ensure proper transparency. Trade reporting systems for fixed income securities have evolved dramatically in recent years, and several non-positioning fixed income brokers have stepped in to fill the void, greatly expanding the opportunities money managers have to obtain research through fixed income trades.
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“[R]esearch [is] not an expense of management.”

— 1975 Senate Report

“If the trustee properly incurs a liability in the administration of the trust, he is entitled to [use] trust property in discharging the liability so that he will not be compelled to use his individual property in discharging it.”

— Restatement Second of Trusts

I. Introduction

Forces at work in U.S. financial markets over the past decade are leading to a sea change in the way Americans’ retirement savings are being managed. Many of the underlying currents are favorable, but some raise troubling questions about the provision of fixed income securities research that have yet to be clearly answered.¹ Important among these is how money managers can best equip themselves with the investment research necessary to fulfill fiduciary obligations to their baby boom clients, who will inevitably shift from equities to fixed income securities as they approach and enter retirement. Perhaps more important is identifying the contractual and business arrangements that provide managers with the proper incentives to do so. Answering these questions is the goal of this essay. Contrary to widespread assumptions, I show that money managers’ use of client commissions to pay for investment research, including fixed income research, is both legally permissible and in their account holders’ best interest.

¹ A fixed income security is one that pays the holder a contractually fixed stream of payments over a specified term. Examples include mortgages, corporate bonds, and a government bonds. Barring default by the issuer, receipt of the promised payments by the holder is riskless, although changes in market interest rates, default risk, and other factors will cause the price at which the security trades in the market to change. Equity securities, in contrast, promise the holder a share of the issuer’s profits. Examples include corporate stock and limited partnership interests. It is widely understood that investors should weight their retirement accounts increasingly toward fixed income securities and away from equities as they approach and enter retirement to ensure a steady stream of retirement income.
The use of client commissions by money managers to pay for equity research has been commonplace for decades. Figure 1 illustrates the relations between the parties. In a typical client commission arrangement the money manager (M) offers the broker (B) a premium commission to execute portfolio trades, with the commissions being paid by client-investors (C) out of portfolio assets (P). Either before or after the manager orders the trades, the broker provides the manager with research as a quid pro quo for the agreed commission premium. The manager uses the research to identify mispriced securities and then executes the associated trades through the broker to enhance investor returns. Probably since the dawn of organized securities trading it has been common practice for brokers to provide their clients with proprietary in-house research bundled into brokerage commissions. For various reasons, however, managers now increasingly rely on independent research bundled into the commission, with their brokers paying a portion of the commission premium to the independent research vendor (V).

Money managers’ use of client commission arrangements to pay for investment research — commonly referred to as “soft dollar brokerage” — is specifically protected by a statutory safe harbor under Section 28(e) of the Securities Exchange Act (1934) known as the “paying up amendment” of 1975. In the SEC’s words, Congress passed the safe harbor “to allow money managers to use client funds to obtain ‘brokerage and

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2 In its 1998 Inspection Sweep, the U.S. Securities & Exchange Commission appropriately re-characterized soft dollars as “client commissions.” The reason for the change is that term “soft dollars” was traditionally used to describe a broker’s provision of third-party research, whereas client commissions is intended to describe the provision of both proprietary and third-party research. Any time a manager receives “brokerage or research services” other than execution from a broker the arrangement raises conflict-of-interest concerns. In Frequently Asked Questions on Form ADV and IARD, for example, the SEC emphasized that managers receiving proprietary research from full-service brokers should treat this as potential Participation or Interest in Client Transactions on form ADV. See Frequently Asked Questions on Form ADV and IARD, available at http://www.sec.gov/divisions/investment/iard/iardfaq.shtml#additional (stating in relevant part, “Answer ‘Yes’ to Item 8.E if you receive any research or other product or service that is not execution from any broker-dealer or third party in connection with client securities transactions. Neither the source of the research (i.e., whether it is produced by a third party or produced by the executing broker) nor your affiliation with the research provider should have any effect on your answer to Item 8.E.”); See also, Part 1A, Item 8.E of Form ADV, available at http://www.sec.gov/about/forms/formadv-part1a.pdf.

research services’ for their managed accounts under certain circumstances without being presumed to have breached their fiduciary duties to clients or violated federal law.”

From 1990 to 2001 the SEC took the position that the safe harbor applied exclusively to agency trades, which are compensated by a commission, but not to dealer trades, which are compensated by a mark-up or mark-down. Accordingly, it interpreted the safe harbor as providing no protection for investment research provided on trades in OTC equities or fixed income securities, which, in 1990, were traded almost exclusively on a dealer basis. Starting in 2001, however, the SEC began relaxing this position with respect to agency and “certain riskless principal” trades by brokers that do not hold or trade fixed income securities for their own account — known as “non-positioning brokers” — and on which the mark-up or mark-down can be stated as a commission equivalent. It has also found that the safe harbor will apply to research bundled into non-positioning broker trades in fixed income securities disclosed through a trade reporting system adequate to ensure proper transparency. Trade reporting systems for fixed income securities have evolved dramatically in recent years, and with this development several fixed income brokers have stepped in to fill the void, greatly expanding the opportunities money managers have to obtain research through fixed income trades.

A threshold question is whether investment research adds value to retirement accounts, or to any other managed account for that matter. The relationship between investment research and investment returns has proven surprisingly controversial and the controversy itself surprisingly durable. Many industry participants defend investment

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5 Starting with 1990 No Action Letter, discussed infra at 7.
6 In an agency trade the broker-dealer promises to use its best effort to execute the trade on its client’s behalf and puts none of its own capital at risk. On a buy order the broker searches for the lowest available price, buys the securities for its client’s account, and then adds a commission equal to, say, five cents per share times the number of shares purchased. In a principal trade, the dealer puts its own capital at risk, buying the securities for its own account and then reselling them to the client after adding a mark-up, and vice-versa for sell transactions. In some cases, the same trader may act as both a broker and as a dealer on different trades. Both commissions and mark-ups/mark-downs are considered to be transaction costs, and are included in the price basis of the securities for the client’s tax purposes.
7 See discussion infra at 7.
research almost viscerally as an indispensable input to money management in what is, after all, the information age. Others point to powerful theoretical and empirical work by academic economists concluding that securities markets are informationally efficient. If corporate stock, for example, is efficiently priced, how can active mutual fund managers possibly hope to pick stocks that outperform the S&P 500 Market Index after charging brokerage commissions and other transaction costs, the advisory fee, and various administrative expenses to the fund? Are the billions of dollars the industry spends on research to identify mispriced securities a huge waste of investor resources?

Section II addresses this question, showing that value-added from research is perfectly consistent with the notion of market efficiency and that early empirical work to the contrary is both fundamentally flawed and inconsistent with more recent and more thorough empirical findings. In addition, recent work shows that retirement account managers’ investment returns increase with the extent to which they pay up for research. And although returns on risky equity securities normally exceed those on less risky fixed income securities, fixed income research can nevertheless substantially increase investor returns. With the life expectancy of U.S. retirees bound to increase over time, it is essential that their retirement accounts earn the maximum possible return consistent with prudent management and existing regulatory constraints.

As various legal, regulatory, and market forces change how investment research is produced and provided, and as baby boomers inevitably shift their portfolios in favor of fixed income securities, money managers and their clients must be made fully aware of the availability, legality, and importance of investment research. Section III describes the forces reshaping the management of Americans’ retirement accounts and the market for investment research. It begins with a brief history of the safe harbor for client commissions, starting with the Securities Acts Amendments of 1975. More recently, financial scandals, the communalization of corporate news, sweeping judicial decisions, ordinary business trends, baby-boom demographics, and changes in the regulatory environment are leading many research analysts to depart bulge bracket brokerage houses to set up independent research shops. At the same time, owing to retirees’ rollover from 401(k) accounts to individual retirement accounts a substantial share of retirement

accounts have or soon will find their way into the hands of smaller investment advisory firms that lack established internal research capacity.

In light of these shifting forces, the critical questions are how retirement account managers can get the research to best serve their clients and how they can be incentivized to do so. Section IV addresses the important role investment research plays in money managers’ fiduciary obligation to their clients. The primary concern clients should have is that their managers will have too little incentive to perform research if they are expected to pay for all research out of their own pockets — which is to say out of their management fee. If managers are under-researched, their clients’ investment returns will suffer. Rather than reflecting a conflict of interest, I show that allowing managers to use client commissions to pay for fixed income securities research provides them with a powerful incentive to aggressively increase their retirement clients’ investment returns. There is nothing unusual or suspicious about this. It is commonplace in virtually all trust relationships for the trust estate to cover the trustee’s necessary or appropriate management expenses. Indeed, both the law of agency and the law of trusts require the principal or trust estate to do so and even allow the agent/trustee to deduct the expenses from the managed account without immediate client approval.

Section V summarizes and provides concluding comments. Given the analysis and empirical findings provided in this essay, it discusses the possibility that money managers might be found to have a fiduciary duty to use client commissions to pay up for research. The circumstances under which this might occur are fairly narrow, but the possibility underscores the point that when addressing conflicts of interest there are always Type I and Type II errors to be considered and that the prudent money manager must therefore balance countervailing conflicts when acting in the best interest of his client-investors.

II. Does Research Add Value?

Those who are skeptical that investment research has value point to powerful theoretical work on market efficiency by pioneering economist Eugene Fama (1970) and
He proposed that if securities markets are informationally efficient neither investors nor their money managers can expect to make money doing research to identify mispriced securities because prices will adjust instantly to newly discovered information. In his framework, markets are “weak-form” efficient if a manager’s research on past prices provides no stock picking advantage. They are “semi-strong form” efficient if a manager’s research on publicly available information provides no such advantage. And they are “strong-form” efficient if manager’s research on any information, public or private, conveys no advantage.11

Fama surveyed the extensive empirical work on securities market efficiency to see if there was evidence available to reject any form of the efficient markets hypothesis. Foremost in his survey was Michael Jensen’s (1968) study of the net asset value (NAV) returns to actively-managed mutual funds from 1945-1964.12 By their very nature, active managers hold themselves out as heavily involved in research to identify mispriced securities, for which they typically charge an asset-based management fee well in excess of the fees passive index fund managers charge.13 To adjust for differences in market risk across funds, Jensen used the following regression equation based on the Capital Asset Pricing Model (CAPM) developed by Sharpe (1964)14 and others:

\[ R_j - R_f = \alpha + \beta(R_m - R_f) + u \]

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13 Active management fees tend to be in the range of 75 to 150 basis points per year on total assets, while the fees index fund and other passive managers charge are closer to 10 to 30 basis points per year. William F. Sharpe, A Prosaic Way to Beat the Average Investor, available at, http://www.leland.stanford.edu/~wfsharpe/art/talks/indexed_investing.htm (“Depending on the market replicated, the cost of managing an index fund should be somewhere between 0.15% and 0.50%, or 15 to 50 “basis points”, using financial jargon. Active managers are very different... Their costs are likely to be at least 1.0% (100 basis points) higher than those of passive managers in the same markets.”); See also, Burton G. Malkiel, *A Random Walk Down Wall Street*, p. 357, W.W. Norton & Company Inc., New York. 2003. (“actively managed public mutual funds charge annual management market expenses that on average are more than 150 basis points (1 ½ percentage points) per year.”).
The variables $R_j$ and $R_m$ are the observed returns to fund $j$ and to the S&P 500 Market Index after accounting for dividend distributions, and $R_f$ is the risk-free rate of return on U.S. government bonds, with each variable being observed over each year in the sample. The differences $R_j - R_f$ and $R_m - R_f$ reflect the returns rational investors must earn to compensate them for investing in risky assets rather than the risk-free asset, the so-called “risk premium.” The model recognizes that rational managers will sell (buy) securities whose expected returns are too low (high) until prices fall (rise) to provide them with a normal expected return.

No doubt the risk premium on any portfolio of stocks is affected by a number of factors, but the factor Jensen thought most important was the risk premium on the market portfolio. As shown in Figure 2, the regression equation above amounts to fitting a straight line to a scatter diagram of points indicating various concurrent observations of $R_j - R_f$ and $R_m - R_f$, with $\alpha$ being the intercept of the line (that is, the value of $R_j - R_f$ when $R_m - R_f$ is zero) and $\beta$ being its slope. The scatter diagram itself will rarely form a straight line, and $u$ is an error term reflecting the deviations of each observation from the fitted line under the conditions that the fit of the line is constructed to minimize the sum of the squared errors and that the sum of all errors is zero.

