

## Notes

# **FIXING SOFT DOLLARS IS NOT THAT HARD: A CONSENT AND REPORTING FRAMEWORK FOR REGULATING CLIENT COMMISSION ARRANGEMENTS**

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### ABSTRACT

*Under soft dollar arrangements, investment advisers promise portfolio trades to participating brokers in exchange for investment research or other benefits. Recently, some academics, financial regulators, and practitioners have scrutinized such arrangements, arguing that they provide an avenue for advisers to unjustly enrich themselves at the expense of their clients. However, others defend soft dollar arrangements, seeing them as a mechanism for binding advisers to clients and increasing client returns.*

*A safe harbor currently protects advisers' use of soft dollars, so long as certain minimum requirements are met. Critics argue that soft dollars should be banned outright, contending that advisers should be required to pay for all investment research and advisory benefits out of their own pocket rather than by using clients' commissions. Supporters recommend maintaining the status quo, arguing that the safe harbor promotes access to diverse research that, ultimately, benefits clients.*

*This Note analyzes the benefits and drawbacks of soft dollar arrangements, the original rationales for the development of the soft dollar safe harbor, and the agency costs and conflicts of interest inherent in maintaining the safe harbor. This Note advocates a middle ground between maintaining the status quo and banning soft dollars outright: a consent and reporting framework for the use of soft dollars that is consistent with general principles of agency and the fiduciary duties that advisers owe their clients.*

## INTRODUCTION

Through soft dollar brokerage arrangements, investment advisers can use their clients' trading commissions to pay for research and brokerage services. Although the use of such arrangements is "virtually invisible" to individual clients,<sup>1</sup> soft dollars constitute a billion-dollar industry<sup>2</sup> in the United States that touches more than ninety-five million people.<sup>3</sup> Almost all investment advisers have soft dollar arrangements with the broker-dealers<sup>4</sup> that carry out their clients' transactions.<sup>5</sup>

To understand how soft dollar arrangements work, consider the following scenario: A parent gives a babysitter ten dollars to buy his kids some ice cream. Although ice cream usually costs five dollars per pint, the babysitter finds a great deal: four pints for ten dollars. She uses the full ten dollars to buy four pints, gives two to the children, and keeps the other two without telling the family, using them when she watches another family's kids or keeping them for herself.

Real soft dollar arrangements are not so different. Clients hire investment advisers to research, identify, and execute portfolio transactions. When an adviser identifies a trade, he contracts with a broker-dealer to execute the trade for the client on the most advantageous terms possible. The adviser has a choice in selecting a broker-dealer: route the trade through a discount broker that charges a commission rate of approximately two cents per share, or, as happens more often, route the trade through a premium broker at a rate of

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1. D. Bruce Johnsen, *Property Rights to Investment Research: The Agency Costs of Soft Dollar Brokerage*, 11 YALE J. ON REG. 75, 77 (1994).

2. OFFICE OF COMPLIANCE, INSPECTIONS & EXAMINATIONS, U.S. SEC. & EXCH. COMM'N, INSPECTION REPORT ON THE SOFT DOLLAR PRACTICES OF BROKER-DEALERS, INVESTMENT ADVISERS, AND MUTUAL FUNDS (Sept. 22, 1998) [hereinafter INSPECTION REPORT], <https://www.sec.gov/news/studies/softdolar.htm> [<https://perma.cc/EE5H-8U63>].

3. Sarah Holden, Daniel Schrass & Michael Bogdan, *Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2016*, 22 ICI RESEARCH PERSPECTIVE 1, 2 (2016) (finding, in mid-2016, that there were 95.8 million U.S. individuals invested in some type of registered fund, including mutual funds). This statistic may be under inclusive, as it does not include those solely invested in individual accounts through private investment advisers that employ soft dollars. *Id.*

4. A broker is an individual who, for a small commission fee, matches buyers and sellers of securities in an exchange. A dealer is an individual who purchases securities at one price from a seller and then sells those securities later to a buyer at a slightly higher price, profiting from the price discrepancy. A broker-dealer acts as both as a broker and a dealer.