The portfolio’s $\beta$ indicates how the risk premium earned by the fund’s portfolio changes, on average, when the risk premium earned by the market portfolio changes. It is the standard measure of undiversifiable “market risk.” Having adjusted for market risk, alpha reveals the fund manager’s ability to pick stocks that outperform the market. If alpha is positive, fund investors have enjoyed positive abnormal risk-adjusted NAV returns, perhaps owing to manager skill in performing investment research; if alpha is negative, they have suffered negative abnormal NAV returns, perhaps owing to manager incompetence or indolence.

After netting out brokerage commissions and other transaction costs, advisory fees, and administrative expenses, Jensen found that the average alpha across funds in his sample was a statistically significant negative 1.1 percent per year, indicating that the returns to active management were less than the returns on the market portfolio.\footnote{Jensen, at 405.} And although he found several funds whose alphas were persistently positive (though only
slightly so) he was unable to rule out the possibility that these observations were due entirely to luck. In Jensen’s parlance, active management (research) adds nothing to “alpha,” and may even reduce it. Fama quotes Jensen’s conclusions in the following passage:

“One must realize that these analysts are extremely well endowed. Moreover, they operate in the securities markets every day and have wide-ranging contacts and associations in both the business and financial communities. Thus, the fact that they are apparently unable to forecast returns accurately enough to recover their research and transaction costs is a striking piece of evidence in favor of the strong form of the [efficient markets] hypothesis.”16

The question of how active management can possibly add value in a strong-form efficient market was answered theoretically by Grossman & Stiglitz (1980).17 They made the important point that it is impossible for markets to be informationally efficient in the traditional sense. If markets are strong-form efficient, instantly impounding all private information into prices, market participants seeking to discover such information will be unable to cover their research costs and will refuse to engage in price discovery. And yet, we know price discovery does not fall from the sky.

The traditional notions of market efficiency — weak form, semi-strong form, and strong form — are simply empirically testable statements of a more fundamental version of market efficiency. According to this version, any given security can be mispriced at any given moment. It may pay market participants to do research to discover mispriced securities and to trade those securities to make money, but this process is costly. If markets are efficient in the Grossman-Stiglitz sense, money managers can expect to earn only a normal competitive return on their investments in research, though ex post some will surely do better and some will do worse. It is therefore quite possible that active fund managers are able to identify mispriced securities from time to time, and perhaps even persistently if they have above average talent. Although the core of the efficient markets hypothesis remains intact, some measure of mispricing can be expected to persist

16 Fama, at 413.
in equilibrium. But traditional informational efficiency is impossible, and what we are left with is a market equilibrium subject to an optimal amount of disequilibrium.

This compelling theoretical hypothesis fails to explain why the empirical evidence at the time appeared almost uniformly to reject it. Horan & Johnsen (1999)\(^{18}\) may have been the first to answer this question. They proposed that mutual funds are akin to an open-access common pool owing to the continuous share issuance and redemption options they provide. No investor has an exclusive claim to fund returns because they are shared in common. Competition between investors to capture returns ensures investment dollars will flow in or out to equalize risk-adjusted NAV returns across funds. The best mutual fund investors can expect is a normal risk-adjusted return on their investment equal to the return on similar alternative investments.

In a seminal article several years later, Berk & Green (2004)\(^{19}\) formalized this hypothesis. Assuming standard investor rationality, by accounting for the effect of investor expectations and competition on fund flows they showed that much of the empirical evidence finding that managers were unable to generate consistent positive alphas was easily explained. In their model, fund size and total manager compensation — typically based on a share of assets under management — as well as transaction costs increase in response to perceived manager skill until returns are equalized across funds going forward. Managers’ failure to outperform a passive benchmark based on NAV returns does not mean they lack skill. “It merely implies that the provision of capital by investors to the mutual fund industry is competitive. . . . [Owing to fund flows] investors cannot expect to make positive excess returns, so superior positive [NAV] performance cannot be predictable [or persistent].”\(^{20}\) This finding is consistent with a Grossman-Stiglitz efficient market equilibrium.

Wermers (2000) assembled a novel and exhaustive database to assess active fund managers’ stock picking skill, transaction costs, and expenses. The database included specific fund security holdings based on SEC filings, NAV returns, portfolio style, annual

turnover, and expense ratios for all U.S. equity funds from 1975 through 1994. The database allowed him to differentiate between manager stock picking returns (which he adduced from changes in portfolio holdings), on one hand, and returns enjoyed by shareholders based on NAV performance, on the other. The difference consists of various transaction costs, flow-driven fees, and administrative expenses.\footnote{He later likened the ability to assess manager stock-picking returns based on portfolio holdings, rather than on NAV returns, as akin to advances in DNA profiling over fingerprint methods in criminal proceedings. Russ Wermers, \textit{Performance Evaluation with Portfolio Holdings Information}, 17 N. Am. J. Fin. & Econ. 207 (2006).} He found that active funds outperformed the market by 1.3 percent per year but that their NAV returns (the returns shareholders enjoyed) fell short of the market by one percent. He accounted for 0.7 percent of the 2.3 percent difference as the result of underperforming non-stock holdings, mostly cash. To meet redemptions, mutual funds must hold a nontrivial portion of their portfolios in cash. The return on cash falls far short of the return on risky securities and acts as a drag on the NAV returns shareholders earn. The remaining 1.6 percent difference consisted of expenses, including advisory fees and transaction costs.

One of the problems a skillful manager faces is that to make a profit he must incur transaction costs to trade the securities he believes are mispriced. Transaction costs, which accrue to the fund, consist of brokerage commissions and any adverse price impact on trades between the moment the manager orders the trade and the moment the broker fully executes it. Price impact results from the mere presence of the manager in the trading environment. If the trade is large and the manager is known for being informed, this information might leak out and cause the price of the security to move against him before he can complete it.\footnote{Stephen M. Horan and D. Bruce Johnsen, \textit{Can Third-party Payments Benefit the Principal? The Case of Soft Dollar Brokerage}, 28 INT’L REV. OF LAW & ECON. 56 (2008).} Price impact can be a substantial drag on portfolio performance.\footnote{Donald B. Keim  and Ananth Madhavan, \textit{Transaction Costs and Investment Style: An Inter-exchange Analysis of Institutional Equity Trades}, 46 J. Fin. Econ. 265 (1997).} The observation that some managers’ trades consistently experience large price impact suggests they represent “smart money” in the securities trading environment. Wermers found that although high-turnover funds (a plausible proxy for manager research) had higher expenses and transaction costs, their net stock picking returns exceeded those of both low-turnover funds and the Vanguard 500 Index fund.\footnote{Wermers (2000), at 1659.}
In a series of papers following on his original study, Wermers added dramatically to our understanding of the relationship between fund performance, fund flows, and fund transaction costs and expenses. Relying on the same exhaustive database he assembled for his 2000 study, in 2003 he showed that portfolio returns based on manager stock-picking skill among the top decile of funds persist for multi-year periods; last year’s winning funds tended to repeat and last year’s losing funds also tended to repeat.25 Investors appeared rationally to use past performance to infer future performance; newly invested funds clearly flowed toward recent winners, suggesting that on average fund investors had smart money.26

More recently, Kosowski, Timmerman, Wermers, and White (2006) applied an emergent statistical method known as a “bootstrap” analysis to the data.27 Among other things, this method allowed them to determine whether managers who generated positive alphas did so through superior skill in picking stocks or purely as a result of luck. If superior performance was based on luck, alone, they expected nine funds in their database to generate alphas (net of costs) exceeding ten percent per year for at least a five-year period. Instead they found 29 funds that did so. This allowed them overwhelming to reject the hypothesis that active managers lack persistent stock picking skill. Consistent with a Berk-Green equilibrium, a sizeable minority of fund managers were able to generate superior stock picking returns, and these managers’ performance tended to persist over time.

Although these findings strongly suggest, in general, that investment research can add alpha, they apply solely to the research performed by active mutual fund managers and not to private money managers such as retirement account advisers. Nor do they say anything directly about the effect of managers’ use client commissions to pay for research. Further discussion of these issues in the context of privately managed accounts is postponed to Section IV.

25 Wermers (2003), at 22.
III. The Market for Investment Research, Then and Now

A. A Brief History of the Section 28(e) Safe Harbor

From its inception in 1792, the association of stock and bond brokers and dealers known until recently as the New York Stock Exchange (NYSE) (now merged with the NASD into the Financial Industry Regulatory Authority, or FINRA) operated under a system of legally mandated minimum commissions. Under “the old fixed commission system,” the small number of full-service brokerage houses that dominated the NYSE produced the bulk of investment research, largely in the form of proprietary conclusions as to mispriced securities — so called “securities picks” — and analyst reports best seen as outputs in the investment research process. They then bundled the costs of proprietary research into a mandated minimum commission and allocated them sequentially to favored clients based, in part, on the amount of commission business the client did with the firm.

Starting with passage of the Investment Company and Investment Advisers Acts (1940), emerging opportunities in investment research brought on by the ever accelerating “electronics revolution” began to change the division of securities holdings between individual brokerage house accounts and independent money managers acting as investment advisers, either to private accounts or to public mutual funds. These advisers gradually developed the wherewithal to avoid the favoritism game played by full-service brokerage houses, allowing them to vertically dis-integrate investment research from securities trading. Instead of relying on full-service brokers’ proprietary in-house securities picks, they increasingly began to combine generic inputs in the investment research process — computer software, hardware, the latest price quotes, databases, research reports, and idiosyncratic bits of company news, etc., having limited intrinsic

information content by themselves — with their own labor effort to generate stock picks internally.

Slowly but surely, political support for fixed commissions waned. Congress made commissions entirely negotiable in May 1975 as part of the Securities Acts Amendments to the SEA.\(^{29}\) Commissions fell dramatically and trading volume surged. There is little doubt that deregulation of fixed commissions on stock trades represented a tectonic shift for the U.S. securities industry whose effects on the provision of investment research are still being felt to this day.\(^{30}\)

In addition to providing for freely negotiated brokerage commissions, the 1975 amendments added Section 28(e), the so-called “paying up” amendment, to the SEA. Congress designed Section 28(e) as a safe harbor to allay money managers’ widespread concern that their state common law and statutory fiduciary duties of best execution, and more likely criminal sanctions under Section 17(e) of the ICA,\(^ {31}\) would limit them to paying only the lowest available commissions for portfolio brokerage regardless of execution quality or the value of any research services they received.\(^ {32}\) Section 28(e) provides, in relevant part:

\[
(1) \text{No person [who exercises] 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 having caused the account to pay a member of an exchange, broker, or dealer an amount of commission . . . in excess of the amount of commission another member of an exchange . . . would have charged . . . if such person determined in good faith that it was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed}
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\(^{31}\) Section 17(e) prohibits an agent from accepting “compensation . . . for the purchase or sale of any property to or for such registered company . . . except in the course of [acting] as an underwriter or broker.” 15 U.S.C. §§ 80a-17(e) (1964).

in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion. . . .

(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.

(3) For purposes of this subsection a person provides brokerage and research services insofar as he —

(A) furnishes advice, either directly or through publications or writings, as to the value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of securities or purchasers or sellers of securities; 

(B) furnishes analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts; or

(C) effects securities transactions and performs functions incidental thereto (such as clearance, settlement, and custody) or required in connection therewith by rules of the Commission or a self-regulatory organization of which such person is a member . . . 33

The Senate Committee Report on Section 28(e) makes several important points that help to understand its motivation and scope.34 It is worthwhile quoting the Report at length:

Under the present environment, most money managers obtain supplementary research support and analysis from brokerage firms which execute their transactions on national securities exchanges charging the fixed commission rate now in effect. . . . Investment managers in turn have relied on the fact that portfolio activity would generate a supply of research and analysis from the brokerage industry.

34 SENATE REPORT NO. 94 - 75; 94TH CONGRESS, 1st Session; S. 249, Section IV, Payment for Research Services with Brokerage Commissions (April, 1975).
The small investment manager has thereby been able to service his clients without being required to charge those clients a higher fee than the [large bank] trust department. Thus, existing investment management relationships, including the size of the management fee, have been based, in part, on an environment which enables the manager to obtain research and other services from broker-dealers, which services are paid out of portfolio brokerage and are not an expense of management.

The transition from the system of fixed to unfixed commission rates is expected by some to cause confusion and disruption. Many fear that governing law applicable to fiduciaries will dictate that the money manager must always seek the lowest execution cost for portfolio transactions and that he may not charge a managed account or fund with an execution-plus research rate which may be higher than an execution-only rate. If that interpretation of fiduciary law should prove accurate, the future availability and quality of research and other services in an environment of unfixed rates could be jeopardized, with potentially harmful consequences to all investors.

S. 249 is therefore intended to permit a fiduciary to cause an account to pay a broker or dealer an amount of commission for effecting a securities transaction in excess of the commission another broker-dealer might have charged for effecting that transaction so long as the investment advisor or fiduciary determines in good faith that the commission was reasonable in relation to the value of the brokerage and research services provided by such broker-dealer. This standard of “reasonableness” does not require that the value of research and brokerage services be imputed to any specific account; rather reasonableness is to be measured in view either of that particular transaction or the fiduciary’s overall responsibilities with respect to the accounts over which he exercises investment discretion. It is thus unnecessary for the money manager to show that specific services benefited specific accounts.

The Committee intends Section 28(e) to be exclusive and plenary unless otherwise expressly provided by contract and to supersede state common law and any other state or federal law in existence prior to the enactment of the amendment insofar as such law might apply to such conduct.

The definition of brokerage and research services is intended to comprehend the subject matter in the broadest terms, subject always to the good faith standard in Subsection (e) (1). The touchstone for determining when a service is within or without the definition in Section 28(e) (3) is whether it provides lawful and appropriate assistance to the money manager in the carrying out of his responsibilities.
Several of these points bear emphasizing. First, one function of the safe harbor is to allow small advisory firms to compete with their larger and more established rivals. Second, market-driven management fees are insufficient to fund investment research, and research therefore is not an expense of management to be covered by the management fee. Third, all investors are harmed if the threat of fiduciary suits leads money managers to be under-researched. Fourth, clients and their money managers may contract out of the safe harbor, presumably as long as clients receive adequate disclosure. Finally, the scope of 28(e) is to be interpreted permissively subject to the good faith standard.

The exact scope of section 28(e)’s protection of “brokerage and research services” has evolved over the years with a number of SEC no-action letters, cases, and administrative proceedings. Early on, the SEC interpreted the term “brokerage and research services” in a way that confined its application to proprietary products. But in response to the “changing array of research products and the impact of new technology on brokerage practices,” and believing “that the issue is ultimately one of good faith on the part of the money manager” best addressed through disclosure, in 1986 the SEC relaxed its interpretation of brokerage and research services to include anything that “provides lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities.” This standard begs the question of exactly what type of assistance is or is not lawful and appropriate, or why the safe harbor is necessary or helpful if its scope is defined by already-existing law, but the SEC lifted it straight from the Congressional Record and so it seems to have taken on a weight disproportionate to the clarity it provides. The 1986 Release clearly allowed generic research inputs to be included in the safe harbor and was followed by considerable

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35 1986 Interpretative Release, at 13-14. It seems plausible that the SEC’s new interpretation was inspired, at least in part, with a view toward the London Stock Exchange’s concurrent deregulation of fixed commissions, a development that no doubt threatened U.S. markets with a loss of trading volume.


37 The most plausible explanation for what the “lawful and appropriate standard” accomplishes that would not be accomplished by existing law in its absence is that it eliminates the presumption that the pleading of receipt of benefits by the manager at a client’s expense might raise regarding self dealing. It may therefore allow a defendant to succeed in a motion to dismiss or for summary judgment where he or she might otherwise fail and have to incur great expense to defend against a claim that ultimately proves meritless under detailed entire fairness review. To my knowledge, this explanation appears nowhere in the Congressional Record or in the SEC’s regulatory record.
expansion in independent research, largely at the expense of established full-service brokerage houses.

B. Fixed Income Trading and Research under Section 28(e) – Early Status

The SEC’s Division of Market Regulation first addressed the provision of brokerage and research services on fixed income securities trades under Section 28(e) in a No-Action Letter dated July 25, 1990, responding to an inquiry from the Department of Labor (DOL). Before taking enforcement action in several pending cases under the Employee Retirement Income Security Act (ERISA) (1974), which regulates the management of private pension funds, the DOL requested the SEC’s opinion on whether the safe harbor applies to trades in fixed income securities and over-the-counter (OTC) stocks, including those listed on the National Association of Securities Dealers Automatic Quotation System (NASDAQ). At the time, these securities were traded primarily by dealers on a principal basis rather than by brokers on an agency basis. In contrast to the commissions brokers receive for acting as agents, when trading for their own account as dealers they earn a mark-up or mark-down equal to the difference between the price at which they buy and the price at which they sell, in many cases selling out of their inventory or buying to add to their inventory.

By its text, section 28(e) covers trades the manager sends to a “broker or dealer,” but in reference to the trader’s compensation it mentions only “commissions,” not mark-ups or mark-downs. In the narrow sense of the term, only brokers earn commissions, while dealers, as principals, earn mark-ups and mark-downs. Since Congress passed section 28(e) to mitigate problems owing specifically to the unfixing of commissions, the No-Action Letter found that dealer transactions in fixed income and OTC equity securities fall outside the safe harbor. In a supplemental No-Action Letter to Hoenig & Co., Inc., dated October 15, 1990, the Division of Market Regulation reiterated this position and clarified that “a transaction fee paid to a broker-dealer for effecting a transaction in a principal capacity is not within the safe harbor irrespective of the label placed on the fee.” “The fact that the broker-dealer imposes a charge that is denominated
as a ‘commission’ or ‘commission equivalent,’ rather than a mark-up would not be relevant to the application of Section 28(e) . . . even though the confirmation received by the money manager reflects a commission equivalent.” It is generally believed that a broker may perform legitimate agency trades in securities normally traded on principal basis as long it provides legitimate agency function such as keeping the client’s identity confidential, searching for a better price than what is available to the client on a principal basis, or providing other special expertise.38

In 1995 the SEC published a proposing release entitled Disclosure by Investment Advisers Regarding Soft Dollar Practices seeking public comment on its call for enhanced disclosure of client commission practices by mutual funds in their annual reports.39 Among other things, the release affirmed the 1990 No-Action Letter finding that principal transactions on fixed income and OTC equity securities fall outside Section 28(e)’s safe harbor.40 Although the release was never adopted, it is notable for its recitation of the conflicts of interest the SEC believed are inherent in the use of soft dollars that might cause a money manager to act contrary to the best interest of its clients.

First, soft dollar arrangements permit “an adviser to cause a client to pay higher commissions than otherwise are available to obtain research that may not be used exclusively for the benefit of the client or used to benefit the client at all.” Second, they may “cause an adviser, in order to obtain soft dollar services, to violate its best execution obligations by directing client transactions to brokers who could not adequately execute the transactions.” Third, they “may give advisers incentives to trade client securities inappropriately to generate credits for soft dollar services.” Fourth, they may “diminish the ability of a client to evaluate the expenses it incurs in obtaining portfolio management services and may hinder the ability of the client to negotiate fee agreements, because the costs of soft dollar services are ‘hidden’ from investors in brokerage commissions.” Fifth, by allowing “advisers to use their clients’ transactions to pay for research services that they otherwise would have to purchase with ‘hard dollars,’ soft dollar arrangements

permit advisers to charge fees that do not fully reflect the cost of portfolio management.” Finally, “[a]dvisers that do not engage in soft dollar arrangements may be put at a competitive disadvantage if they pay for services with hard dollars and attempt to pass the cost of these services on to clients through higher fees.”

In 1998, the SEC’s Office of Compliance Inspections and Examinations (OCIE) published its *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds*, in which it reviewed the results of an audit sweep of some 355 broker-dealers, advisers, and mutual funds. The Report began by correctly emphasizing that “[r]esearch is the foundation of the money management industry. Providing research is one important, long-standing service of the brokerage business.” It went on to provide the following troubling legal analysis, however:

Under traditional fiduciary principles, a fiduciary cannot use assets entrusted by clients to benefit itself. As the Commission has recognized, when an adviser uses client commissions to buy research from a broker-dealer, it receives a benefit because it is relieved from the need to produce or pay for the research itself. In addition, when transactions involving soft dollars involve the adviser “paying up” or receiving executions at inferior prices, advisers using soft dollars face a conflict of interest between their need to obtain research and their clients’ interest in paying the lowest commission rate available and obtaining the best possible execution.

The OCIE staff justified these conclusions later in the *Report* by citing what it touted as well-accepted rules of trust law from Section 170 of the *Restatement, Second, of Trusts*. In its view, “[a]n adviser is obligated under both the Investment Advisers Act . . . and state law to act in the best interests of its client. This duty generally precludes the adviser from using client assets for its own benefit or the benefit of other clients, without

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41Disclosure Proposal, at 4-5. Among other things, the proposed rule would have required money managers to disclose the twenty brokers to which it directed the largest amounts of commissions and certain other transaction-related payments. Disclosure Proposal, at 2. The proposal was met by a storm of protest from the industry. As one trade publication reported, for example, “[t]hough the tougher disclosure standards would put untold hardships on the small firms, they would mean nothing to the full service firm because their services are bundled together and, as such, are inseparable.” See Jack Willoughby, Goldman and Morgan Bow Under Client Pressure on Soft Dollars; Deluge of Client Complaints Softens Get-tough Provisions, Investment Dealers’ Digest (August 21, 1995), at 3.


431998 OCIE Report, at 2-3?
obtaining the client’s consent based on full and fair disclosure.”

It concluded that soft dollar bundling would violate trust law absent safe harbor protection.

Although this was, by definition, a clear statement of the OCIE staff’s view of a money manager’s fiduciary duty — and later adopted by the full Commission — the statement is by no means consistent with established law. First, the Senate Report clearly stated, aspirationally, that research and other services “are not an expense of management,” which plainly contradicts the staff’s assertion that a money manager’s use of client commissions provides the manager with a “benefit” because the manager would otherwise have to pay for these services out of its own pocket. Further, the Report fails to disclose the comments following Section 170 of the Restatement, which make clear that the nature of the precluded “benefits” to which it refers involves situations in which the trustee “profit[s] at the expense of the beneficiary [or] . . . enter[s] into competition with him.” A representative example is sale by the trustee of trust property to himself, either directly or indirectly. Even ignoring the likely advantage investors enjoy from having their money managers fully researched, it is implausible to suggest that a manager’s receipt of research ordinarily allows him or her to “profit” at investors’ expense in the sense covered by Section 170.

This conclusion is obvious from the language of Section 244, which the OCIE staff also failed to disclose in the Report. It states that “[t]he trustee is entitled to indemnity out of the trust estate for expenses properly incurred by him in the administration of the trust.” Comment b to Section 244 goes on to explain that

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44 The note accompanying this passage reads as follows: “Restatement (Second) Trusts § 170 comment a, § 216 (1959). See also Advisers Act Release No. 1469 (February 14, 1995), at fn. 8 and accompanying text. As discussed herein, the Investment Company Act of 1940 generally prohibits fund advisers from using fund commissions to acquire any product or service outside of the Section 28(e) safe harbor.”

45 Regarding the types of expenses a trustee may properly incur, Section 188 of the Restatement Second of Trusts states that:

**Power to Incur Expenses.** The trustee can properly incur expenses which are necessary or appropriate to carry out the purposes of the trust and are not forbidden by the terms of the trust, and such other expenses as are authorized by the terms of the trust.

Comments following this section provide relevant examples, and include:

- **a. What expenses are proper.** The trustee can properly incur expenses which are necessary or appropriate for performing his duties as trustee. Thus, he can properly incur expenses necessary or appropriate to . . . make the trust property productive. . . .
“[i]f the trustee properly incurs a liability in the administration of the trust, he is entitled to indemnity out of the trust estate either by way of exoneration, that is by using trust property in discharging the liability so that he will not be compelled to use his individual property in discharging it, or by way of reimbursement, that is if he has used his individual property in discharging the liability, by repaying himself out of trust property.”