5. See INSPECTION REPORT, *supra* note 2 ("[A]lmost all advisers obtain products and services (both proprietary and third-party) other than pure execution from broker-dealers.").

about six cents per share.<sup>6</sup> While either kind of broker can execute the transaction, premium brokers provide advisers with additional research or brokerage services that advisers can use in managing their clients' accounts—soft dollar benefits. Although these benefits accrue to the adviser, the broker's commission cost comes directly out of the client's holdings.<sup>7</sup>

Investment advisers must abide by fiduciary duties in managing their clients' accounts.<sup>8</sup> These include the general common-law duties of care and loyalty, which require the adviser to seek “the most favorable terms” for the execution of client transactions that are “reasonably available under the circumstances.”<sup>9</sup> However, federal law contains a safe harbor provision that protects investment advisers when they receive soft dollar benefits: Advisers are allowed to use research and brokerage services paid for by *one* client for the benefit of *any* of their clients without breaching their fiduciary duties, so long as the commission paid is “reasonable” compared to the services received.<sup>10</sup> Thus, an adviser can disregard whether his receipts will actually benefit the client that paid for them and, instead, seek out services that benefit other clients' accounts. In other words, although soft dollar benefits that accrue from a single client's commission should, in theory, belong to that client,<sup>11</sup> an adviser is free to use the benefits broadly instead.

While conflicts of interest inhere in all investment-advisory relationships,<sup>12</sup> two conflicts specifically relate to advisers' use of soft

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6. Stephen M. Horan & D. Bruce Johnsen, *Can Third-Party Payments Benefit the Principal? The Case of Soft Dollar Brokerage*, 28 INT'L REV. L. & ECON. 56, 57–58 (2008).

7. Typically, the price of purchased securities includes the commission. For example, if a stock is trading at \$10.00 per share, the cost to the client to purchase one share of the stock would be approximately \$10.02 if the trade is routed through a discount broker, but \$10.06 if routed through a premium broker.

8. *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 471 n.11 (1977) (interpreting a prior Supreme Court decision as “recognition that Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers”).

9. *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 270 (3d Cir. 1998).

10. 15 U.S.C. § 78bb(e)(1) (2012).

11. *See* SOFT DOLLAR STANDARDS § IA1 (CFA INST. 2011) (creating soft dollar standards for CFA Institute members centered on the fundamental principle that “[b]rokerage is the property of the Client”).

12. For example, investment advisers usually earn a flat fee based on the value of assets under management. Accordingly, advisers have little incentive to research trades intensively; they will only receive “a small share of any wealth increase they generate.” Johnsen, *supra* note 1, at 87. When trades are not well researched, clients become worse off. Further, unscrupulous broker-dealers can cheat advisers and their clients by poorly executing trades, costing the client money but saving the broker-dealer the cost of proper trade execution. *Id.*

dollars. First, the safe harbor described above creates conflicts between an adviser's various clients, as advisers need not use soft dollars to benefit the specific client whose commissions generated them. Second, under the guise of receiving research or brokerage services, an adviser may use soft dollars generated from client commissions to enrich himself—and trade excessively to increase the value of said enrichment.<sup>13</sup> For example, advisers have used soft dollars to pay for general administrative expenses,<sup>14</sup> simply pocketed the money,<sup>15</sup> and engaged in any number of specific abuses,<sup>16</sup> like using soft dollars to make rent,<sup>17</sup> covering personal travel expenses<sup>18</sup> and vacation timeshare fees,<sup>19</sup> and paying \$300,000 toward a marital settlement.<sup>20</sup> Unsurprisingly, one former Chairman of the Securities and Exchange Commission, Christopher Cox, has called soft dollars a “witch’s brew of hidden fees, conflicts of interest and complexity . . . at odds with the investor’s best interest.”<sup>21</sup>

In light of these abuses, the current framework governing soft dollar arrangements should be adjusted, and the safe harbor should be repealed. By creating the safe harbor, Congress has allowed advisers incredible discretion in their use of soft dollars. The safe harbor runs contrary to both advisers’ fiduciary duties and the principles of agency

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13. See, e.g., Sage Advisory Servs. LLC, Securities Act Release No. 7997, 2001 WL 849405, at \*2 (July 27, 2001) (finding that an adviser misappropriated almost \$900,000 in soft dollar credits and churned client accounts to generate more credits). This may also motivate an adviser to select a broker-dealer based on research rather than execution capability.