Section 244 squarely contradicts the staff’s claim that receipt of research is the type of “benefit” prohibited under trust law. Unless managers receive benefits to the exclusion of investors, as where the broker provides the managers with personal benefits that have no bona fide business purpose, no self dealing has occurred and no suit for fiduciary breach is warranted under the common law of trusts. If any of its troubling analysis regarding the contours of state trust law were to be tested in federal court, the SEC could easily suffer a humiliating defeat. Nevertheless, prudence on the part of

c. Employment of agents. The trustee can properly incur expenses in employing attorneys, brokers or other agents or servants so far as such employment is reasonably necessary in the administration of the trust. He cannot properly incur expenses, however, in employing agents to do acts which the trustee ought personally to perform, as where it would be an improper delegation of his duties or powers to act through an agent . . . , or where although it would not be an improper delegation to employ an agent yet the service of the agent is one which is covered by the trustee’s compensation.

d. Expenses of management. The trustee can properly incur expenses necessary in the management of the trust property . . . .

A cursory reading of subsection c might seem troublesome because it suggests that money managers could be presumed to have an obligation to perform all research internally and to pay for it out of their management fee rather than hiring an agent at its clients’ expense to do it for them. This reading squarely contradicts the Senate Report, which clearly states that the purpose of the safe harbor is to protect the pre-1975 status quo wherein the costs of research were lawfully and appropriately bundled into the brokerage commission. What is more, a standard rule of contract construction is that the court will look to “the customs of [the] business or prior dealings between the parties.” See note ?, infra.

46 Restatement (Second) of Trusts (1959).
47 The rule requiring trust beneficiaries to indemnify trustees out of trust assets is by no means peculiar, having a close parallel in the common law of agency. Section 428 of the Restatement, Second, of Agency explains that

“(1) A principal is under a duty to indemnify the agent in accordance with the terms of the agreement with him; (2) In the absence of terms to the contrary in the agreement of employment, the principal has a duty to indemnify the agent where the agent, (a) makes a payment authorized or made necessary in executing the principal’s affairs or, unless he is officious, one beneficial to the principal [emphasis added], or, (b) suffers a loss which, because of their relation, it is fair that the principal should bear.”

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money managers suggests they should treat the SEC’s interpretation of Section 28(e)’s scope as a compelling bright line for protected research.

Notwithstanding its troubling legal analysis, the 1998 *OCIE Report* described the range of products and services advisers were obtaining from their institutional brokers. Among other things, it raised concern about the products advisers were treating as research under 28(e), opining that many of them did not deserve safe harbor protection under the 1986 standard. It recommended that “the Commission provide further guidance on the scope of the safe harbor and require better recordkeeping and enhanced disclosure of client commission arrangements and transactions.”

C. Recent Forces Affecting the Provision of Research

The first decade of the 21st century has witnessed a confluence of forces in U.S. financial markets that amount to a sea change. From deregulation of banking, to the communalization of corporate news, to financial scandal and regulatory reform, to sweeping judicial decisions, the forces at work are fast reshaping the provision of investment research in ways that have critical implications for the efficient management of Americans’ retirement accounts.

To understand how these forces are shaping the provision of investment research it is critical to understand that when people use the term “research” they are often referring to dramatically different things. At one extreme of a spectrum is proprietary research in the form of conclusions about mispriced securities that can have substantial

Comment b to this section, titled “Reimbursement, exoneration, and subrogation,” continues on to find that

“[t]he agent’s right of indemnity always includes a right to reimbursement for amounts properly paid or losses suffered without his fault in transactions authorized by the principal. This right arises at the time when the agent makes an authorized payment, or suffers a loss, without his fault. In some cases, he has only a right of reimbursement, as where he specially agrees to use his own assets to pay claims arising against himself or the principal, or where such an agreement can be inferred by the *customs of business* [emphasis added] or prior dealings between the parties. . . .”

alpha value in a trading environment. At the other extreme are generic publications, reports, databases, hardware, etc., that have no intrinsic alpha value standing alone. Even idiosyncratic bits of news about a securities issuer or events likely to influence the price of its securities that are legally immaterial are closer to generic inputs if they add alpha only when assembled together with other bits like jigsaw puzzle pieces to form a coherent picture. Generic research is an input to an investment research process, while proprietary research conclusions are the output. To come up with profitable research conclusions, a money manager must combine its labor effort with inputs of various degrees and then seek a broker to execute the trades. A manager has two basic choices about how to transact research in the marketplace, but he can of course employ some measure of both. He can use client commission to pay up for brokerage together with bundled-in access to a full-service broker’s proprietary research conclusions, as under the old fixed-commission system. Or he can use client commissions to pay any variety of brokers to provide him with research credits to buy independent third-party research inputs, which he then combines with his labor effort to identify his own research conclusions. Either choice suffers from inherent conflicts of interest.

One inherent conflict with proprietary research is the favoritism problem. Under the old-style system, which is still alive to some extent today, there are never enough good research conclusions to go around. Broker-dealers naturally select in favor of preferred clients by calling them first with news of the most recent trading opportunities identified by their in-house analysts. The broker-dealer then works its way down the list, finally disclosing the research conclusions widely among its client base. Those called earlier have better trading opportunities than those called later. This is no doubt where the herald “first-call” originated. Although some clients are favored over others, those clients must pay more to gain favor. The favoritism problem requires clients to compete to be favored in the allocation process, perhaps by directing a sub-optimal volume of their execution business to the providing broker-dealer or by giving the broker-dealer their own idiosyncratic bits of news. The resulting competition leads them to dissipate a portion of the surplus value they stand to receive from being favored. In such a system, few broker-dealer clients have the bargaining power to command above-normal returns.

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49 See, e.g., http://findarticles.com/p/articles/mi_m0BDS/is_35_26/ai_77954281/.
The conflicts inherent in transacting research in the market go beyond simple favoritism and help explain why independent third-party research tends to consist of research inputs toward the generic end of the spectrum. One is a measurement problem and results from the high cost to investors of assessing the value of research conclusions. In a nonrecurring market setting, how does the buyer know whether the associated trading opportunity has any value? To verify the value of the research, the buyer would have to devote considerable time and attention to assessing its merit. In the extreme, the buyer would have to completely reproduce the research, which would eliminate any gains from specialization. The measurement problem makes transacting over research conclusions difficult and accounts for the heavy reliance full-service broker-dealers place on long-term relationships based on loyalty and trust.

No doubt owing in part to the electronics revolution, over time there has been a steady rise in money managers’ reliance on generic research inputs combined with their own labor effort to identify research conclusions. The conflict inherent in this method is the leakage problem. When, for example, a money manager identifies a profitable research conclusion internally, he must maintain his trading anonymity because the market is filled with those eager to front-run informed trades. A disloyal executing broker anticipating a price-moving order might trade ahead of the manager or tip associates. More benignly, any manner of astute market participants are capable of taking advantage of the slightest sign of carelessness by an executing broker, if only in the nervous tick he exhibits when working a large block trade. Either way, an informed money manager stands to lose some or all of the value of his research conclusions to price impact, which, together with brokerage commissions, is widely recognized as an important component of transaction costs that can erode investor returns.\(^\text{50}\) In noisy securities markets it can take substantial time for a manager to identify excessive price impact resulting from broker misbehavior and to terminate the relationship.\(^\text{51}\)


\(^{51}\) Many commentators have criticized the old fixed commission system from a normative position, arguing that the NYSE was nothing more than an exclusive club whose primary functions were to exclude outsiders and to perpetuate the spoils of government protection on behalf of its members. See, e.g., Chris Wells, The Last Days of the Club (1975). Given the inherent pitfalls in transacting investment research, my own view is that it was probably an efficient system, but perhaps one whose time is quickly passing.
The forces of change are now dramatically accelerating the shift toward independent third-party research. An early precipitant was passage by Congress of the Gramm-Leach-Bliley *Financial Services Modernization Act* in November 1999.\(^\text{52}\) This legislation repealed the New Deal-era Glass-Steagall Act (1932), which had succeeded for decades in mandating strict separation between commercial banking, investment banking, and insurance underwriting. Anticipating passage of Gramm-Leach-Bliley, many large insurers, commercial banks, and investment banks, along with their affiliated broker dealers and asset management units, had already begun to merge pursuant to an expanded Federal Reserve Board exception to Glass-Steagall,\(^\text{53}\) in many cases turning themselves into bank holding companies with access to Federal deposit insurance but subject to relatively strict banking regulations on their capital requirements. By the time the dust began to settle in 2003, Citicorp and Travelers Insurance Company had become the giant financial services firm Citigroup, Inc., also including the former Primerica, Shearson Lehman, Smith Barney, and Solomon Brothers. UBS bought Paine Webber. Credit Suisse, having already merged with First Boston, a prominent investment bank, quickly swallowed Donaldson, Lufkin & Jenrette, also a prominent investment bank. Around the same time, JP Morgan, Chemical Bank, and Chase Manhattan Corporation merged into the colossus JP Morgan Chase and soon went on to acquire Bank One Corporation.\(^\text{54}\)

In the midst of the financial merger wave, the SEC approved *Regulation Fair Disclosure*. Prior to its passage many investment bank analysts had established relationships with corporate managers that allowed them favored access to emerging issuer information. *Reg FD* changed all that. It requires that “when an issuer, or person acting on its behalf, discloses material nonpublic information to certain enumerated persons (in general, securities market professionals and holders of the issuer’s securities who may well trade on the basis of the information), it must make public disclosure of that information.”\(^\text{55}\) The trouble is that the materiality standard is vague.\(^\text{56}\) The net cast

\(^{52}\) [http://www.pbs.org/wgbh/pages/frontline/shows/wallstreet/weill/demise.html](http://www.pbs.org/wgbh/pages/frontline/shows/wallstreet/weill/demise.html)  


\(^{54}\) [http://en.wikipedia.org/wiki/List_of_bank_mergers_in_the_United_States](http://en.wikipedia.org/wiki/List_of_bank_mergers_in_the_United_States)  

by Reg FD ended managers’ willingness to provide broker-dealer analysts with idiosyncratic bits of nonmaterial news. “When in doubt, say nothing” quickly became the norm.57 For investment bankers whose value-added had been to assemble bits of news from company executives — many of them investment banking clients — as well as other sources this must have come as a stunning blow that further tipped the production of research outputs toward money managers relying on independent third-party research.

If the events leading to the passage of the Sarbanes-Oxley Financial Reporting Improvements Act (2002) were not enough, scandal rocked the financial services industry in 2003 when then New York attorney general Eliot Spitzer discovered that equity research analysts at ten top full-service broker-dealer firms had routinely published research reports biased in favor of their affiliated investment bank clients but contrary to their private communications. The scandal unraveled into the widely-publicized Global Settlement condemning these firms for allowing their analysts to engage in conflicts of interest.58 In the aggregate, Bear, Stearns, Credit Suisse First Boston, Goldman Sachs, Lehman Brothers, J.P. Morgan, Merrill Lynch, Morgan Stanley, Citigroup Global Markets (f.k.a. Salomon Smith Barney), UBS Warburg LLC (UBS), and U.S. Bancorp Piper Jaffray Inc. made payments of $1.4 billion and agreed not to seek indemnification, tax deductions, or tax credits for any penalties they paid. This may be the largest settlement securities regulators have ever extracted from the financial services industry. Of this amount, the settlement consisted of $432.5 million to fund independent research, requiring each firm to contract with independent research providers and to make this “objective” research available to their customers for a five-year period. An additional

56 The U.S. Supreme Court defines a statement as material if there is a “substantial likelihood that, under all the circumstances, [it] would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” TSC Industries, Inc., v. Northway, Inc. 426 U.S. 438, 450 (1976). See also Basic, Inc., v. Levinson, 485 U.S. 224 (1988) (modifying TSC v. Northway with what the Court called the “probability-magnitude” test for materiality).


$80 million went to fund investor education. Regulatory actions aimed at ensuring the integrity of in-house research required them to sever the links between research analysts and investment banking, including a requirement that “the research department’s budget [must be determined] without input from investment banking and without regard to specific revenues derived from investment banking.”

The effect of the Global Settlement has clearly been to further shift the balance away from proprietary research and in favor of third-party research. The financial press reports a mass exodus of the most talented research analysts from full-service broker dealers, who have set up private research shops tailored to providing money managers with all manner of research. One industry publication reported that between 2000 and 2007 the number of large brokerage house analysts fell by 9,300, or 40%, and projected another one-third decline by 2008. As a result, nearly 17% of publicly traded issuers lost their analyst coverage. As Fortune Magazine put it,

> [a]nalyst pay has been slashed in half--or more. Highly paid stars have been ushered out the door, replaced by junior analysts. Most big research departments have shrunk by more than a third. But more profound changes are coming, because Wall Street research finds itself under a far graver threat than even Eliot Spitzer: Its business model is under assault. Dozens of new research boutiques have cropped up in recent years claiming to offer truly independent research.

More recent reports indicate that the going has been rough for the new crop of independent research firms, no doubt because of problems transacting conclusory investment research separate from the execution of the underlying trades it might generate. As one commentator observed,

> [e]ven many independent research firms, which seemed poised to blossom after scandal shamed Wall Street analysts, are struggling to persuade investors to pay for their advice. As part of the 2003 settlement, Wall Street investment banks were required to provide independent research in addition to their own analyst reports. Many have opted to use reports from stalwarts such as Standard & Poor’s and

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60 Thomas D. Saler, Rethinking Research, Barons Online, January 22, 2007 (available at http://online.barrons.com/article_print/SB116925398457082185.html).
Value Line Inc. rather than turn to small, independent startups. . . . The number of independent researchers worldwide probably has dwindled to about 400 from 450 two years ago, says Robert Hoehn, research director at New York–based Soleil. That number will probably fall to 150 in the next few years, he says.62

The merger wave that had shown signs of slowing in 2004 received new impetus from the financial crisis of 2008. Beginning with Bear Stearns’ near bankruptcy (truncated only by federally administered buyout by J.P. Morgan Chase) and followed by the Lehman Brothers bankruptcy, the financial services industry experienced and continues to experience another wave of consolidations. J.P. Morgan Chase bought the once-innovative Washington Mutual as its failure loomed.63 To recount just a few of the widely publicized deals that followed, in 2008 Bank of America merged with the failing mortgage bank Countrywide and investment bank Merrill Lynch, and Wells Fargo acquired Wachovia.64 The result is a financial services industry crowded with giant bank holding companies that offer a full line of investor services. Of the formerly prominent investment banks, only Goldman Sachs remains independent.

Unsurprisingly, many of these giant financial industry firms hold substantial retirement and other investor assets under management, either directly or through money management affiliates.65 Much of this money has been ministered for brokerage house clients by employee-brokers. But many of these brokers have grown frustrated with the

64 http://newsroom.bankofamerica.com/index.php?s=43&item=7956
bureaucracy associated with their massive bank holding company employers and are beginning to depart in large numbers to set up their own registered investment advisory firms, taking their clients’ money with them. As baby boomers retire, their employer-sponsored 401(k)s will have to be rolled over to individual retirement accounts. A recent Wall Street Journal story reports that “[t]he number of brokers serving individual clients at major firms fell 14% to less than 55,000 in the three years ending in December 2008, while the number of independent financial advisers rose 29% to 33,000.”

This trend is no doubt being fueled in part by a sweeping 2007 legal decision by the U.S. Court of Appeals for the D.C. Circuit. In Financial Planning Association v. SEC, the court addressed the SEC’s Rule 202(a)(11)-1 under the Advisers Act. The principal purpose of this rule had been to exempt brokers offering fee-based brokerage accounts together with investment advice from having to register under the Advisers Act. Brokers are regulated under the Securities Exchange Act (1934). By the language of the Advisers Act defining the term “investment adviser,” they are exempt from registration under that Act if they provide investment advice “solely incidental” to their function as brokers and receive “no special compensation” for that advice other than their customary commissions. The SEC rule allowed brokers to charge a separate asset-based fee in exchange for advising clients’ accounts without having to register under the Advisers Act. The court found the SEC’s added exemption clearly contrary to the language of the Act and vacated the rule.

The year 2008 witnessed publication of the long-awaited Rand Study of the securities brokerage and investment advisory industries, especially as they are perceived by small retail investors. The study’s most important finding is that retail investors are

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67 See Certain Broker-Dealers Deemed Not to be Investment Advisers, Investment Advisers Act Release No. 2376 (Apr. 12, 2005) [70 FR 20424 (Apr. 19, 2005)] (“2005 Adopting Release”). As the release explains, “[f]ee-based brokerage accounts are similar to traditional full-service brokerage accounts, which provide a package of services, including execution, incidental investment advice, and custody. The primary difference between the two types of accounts is that a customer in a fee-based brokerage account pays a fee based upon the amount of assets on account (an asset-based fee) and a customer in a traditional full-service brokerage account pays a commission (or a mark-up or mark-down) for each transaction.”
confused about the legal status of the professionals to whom they entrust their money as well as the method by which these professionals are compensated and the associated conflicts of interest.\textsuperscript{69} Most important, securities brokers have only limited duties to their clients, while investment advisers have full-blown fiduciary duties thought to provide investors with far better protection. Being paid a transaction-based commission rather than an asset-based fee, it is widely believed brokers face a conflict of interest that encourages them to “churn” their clients’ accounts to generate commissions. The looming regulatory issue is whether brokers should be subject to fiduciary duties that would greatly temper this tendency.\textsuperscript{70} Industry reports express concern that brokers will “find themselves embroiled in far-flung lawsuits and arbitration hearings that no one in their right mind could envision, all under the banner of ‘breach of fiduciary duty.’”\textsuperscript{71} Regulation to this effect appears imminent and will no doubt hasten the departure of brokers from their gigantic banking houses in favor of registering as independent investment advisers, allowing them to collect asset-based fees.

D. The Current Regulatory Status of Fixed Income Research

Given that the full Commission never adopted the 1995 Disclosure Release its legal status is unclear, but the SEC largely reversed the position it took there as to the eligibility of dealer trades on OTC equities for safe harbor protection in its 2001 release

\textsuperscript{69} The touted explanation for investor confusion is asymmetric information. Investors, the Study concludes, lack the information necessary to assess the incentives of those to whom they entrust their wealth. The problem with this position is that it assumes investors in the aggregate are powerless to help themselves, which is a dubious proposition, especially as the stakes increase. An alternative explanation for apparent investor confusion between brokers and advisors is that at least some investors are well aware of the differences but that the differences are so inconsequential at the margin that it does not pay the average investor to gather the information to be informed. According to this explanation, rather than being thrust on powerless investors by circumstance, information asymmetry is a situation they tolerate because market mechanisms provide them with sufficient protection against being taken advantage of that it is not in their interest to correct the situation. Marginal investors are sufficiently informed to discipline the broker-client and adviser-client relationship.


Commission Guidance on the Scope of Section 28(e) of the Exchange Act. Earlier in 2001 the National Association of Securities Dealers (NASD) had implemented so-called “decimalization,” which required bid-ask price posting by its equity market makers in minimum increments of cents per share rather than in eighths-of-a-dollar. This led many OTC dealers to cease trading on a “net-of-spread” basis and to trade instead on a “commission equivalent” basis. At roughly the same time the NASD changed its confirmation rules on what it called “Eligible Riskless Principal Transactions” in OTC equities to provide more complete disclosure to money managers. In light of these developments, and to fulfill its oversight duties as a self regulatory organization (SRO), the NASD requested that the SEC find Eligible Riskless Principal Transactions to be within the safe harbor.

In what the SEC described as traditional Riskless Principal Transactions, the manager informs the broker-dealer of his trading interest in advance. In a “buy” transaction, the dealer buys the securities from another dealer and contemporaneously resells them to the manager at a predetermined mark-up, and vice-versa for sell transactions. The dealer therefore bears no principal risk on the transaction. The NASD defined an Eligible Riskless Principal Transaction more narrowly as one “in which a member, after having received an order to buy a security, purchases the security as principal at the same price [emphasis added] to satisfy the order to buy or, after having received an order to sell, sells the security as principal at the same price to satisfy the order to sell” and for which it charges the money manager a commission equivalent. The new NASD disclosure rules “required a riskless principal transaction in which both legs are executed at the same price (‘Eligible Riskless Principal Transaction’) to be reported once, in the same manner as an agency transaction, exclusive of any markup, markdown, commission equivalent, or other fee.” Eligible Riskless Principal Transactions are executed at the same price for both the buyer and the seller, with the broker-dealer receiving a commission equal to an agreed fraction of the transaction price.

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75 2001 Interpretive Release, n. 7.
76 2001 Interpretive Release, at 7.
In the broader category of traditional riskless principal transactions, however, the broker-dealer receives a mark-up (mark-down) equal to the difference between the price at which he sold (bought) and the price at which he bought (sold), whatever that difference might be.

In either case, according to the SEC the relevant determinant of safe harbor protection is transparency. The 2001 Interpretive Release notes that at the time it issued the 1995 Disclosure Release the spread cost on principal trades was neither quantifiable nor verifiable, precluding the manager from making the necessary reasonableness determination. In its words, the term “commission” under Section 28(e) “is informed by the requirement that a money manager relying on the safe harbor must determine in good faith that the amount of “commission” is reasonable in relation to the value of research and brokerage services received. This requirement presupposes that a “commission” paid by the managed account is quantifiable in a verifiable way and is fully disclosed to the money manager.”

Accordingly, the term “commission” under the safe harbor includes a “markup, markdown, commission equivalent or other fee paid by a managed account to a dealer for executing a transaction where the fee and transaction price are fully and separately disclosed on the confirmation and the transaction is reported under conditions that provide independent and objective verification of the transaction price subject to self-regulatory organization oversight.”

The 2001 Interpretive Release was careful to emphasize that for the time being markets for fixed incomes securities were subject to insufficient confirmation and reporting requirements to meet these conditions and therefore enjoyed no safe harbor protection. In the SEC’s view, such transactions failed to afford money managers the level of transparency necessary to determine if the remuneration paid to the broker-dealer was reasonable in relation to the value received, as required by Section 28(e). But the release makes clear that as these and other markets develop regulations to ensure sufficient transparency, transactions “that meet the requirements of this interpretation will [emphasis added] be considered to fall within the interpretation.”

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77 2001 Interpretive Release, at 7.
78 2001 Interpretive Release, at 7.
79 2001 Interpretive Release, at 7.
In May 2004 the SEC requested the National Association of Securities Dealers (NASD) to form a task force to provide it with guidance on how to “improve the transparency of mutual fund portfolio transaction costs and distribution arrangements.” The report of the NASD Task Force appeared in November 2004. Among other things, it found that relatively small advisory firms were relatively heavy users of third-party research and emphasized that investors will be best served if proprietary and third-party research are treated equally under 28(e), so that research is readily available to all portfolio managers.

More than a year and a half later the SEC issued its release Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934. The release begins by noting that the term “soft dollars” has become increasingly ambiguous. It originally referred to the explicit bundling of third-party research into premium brokerage commissions, with a formal accounting for the proportions of the commission devoted to execution and research. Bundling of proprietary research by full-service brokers, which had always been implicit in the relationship, receives no formal accounting. Eventually one scholar, and then regulators, came to recognize that whatever conflicts arise with soft dollars are actually the result of bundling and not the provision of third-party research, per se. The implicit bundling of in-house proprietary research into premium brokerage commissions is subject to the exact same alleged conflicts of interest.

Regardless of how it is accounted for, the Guidance found that bundling may allow or encourage managers to co-mingle the benefits of research across multiple accounts, to sacrifice execution quality out of a misplaced sense of loyalty to the providing broker, to engage in excessive trading to generate added research credits, and

83 D. Bruce Johnsen, Property Rights to Investment Research, supra n. ?, at 109-10. To the best of my knowledge, this was the first scholarly article to recognize that the popular criticisms of soft dollars apply equally to proprietary in-house research. The first indication that the SEC recognized the equivalence appears in its proposed but never adopted 1995 disclosure release, where it first uses the more even-handed phrase “client commissions” to describe bundled-in research.
to obscure the expenses of management. To ensure equal treatment of third-party and in-house research, the Guidance explains that the SEC now uses the phrase “client commissions” to refer to any situation in which the manager receives bundled brokerage and research services protected under the Section 28(e) safe harbor.  

With the backing of the full Commission, the Guidance repeated the troubling legal analysis from the 1998 OCIE Report. Like that report, it cites Section 170 of the Restatement (Second) of Trusts, emphasizing that fiduciary principles require “the adviser to act in the best interest of his client [and preclude] the adviser from using client assets for the adviser’s own benefit or the benefit of other clients, at least without client consent.” According to the SEC’s reasoning, client commissions are assets of the client. A manager who uses client commissions to pay for brokerage and research services he or she would otherwise have paid out of pocket receives a personal benefit. Ergo, a manager who receives brokerage or research services ineligible for safe harbor protection under 28(e) faces a conflict of interest that may constitute a breach of fiduciary duty. A manager’s receipt of benefits falling outside of 28(e) may also constitute a criminal violation of ICA Section 17(e), which prohibits agents, other than brokers, from accepting outside compensation when buying or selling property for a registered investment company.

The release explains that in light of various market developments the SEC is revising its 1986 interpretation of the scope of “brokerage and research services” under the safe harbor, even though it will continue to rely on the “lawful and appropriate standard” more generally. The resulting framework for analysis requires the manager to make three determinations. First, “whether the product or service falls within the specific

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84 2006 Guidance, at 41978.
85 2006 Guidance, at 41978.
86 Section 17(e) of the Investment Company Act (1940), 15 U.S.C. Section 80a-17(e), reads as follows:

Acceptance of compensation, commissions, fees, etc. It shall be unlawful for any affiliated person of a registered investment company, or any affiliated person of such person— (1) acting as agent, to accept from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property to or for such registered company or any controlled company thereof, except in the course of such person’s business as an underwriter or broker. . . .

Criminal cases falling under Section 17(e) include United States v. Deutsch, 451 F.2d 98 (2d Cir. 1971); In re Investors Research Corporation, 628 F.2d 168 (D.C. Cir. 1980); and U.S. v. Ostrander, 999 F.2d 27 (2d Cir. 1993).
statutory limits of Section 28(e)(3) (i.e., whether it is eligible ‘research’ under Section 28(e)(3)(A) or (B) or eligible ‘brokerage’ under Section 28(e)(3)(C)).” Second, “whether the eligible product or service actually provides lawful and appropriate assistance in the performance of [the manager’s] investment decision-making responsibilities,” with mixed-use products and services requiring “a reasonable allocation of the costs of the product according to its use.” Third, whether the manager believes in “good faith [that] the amount of client commissions paid is reasonable in light of the value of products or services provided by the broker-dealer.”

The Guidance modifies the SEC’s interpretation of “provided by” from its 1986 Release. On one hand, the SEC understands the benefits of specialization and the attendant pressure to separate brokerage and research. On the other hand, it expresses concern that money managers might use the associated arrangements to “conceal the payment of client commissions to intermediaries (including broker-dealers) that provide benefits only to the money manager.” Accordingly, it finds the safe harbor is available to the manager only if the broker “pays the research preparer directly” and actively engages in monitoring “to assure itself [that any client commissions] the manager directs it to use to pay for such services are used only for eligible brokerage and research.”

Most important for the purposes of this essay, the Guidance specifically addresses the eligibility of fixed income trades for safe harbor protection. In its words, “[m]anagers may not use client funds to obtain brokerage and research services under the safe harbor in connection with fixed income trades that are not executed on an agency basis, principal trades (except for certain riskless principal trades)[emphasis added], or other instruments traded net with no explicit commissions.” Though far from a model of clarity, this passage establishes trades in fixed income securities executed by positioning dealers receive no safe harbor protection, while agency and certain riskless principal trades do. The language of the Guidance recognizes that trade reporting systems for

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87 2006 Guidance, at 41985.
88 2006 Guidance, at 41994-95. This requirement would seem to impose on the broker the duty to render a legal conclusion regarding the SEC’s likely interpretation of 28(e) with respect to specific research services. Brokers do not have the wherewithal to render such judgments. Indeed, the SEC’s wherewithal is doubtful. It has now re-interpreted the Section 28(e) safe harbor at least four times, abandoned a major soft dollar disclosure proposal, and abandoned its suggestion with the Concept Release that implicit transaction costs might be disclosed.
89 Guidance, n. 27.
fixed income agency trades have evolved sufficiently in recent years to allow money managers to meet the good faith standard under the safe harbor. For example, FINRA’s Trade Reporting and Compliance Engine (TRACE), requires members to report prices on both sides of transactions in eligible corporate bonds, equity-linked debt instruments, and, certain government agency debt issues. The Municipal Securities Rulemaking Board (MSRB) reporting system provides price quotes in municipal debt securities. This substantially expands the opportunities money managers have to obtain research through fixed income trades.

IV. The Incentive Effects of Bundling Research into Client Commissions: Conflict or Cooperation?

This essay has already established that research adds alpha, at least as proxied by “active” management in the context of publicly-held equity mutual funds. It also showed that money managers are increasingly shifting toward independent third-party research, that the financial services industry is experiencing an influx of independent research firms and start-up investment advisers, and that baby boom demographics portend both a rollover from 401(k) accounts to individual retirement accounts and a steady weighting of retirement accounts toward fixed income securities and away from equities. Finally, it showed that the SEC believes research bundled into client commissions on fixed income agency and certain riskless principal trades are covered by the safe harbor. This section shows that money managers’ use of client commissions properly motivates them to perform the research necessary to maximize the returns their retirement account clients earn. It also provides compelling empirical evidence showing that research as proxied by premium client commissions adds alpha to retirement and other privately-managed accounts.

In addition to the favoritism, measurement, and leakage problems inherent in the provision of investment research, another conflict of interest is the agency problem that

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arises when an investor or investors collectively hire a money manager. Whether the manager is paid a recurring asset-based fee or a so-called “incentive fee” consisting of a large share of periodic alpha relative to a statement benchmark, in neither case does the manager receive the full benefits of his research efforts. If called on to pay for all research out of their management fee, money managers will be tempted to do too little research. So-called “closet indexing,” in which the manager charges a high fee for active (well researched) management but quietly follows a low-cost indexing strategy is a notorious case on point. In a variant of the leakage problem, moreover, the brokers that execute a manager’s trades might be disloyal or careless in a way that leads to price impact that erodes investor returns. Even for a highly motivated manager, price impact can be difficult to discern in noisy securities markets, but where the manager receives less than one hundred percent of the benefits from monitoring its brokers the shortfall could be substantial. Contrary to conventional wisdom, a money manager’s use of client commissions to pay for research reduces these conflicts of interest. As the 1975 Senate Report recognized, soft dollars (as they were then known) are an evolved business arrangement that provides investors substantial advantages.

A. The Principal-Agent Problem in Money Management

1. Conventional Wisdom

Following deregulation of fixed commissions, a number of commentators insisted that soft dollars malign managers’ incentives, leading them to churn the portfolio to generate additional brokerage commissions to pay the research bill they should instead pay out of their management fee. Others argued that soft dollars lead the manager to compromise execution quality out of a misplaced sense of loyalty to a providing broker whose execution quality is low. According to Robert Pozen (1976) — now CEO of mutual fund adviser Massachusetts Financial Services — writing shortly after the

92 An asset-based fee consists of a recurring percentage of the value of the client’s account, often around 30 basis points. An “incentive” fee might consist of an asset-based fee plus or minus a larger share of alpha relative to a stated benchmark, with the money manager bearing a share of both positive and negative alpha within prescribed limits.
deregulation of fixed commissions, “money managers have an incentive to make an excessive number of trades for their clients’ accounts under soft dollar payments . . . [and to] maximize the flow of securities research at their clients’ expense.”

Ten years later, Lee Burgunder and Karl Hartmann (1986) attempted to describe the conflicts arising from bundling in cost-benefit terms:

“In an environment without section 28(e), research would be purchased until the last hard dollar spent for the research equalled [sic] the value of that research to the clients. Any additional research would benefit the clients less than its cost, and thus would be an unreasonable expenditure. Thus, if one argues that managers are more willing to buy additional research with soft dollars than they would using hard dollars, then one admits that the purchases are unreasonable in relation to their cost.”

Dennis Logue (1991) may have been the first scholar to suggest that a money manager’s use of client commissions to acquire research could compromise execution quality. He emphasized that brokerage commissions “are only one part of transaction costs.” Price impact, he correctly observed, must also be included in the calculus. In his view, the failure of a pension plan sponsor or fund manager to account for these costs can have a substantial effect on total transaction costs and ultimately on fund performance. As he put it:

The costs of extremely poor trade executions can far exceed the cash value of the research service. Thus in many instances it is likely true that paying cash for what is truly needed and systematically selecting the broker likely to produce the lowest total transaction cost may be far less costly than the soft-dollar arrangements that may push a [pension] sponsor or [money] manager to deal with a brokerage firm which has very high market impact costs.

The sentiment conveyed by these and other commentators is no doubt the source of the SEC’s continuing concern over the conflicts of interest thought to plague soft

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dollar brokerage. Owing to their apparent ignorance of the simple economics of principal-agent relations, however, these commentators have stated the incentive effects of bundling research into client commissions exactly backwards.

2. The Simple Economics of Principal-Agent Relations

In 1976, Jensen & Meckling published the seminal work on principal-agent relations. Their descriptive analysis relies on “agency costs” to explain how transacting parties organize their business affairs to maximize the gains from trade, in part by reducing the conflicts of interest inherent in agency relations. Agency costs consist of “monitoring costs” incurred by the principal, “bonding costs” incurred by the agent, and “residual losses.” The principal can limit the divergence of an agent’s actions by establishing appropriate incentives, such as sharing profits or other benefits and providing the agent with various inputs complementary to the production process. The principal can also monitor the agents compliance with performance standards, with the threat of termination if his actions prove sub-optimal. In some situations it will pay the agent to spend resources bonding itself against actions that would reduce the benefits of the relationship to the principal. In many agency relationships the parties incur both monitoring and bonding costs. In addition, it is inevitable that some beneficial trade does not occur that would have occurred absent agency costs. These are the residual losses. As long as residual losses persist, the parties have an interest in innovating new types of

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97 It is commonplace to hear soft dollar critics proclaim that all conflicts of interest must be “eliminated.” This is an unworkable goal because conflicts, both specific and general, arise whenever a principal acts through a specialized agent, whom all parties recognize is self interested.

Under agency law, a conflict of interest exists when the agent’s interests are adverse to the principal, but a breach of loyalty occurs only if the agent takes action adverse to the principal without the principal’s knowledge. The American Law Institute, Restatement of the Law, Second, Agency (1958) §§ 23, 389. It is a breach of loyalty that gives rise to a legal claim against an agent, not the mere fact of a conflict of interest. Agents should, of course, make all reasonable efforts to inform their principals of the presence of specific conflicts of interest.

business arrangements to reduce them, that is, to increase the gains from trade. Agency costs limit this process.

_Bundling: An Efficient Research Subsidy_

The extensive literature on the economics of agency relations uniformly recognizes that agents, such as money managers, whose compensation is based on a fractional share of benefits to their clients, have too little incentive to produce gains for their principal if they are required to pay the entire expense of generating those benefits out of their own account. It is therefore in the principal’s interest to subsidize inputs that complement the agent’s labor effort. Few corporate managers or other agents pay for their own business travel, office space and furniture, computers, telephone calls, copies, etc., because these and other inputs enhance their productivity, and in any event labor market competition will ensure they earn only a normal wage as compensation for their human capital. The standard market-driven arrangement between money managers and their clients is to allow research to be bundled into client commissions. The obvious alternative to bundling would be to increase managers’ compensation by the expected cost of such inputs and to require them to bear the research expenses directly. But unless the client (or clients) can effectively monitor their managers’ research expenditures this would very likely lead managers to be inefficiently frugal. Following this logic, the primary concern money management clients should have is not that managers will over-use brokerage and research services but that they will under-use them if required to pay the entire expense out of their management fee.\(^99\)

Contrary to prevailing wisdom, the critical conflict of interest for fund managers is that they will spend too little on research, devote too little labor effort to identifying mispriced securities, and do too few profitable trades.\(^100\) If spending a dollar out of his own pocket on research yields a two-dollar increase in portfolio wealth but the manager

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99 Even an individual principal will decline to spend a dollar monitoring his agent if the benefits from improved agent decision making are less than a dollar, but the situation becomes especially acute where the principal consists of a securities portfolio whose investors are numerous and dispersed.

100 They may also engage in sub-optimal monitoring of execution quality, but the use of a quality-assuring performance bond reduces this problem.
receives only fifteen cents as his fractional share, he may decline to spend the dollar. This kind of underinvestment is known in the agency literature as the “shirking” problem, and in the context of money management it could lead the manager to be under-researched absent a research subsidy from the client.101

The efficiency of bundling research into client commissions to reduce the manager’s tendency to shirk is illustrated in Figure 2. MC shows the marginal cost of active management inputs, consisting of the optimal combination of raw research inputs, manager labor effort to identify mispriced securities, and broker executions. As the manager increases management inputs, marginal cost rises while the increment to portfolio wealth declines, shown by $\Delta$NAV. As a conflict-free benchmark, if the manager owns the entire portfolio and pays all the costs of generating profitable trades he continues providing management up to $M^*$, where $MC = \Delta$NAV, and total portfolio wealth is maximized. But because he receives only a small fractional share, $\theta$, of $\Delta$NAV he instead provides management inputs only up to $M^\circ$,102 where $MC = \theta\Delta$NAV. This outcome fails to maximize the parties’ joint wealth because an additional dollar spent on research generates more than a dollar in $\Delta$NAV. Presumably the cost to clients from monitoring the manager to ensure he completely refrains from shirking are prohibitive. Burdunder & Hartmann are correct that bundling leads managers to do more research than they would otherwise do, but by failing to account for the manager’s tendency to do too little research the conclusion they draw that managers will therefore use too much research is simply wrong. No one familiar with the simple economics of principal-agent relations could draw their conclusion.

It is unsurprising that the beneficiaries of managed portfolios — whether fund investors, trust beneficiaries, 401(k) participants, individual retirement account holders, or pension plan sponsors — routinely subsidize their managers’ use of brokerage and allow them to bundle the cost of research and other services into the brokerage commission through some form of soft dollar arrangement. It is economically incorrect to suggest that investors are in some way defrauded by their managers’ use of bundled

101 See Jensen & Meckling, supra n. ?.
102 It is important to note that managers’ share of the portfolio residual is substantially larger than their one-period management because they receive a recurring fee. Any permanent increase in portfolio wealth provides them with an increase in compensation equal to the present value of the increase in future fees.
research given the findings of the 1975 Senate Report, which explain that bundling was and should continue to be standard practice, essentially a custom of the industry. In any market setting there are all sorts of things the typical consumer does not actually know about any product. This is essential to avoid information overload. In an efficient, competitive market, however, they can be presumed to have constructive knowledge because marginal consumers, who have actual knowledge, adjust their demand and supply until all relevant benefits and costs are impounded into the price everyone pays.

By agreeing to pay brokerage commissions covering pure execution costs, for example, the client causes the manager’s cost of inputs to fall, say, to MC-E, in which case he increases management to $M^*$. By also allowing the manager to bundle the cost of research into the brokerage commission, the client further reduces the manager’s costs, say to MC-E-R. This encourages him to increase management inputs, perhaps all the way to $M^*$. With increased management, including research, the manager is likely to identify more profitable trading opportunities and to have good reason to order more portfolio trades. Managers earn no expected surplus as a result of the research subsidy because competition bids down their fees so they just cover their opportunity cost. The important point regarding incentive alignment is that, at the margin, bundling adjusts relative prices to encourage managers to do more research and more trading for the benefit of portfolio investors. According to the simple economics of agency relations, research can be expected to add alpha.

### Bundling and Quality Assurance

A final conflict of interest worth noting is a variant of the leakage problem: price impact owing to low-quality brokerage execution. It would be difficult to find an industry that departs more radically than institutional securities brokerage from the neoclassical economic model of frictionless exchange of goods whose quality is known to

103 See Tae-Young Paik and Pradyot K. Sen, Project Evaluation and Control in Decentralized Firms: Is Capital Rationing always Optimal?, 41 MGMT. SCI. 1404 (1995), whose results suggest that if research inputs, labor effort, and broker executions are complementary and normal inputs in portfolio management, subsidizing any single input will encourage managers to use more of all inputs.

104 This form of organization is known as a “two-part tariff in the economics literature.” Walter Y. Oi, A Disneyland Dilemma: Two-Part Tariffs for a Mickey Mouse Monopoly, 85 Q.J. Econ. 77 (1971); Richard Schmalense, Monopolistic Two-Part Pricing Arrangements, 12 Bell J. Econ. 445 (1981).
both parties. In contrast to such “search” goods, institutional brokerage is what economists recognize as an “experience” good, one that is too costly for the buyer to fully evaluate at the moment trade occurs and whose precise quality will become apparent only in time or with repeated use. For certain experience goods, moreover, unexpectedly low quality can impose substantial indirect costs on the buyer. Not only is the quality of a broker’s execution costly for a portfolio manager to evaluate owing to the inherent noisiness of securities prices, as Logue emphasized, but price impact on large block trades can easily overwhelm brokerage commissions and create a substantial drag on investor returns.105

The problem of assuring the quality of experience goods is one economists have examined in detail. Various economic models demonstrate the effectiveness of reputational capital, long-term relationships, performance bonding, hostages, monitoring, and other forms of organization at overcoming the moral hazard and adverse selection problems experience goods present.106 The solution often requires the buyer to pay a premium price that provides the seller with a surplus, or “economic rent,” for honoring his quality commitment. This should come as no surprise. The average consumer routinely buys hundreds of experience goods for which he happily pays a premium price to assure quality — gasoline, golf balls, fine perfume, and even garden-variety aspirin are just a few such goods. Aspirin buyers often pay a premium price for branded tablets, for example, although the generic equivalent is far cheaper and said to be chemically identical. Studies suggest that even those consumers who buy generic aspirin for

105 From the Concept Release: Footnote 32 “Virtually all the major institutions have a transaction-cost measuring system in place. They compare their actual execution costs to pre-trade benchmarks from models or peer comparisons from different firms. That puts pressure on the trading desks to control costs. So the guys who aren’t doing it are being left behind.” Sahoo, supra note ?? (quoting Ananth Madhavan). “... [M]ore pension funds and investment managers are measuring transaction costs -- either by using proprietary systems or third party services ... Since the wrenching bear market of 2000 - ’02, institutions have learned that transaction costs can be a significant drag on performance, and they have begun managing them as intently as they research stocks.” See, also, Schack, supra note 10, at 32; and See, e.g., Stephen A. Berkowitz et al., The Total Cost of Transactions on the NYSE, 43 J. Fin. 97, 98 (1988).
themselves tend to favor branded aspirin over generic for their children, where quality assurance is considered particularly important.107

The mechanism by which premium prices can be used to assure quality is illustrated in Figure 4. It is plausible to assume that high-quality trades that minimize price impact are more costly for a broker to execute than low-quality trades. For simplicity, assume the broker’s cost of low-quality execution is zero and that high-quality execution costs three cents per share. If the cost of legally verifying the quality of broker executions was reasonably low, managers could enter into binding warranties with their brokers and seek money damages on behalf of the portfolio against those whose carelessness or greed led to excessive price impact. Absent egregious conduct by a broker — frontrunning being a potentially verifiable example108 — it is impossible for a manager to seek legal recourse against a careless broker because the cost of verifying mere carelessness to an outside party in such a noisy setting is prohibitive. The best the manager can do to protect the portfolio is to terminate brokers whose execution quality proves to be sub-par over an extended series of trades.

Assume, then, that it takes the money manager T trades (or time periods involving a fixed number of trades) to accurately assess execution quality. The obvious arrangement would be for the broker to promise to perform high quality executions and for the manager to agree to pay him three cents per share, so that the broker, who faces competition, exactly covers his opportunity cost. The problem is that the broker may cheat by performing low-quality executions. This allows him to reduce his execution costs from three cents per share to zero, but he nevertheless collects three cents per share from the manager on T trades before the manager terminates him for disloyalty. Even though the broker is terminated after T trades, he earns a surplus of three cents per share on that many trades. This is represented in Figure 4 by the box 3¢ x T.

No manager will allow himself to be consistently fooled by brokers in this way, and they will seek alternative arrangements. One obvious solution is to refuse to pay the broker any commission greater than the cost of executing low-quality trades, which in

107 See Klein & Leffler, at n. 18 (in 1978 the market share of generic aspirin for children was less than 1% compared to a 7% share for generic adult aspirin) and http://www.econlib.org/Library/Enc/BrandNames.html.
108 Frontrunning occurs when a broker or his tipee purposely trades a security ahead of the client’s trades in anticipation of a price correction. The inevitable result is price impact.
this case is zero.\footnote{Obviously even low-quality executions cost the broker something. The example is constructed for simplicity on a net-of-low-quality-cost basis. If the reader is uncomfortable with this simplification, simply add back two cents per share for the cost of low-quality execution into all commission levels.} This solution is less than ideal because the manager (and his client(s)) must suffer the price impact associated with low-quality executions. The manager can do better. He can offer to pay the broker a premium commission of five cents per share and, again, he threatens the broker with termination after T trades if he discovers low quality. The broker faces the following calculus. If he cheats he earns a surplus of five cents per share times T trades, shown in Figure 4 by the box $5\epsilon \times T$. Alternatively, he can provide the manager with the promised high-quality executions, in which case he earns a surplus of two cents per share for as long as the trading relationship lasts, which in the limit is forever. This is shown by the long strip $5\epsilon - 3\epsilon$. Whether or not the broker chooses to cheat depends, in part, on the discount rate because the benefits from maintaining high quality accrue further out in time than the benefits from cheating. Nonetheless, whatever reasonable discount rate one chooses there is some commission premium sufficiently high that the broker will never choose to cheat. The only question the manager has is whether the premium commissions he must pay are less than the price impact he avoids. It is entirely plausible, in theory, that he is better off paying a quality-assuring commission premium. The statement by Logue quoted above suggests that price impact can easily swamp the premium commission necessary to compensate for bundled in research.

Before examining the empirical work, it is worth looking at the role research might play in quality assurance. The lingering question in the above example is how the broker can persistently earn a surplus of two cents per share given that he faces competition from other brokers. The answer is that the broker competes for the manager’s business by providing research rather than by lowering the commission he charges. Indeed, it is widely understood in this setting that if the broker offers to cut the commission managers will take it as a reliable signal that he intends to cheat and will terminate the relationship. This is the sense in which \textit{price assures quality}, as with so many consumer goods.

The quality assuring role of premium commissions can be further enhanced where the broker provides the research up-front in exchange for the managers promise to send
him a sufficient number of trades as compensation. In essence, the up-front research payment by the broker serves as a quality-assuring performance bond. If the manager discovers the broker cheating, he is free to terminate the broker, who will be out-of-pocket for any shortfall. There is nothing the broker can do to claw back the research because all parties know the manager is legally prohibited from binding himself to trade with a particular broker. To do so would violate the manager’s fiduciary duty of “best execution.”

In some settings, as in equity markets, it appears that brokers routinely provide managers with up-front research, as, for example, where a prime broker finances a start-up hedge fund’s entire trading desk in anticipation of receiving its future premium commission business. Whether or not there are opportunities for this kind of performance bonding in fixed income markets remains to be seen. In part, this depends on the extent to which price impact is a problem in fixed income trading. In some cases the answer is probably no, as where a single trader seldom holds more than a tiny fraction of a bond issue, as with U.S. government bonds. Where the trader holds corporate bonds, however, one can easily imagine price impact on trades by those who specialize in assessing corporate bankruptcy risk and participating in reorganization.

There are many possible forms a performance bond can take other than research. The broker might offer to put cash into the portfolio in exchange for the manager’s promise to generate a compensating amount of future premium commission business. Ordinarily, however, a dollar’s worth of research will be worth more to the client than a dollar in cash because of the incentive it gives the manager to be fully researched. At \( M^+ \), in Figure 3, for example, the benefit to the portfolio from additional research, reflected in the height of \( \Delta \text{NAV} \), far exceeds the marginal cost of additional research, as reflected by the vertical difference between \( \text{MC-E} \) and \( \text{MC-E-R} \), which is of course simply \( R \).

The preceding economic models of principal-agent relations and quality assurance are, by themselves, plausible explanations of how bundling research into client commissions can benefit clients by properly aligning managers’ incentives to do the research that generates alpha. The alternative to the \textit{incentive alignment hypothesis} — as

described above by Pozen, Burgunder & Hartman, and Logue, and as reflected in the SEC listing of concerns over conflicts of interest — is what can be termed the *unjust enrichment hypothesis*. The only way to differentiate the two is to identify situations in which they predict opposite relationships between bundling and other variables and to test the predictions against the observed relationships.

B. Empirical Tests

Recent work by Horan & Johnsen (2008) examines the effects of bundling on investor welfare. They derive testable implications for the incentive alignment and unjust enrichment hypotheses and use a large database of quarterly money manager portfolio returns from 1989 to 1997 to perform empirical tests. Rather than being concerned with the performance of public mutual fund managers, as in the studies discussed above, they examine the performance of private money managers — those who manage portfolios for institutional clients such as insurance portfolios, trusts, pension funds, and other large retirement accounts. And rather than relying on the active/index distinction as a proxy for research, they rely on the premium commissions money managers actually paid. Although their inquiry focuses primarily on the use of client commissions for research on equity trades, their database includes both taxable and non-taxable portfolios. The difference is likely to be that tax-exempt portfolios reflect retirement accounts weighted more heavily toward fixed income securities than equities. What is more, their database allowed them to use a more parsimonious measure of research than these studies. Their results strongly suggest managers’ use of client commissions to obtain research benefits for their investors.

1. Theoretical Implications

Both the unjust enrichment hypothesis and the incentive alignment hypothesis predict that bundling leads managers to pay premium commissions and to increase

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portfolio trading (turnover). According to the incentive alignment hypothesis, managers increase turnover as a natural response to the implicit research subsidy, which provides them with both the incentive and the ability to identify profitable trading opportunities. According to the unjust enrichment hypothesis, managers increase turnover to reduce their direct research costs and increase their net compensation at the portfolio’s expense. The effect of bundling on commissions and portfolio turnover would therefore fail to distinguish the two hypotheses.

Comparing the use of bundled brokerage between situations in which investors face high versus low costs in monitoring managers also fails to distinguish the two hypotheses. The unjust enrichment hypothesis predicts bundling will be greater in situations where, for example, multiple investors face a collective action problem because weak monitoring enables managers to unjustly enrich themselves. The incentive alignment hypothesis predicts bundling will be greater where investors face a collective action problem in monitoring managers to ensure they do more research and to carefully evaluate brokers’ execution quality. In this sense, bundling is a substitute for monitoring.

One way to distinguish between the incentive alignment hypothesis and the unjust enrichment hypothesis is to examine the effect of bundling on management fees. Under the unjust enrichment hypothesis, bundling constitutes a “second best” form of manager compensation. In a competitive managerial labor market at least a portion of the associated wealth transfer should be reflected in a lower management fee. Alternatively, if bundling improves managers’ and brokers’ incentives when other mechanisms fail, management fees should be either unrelated to bundling or positively related to it under the plausible assumption that managers collectively share in the gains from efficient economic organization.

The most obvious way to distinguish between the two hypotheses is to examine how bundling affects risk-adjusted returns. The incentive alignment hypothesis predicts that bundling leads to higher risk-adjusted returns as a result of the manager’s increased use of research, labor effort, and brokerage execution as well as his ability to use up-front research to assure execution quality. The unjust enrichment hypothesis predicts bundling will result in lower risk-adjusted returns because the cost of the premium commissions from misappropriating client assets exceeds the value to the portfolio of improved research and execution and any reduction in the management fee.
2. Empirical Effects

*PCMD and Risk-adjusted Returns*

Horan & Johnsen rely on the Mobius database, now owned by CheckFree Investment Services, which has been in the business of selling returns data on money managers to the public since 1989. The database represents both pension assets and institutional money management more generally. Since the database covers private institutional managers rather than mutual fund managers, it contains large index managers such as Wells Fargo-Nikko but not the popular retail Vanguard Index 500 Trust mutual fund. The database does not reflect money managers’ receipt of bundled research directly and therefore does not differentiate between managers’ receipt of proprietary and third-party research. As an indirect measure of bundling, Horan & Johnsen proxy research with Premium Commissions per Managed Dollar (PCMD), calculated as the average premium commission rate multiplied by annual turnover expressed as a percentage of portfolio value. From the average commission rate of roughly seven cents per equity share they deduct the execution-only rate of two cents per share to arrive at PCMD. During the period covered by the database, two cents per share was the amount managers generally paid for brokerage that included no bundled-in research.

Many factors other than bundling are likely to affect commission rates and turnover, including portfolio size, the number of accounts, and trade difficulty. Holding other factors constant, Horan & Johnsen find a negative relation between total portfolio assets and PCMD, no doubt because significant economies of scale exist in trading securities. They also find that an increase in the number of accounts included in the portfolio increases PCMD, which is consistent with the notion that a larger number of accounts increases administrative costs for the broker booking the trades for multiple account.

Investors can monitor managers in a number of ways, and when ownership concentration is high they have a greater incentive to do so. Horan (1998) presents evidence suggesting that managers having pension funds as clients (i.e. those managing tax-exempt defined benefit assets) are more heavily monitored than those without, among
other reasons because the plan sponsor (the employer) rather than disbursed employees and retirees bear the residual from portfolio performance. Barring insolvency, if the portfolio performs poorly the plan sponsor must nevertheless fulfill its fixed pension promise to retirees. Plan sponsors therefore have a strong incentive to monitor their portfolio managers, and they routinely rely on professional pension consultants to help them do so. The database indeed shows that portfolios composed of pension assets use less bundled brokerage, as do portfolios in certain strategy classes (e.g., index, mutual fund timing). These results suggest that bundling is less common in situations subject to supplemental monitoring mechanisms and are consistent with both the unjust enrichment hypothesis and incentive alignment hypotheses.

Horan & Johnsen calculate each portfolio manager’s risk adjusted returns (alpha) using various models, including Jensen’s one-factor model as described above. The results are unchanged across the various specifications. After performing a number of robustness checks and using multivariate regression analysis to adjust for the effects of total portfolio assets, number of accounts, tax-exempt assets, indexing, and trade difficulty as reflected in various style categories, they find that PCMD is positively associated with risk-adjusted returns at the 99% confidence level. Since risk-adjusted returns are net of commissions (and other transaction costs), bundled brokerage clearly appears to provide a net benefit to investors. For a typical manager having 50% annual turnover, increasing the average commission rate by two cents per share increases alpha by 4.3 basis points per quarter, or about 13 basis points annually.

Consistent with Wermers (2000), the results suggest that indexed portfolios under-perform their actively managed counterparts both in the presence or absence of other strategy class control variables. Moreover, portfolios with a high proportion of pension assets have relatively low returns compared to portfolios having non-pension assets, which is consistent with evidence presented by Ambachtsheer (1994). One reason for this might be that pension portfolios are more heavily weighted toward fixed

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income securities than non-pension portfolios. These results are inconsistent with the unjust enrichment hypothesis but fail to reject the incentive alignment hypothesis.

**PCMD and Management Fees**

Horan & Johnsen find that management fees expressed in basis points for various account sizes appear unrelated to bundling regardless of account size. Interestingly, fees tend to increase with past performance, suggesting that managers who recently reported positive risk-adjusted returns gain the power to bargain for higher fees. Although the estimated coefficients on alpha are statistically insignificant, their significance increases with account size, and the expected negative relation between indexing and management fees is clear. They find that the relation between bundling and management fees is generally positive and statistically significant for large accounts. A typical manager of a US$ 100 million account having 50% annual turnover who pays an extra two cents per share in brokerage commissions is able to charge an extra 1.05 basis points in management fees. It appears that managers do not accept lower management fees in an attempt to unjustly enrich themselves through bundled brokerage. Rather, investors appear to reward managers that rely on bundling with slightly higher management fees or, at least they do not appear to punish the practice. These results withstand various robustness checks and are consistent with the incentive alignment hypothesis but inconsistent with the unjust enrichment hypothesis.

V. Summary and Concluding Remarks

This essay has made several novel and important points regarding money managers’ use of client commissions to obtain fixed income research. First, the prevailing evidence shows that research adds alpha, both in the context of public mutual fund management and in the context of private institutional money management. Second, allowing money managers to bundle research into client commissions efficiently incentivizes them to be fully researched and can be used to reduce their costs of monitoring brokers’ execution quality. Both of these effects benefit their client-investors.
Third, there has been a sea change in the financial services industry leading in-house analysts to depart bulge-bracket banks to set up private research shops providing independent third-party research. At the same time, many established brokers are departing bulge-bracket banks to set up their own registered investment advisory firms, no doubt bringing much of their established client base with them. Fourth, as baby boomers near retirement they will increasingly weight their portfolios toward fixed income securities and away from equities. Their actual retirement will bring a wave of rollovers from 401(k) plans to individual retirement accounts. Much of this money will likely find its way into the hands of startup investment advisers who lack established research departments. Fifth, the SEC has affirmatively found that money managers’ receipt of research on fixed income agency and certain riskless principal trades is protected by the Section 28(e) safe harbor. The eligible opportunities for safe harbor protection on fixed income securities trades are expanding with the entry into the market of non-positioning bond traders. Finally, client commission arrangements on fixed income trades will allow them to obtain the research necessary to fulfill fiduciary obligations to their client-investors by increasing alpha while maintaining suitably low portfolio risk for retired investors.

The widespread antipathy toward bundling research into client commissions may arise because the practice appears intended to influencing the money manager’s decisions. Rather than creating conflicts of interest for money managers, however, bundling actually appears to reduce conflicts by encouraging the manager to be fully researched and, at least in some situations, by reducing his cost of monitoring brokers’ execution quality. In the highly specialized world of financial services, transacting parties must balance myriad countervailing conflicts. A foremost example is managers’ decision, almost invariably, to use brokers to execute trades rather than trading directly for their own accounts. Managers and their clients benefit from the expertise of specialized execution and at the same time gain an important measure of anonymity. Anonymity reduces price impact, but it comes at the cost of insinuating a self-interested broker into the equation, thereby creating a countervailing conflict of interest.

Clearly, money managers have a fiduciary duty to be fully researched as reflected by M* units of management in Figure 3. Given the research subsidy inherent in
bundling, the possibility remains that managers use too much research, perhaps going beyond M*. Where the manager receives third-party research in the form of generic inputs he has little to gain from overuse, however, because generic research has no intrinsic value unless the manager provides his own labor effort to transform it into conclusions regarding profitable trading opportunities. From this perspective it may be that managers overuse proprietary research. With proprietary research the broker provides the labor effort to identify mispriced securities, thereby allowing the manager to conserve his own labor effort. This suggests yet another possible conflict of interest.

Several commentators have suggested that a manager’s failure to be fully researched might subject him to civil suits for breach of fiduciary duty under certain circumstances. Recent developments in Delaware State corporation law suggest, for example, that its courts are increasingly willing to impose on corporate fiduciaries liability for omissions, that is, for failure to act in the face of an affirmative duty to do so. As Lemke & Lins put it in the context of money management,

“Some in the industry have raised the possibility that it could be a breach of fiduciary duty for a money manager not to take advantage of the wide variety of brokerage or research services made available with [client commissions]. . . . ‘[And] some money managers have expressed concern about being sued for paying up for research . . . . It appears they should be more concerned about being sued for acting imprudently if they deliberately cut themselves off from street research or refuse to pay up for other needed brokerage services to the detriment of the accounts they manage.’”

Being under-researched could be an especially troublesome prospect for the new wave of registered investment advisers migrating away from their former positions as brokers in

\[114\] See, e.g., Smith v. Van Gorkom, 488 A.2d 858 (Supreme Court of Delaware, 1985)(holding corporate directors in a control transaction liable for gross negligence in failing to inform themselves of alternative buyers); In re Caremark Intl. Inc., 698 A.2d 959 (Del. Chancery Ct., 1996)(Chancellor Allen: “the core element of any corporate law duty of care inquiry [is] whether there was good faith effort to be informed and exercise judgment. . . . Liability for failure to monitor . . . is theoretically possible [in] circumstances in which a loss eventuates not from a decision but, from unconsidered inaction.”); Stone v. Ridder, 911 A.2d 362 (Del. S. Ct., 2006)(“A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, . . . or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.” J. Holland quoting Brehm v. Eisner (In re Walt Disney Co. Derivative Litig.), 906 A.2d 27 (2006).

bulge-bracket banks, especially if poor performance can be causally linked to a failure to employ research inputs widely regarded as prudent by industry standards. Lacking established research departments, it is essential that smaller management operations use all available resources within the bonds of prudence and existing law to obtain the research necessary to benefit their clients.
Figure 1
Relations Between the Parties
Figure 2: Regression Line
Figure 3
The Agency Problem in Money Management

Management = M(R, L, E)
Figure 4
Quality Assurance