14. See, e.g., INSPECTION REPORT, *supra* note 2 (stating that advisers have used soft dollars to pay for office rent, equipment, cellular phone services, and other administrative costs).

15. See, e.g., SEC v. Sweeney Capital Mgmt. Inc., Litigation Release No. 15664, 1998 WL 102672, at \*1 (Mar. 10, 1998) (finding that an investment adviser misappropriated \$109,000 in soft dollars to pay for, among other things, artwork, furniture, and other personal expenses).

16. See Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 54165, 2005 WL 4843294, at \*2 n.8 (July 18, 2006) [hereinafter 2006 Guidance] (listing examples of SEC enforcement actions involving client commission practices).

17. INSPECTION REPORT, *supra* note 2.

18. Dawson-Samberg Capital Mgmt., Inc., Investment Advisers Act Release No. 1889, 2000 WL 1092961, at \*3 (Aug. 3, 2000).

19. J.S. Oliver Capital Mgmt., LP, Securities Act Release No. 10100, 2016 WL 3361166, at \*7 (June 17, 2016).

20. *Id.*

21. Joseph Giannone, *SEC Head Urges Crackdown on “Soft Dollar” Deals*, REUTERS (May 31, 2007, 2:50 PM), <http://www.reuters.com/article/businesspro-sec-softdollars-dc/sec-head-urges-crackdown-on-soft-dollar-deals-idUSN3122527720070531> [<https://perma.cc/VXT7-TSF9>].

that underlie investor-adviser relationships.<sup>22</sup> And the original rationales for the safe harbor—promoting the availability of investment research and protecting those advisers that use soft dollar arrangements, but lack sufficient technology to prove compliance with their fiduciary duties—no longer hold.

Still, soft dollar arrangements should not be banned entirely. When employed effectively and in each client’s best interest, soft dollar arrangements can be beneficial. Soft dollars can serve to bind the broker-dealer executing the trade to the adviser, and the adviser to the client, which helps to minimize the agency costs of investment relationships.<sup>23</sup> Empirical evidence also shows that using soft dollars can increase investor returns.<sup>24</sup>

If Congress were to repeal the soft dollar safe harbor, the general agency laws and fiduciary duties that underlie other agency relationships would govern soft dollar arrangements instead. These fiduciary duties generally require the agent to make full disclosure of all material facts to the principal and gain the principal’s consent.<sup>25</sup> In keeping with this typical standard, the SEC should require investment advisers to obtain consent from their clients before engaging in soft dollar arrangements that use client commission dollars. Then, the SEC should impose detailed periodic reporting requirements on advisers’ soft dollar use, including a quantitative requirement—presenting the commission dollars spent and the soft dollar benefits received—and a qualitative requirement—discussing how the soft dollar benefits received by the adviser are used in the client’s individual best interest. By requiring advisers to periodically let their use of client commissions see the light of day, this consent and reporting framework would deter abuse and, in turn, help clients determine whether their advisers are acting in their individual best interests.

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22. See *In re Hughes*, Exchange Act Release No. 4048, 1948 WL 29537, at \*4 (Apr. 1, 1948) (“The very function of furnishing investment counsel on a fee basis . . . cultivates a confidential and intimate relationship and imposes a duty upon [the adviser] to act in the best interests of her clients and to make only such recommendations as will best serve such interest.”), *aff’d sub nom.*, *Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949).

23. Johnsen, *supra* note 1, at 87.

24. Horan & Johnsen, *supra* note 6, at 74–75 (finding, through an empirical study, that premium commissions are positively related to management fees in the private wealth management context).

25. See *Cooke v. Oolie*, No. CIV. A. 11134, 2000 WL 710199, at \*13 (Del. Ch. May 24, 2000) (stating that conflicted transactions will be upheld if the interested party makes full disclosure of material facts and gains approval to undertake the transaction).

This Note proceeds as follows: Part I provides a background on soft dollars and their current regulatory framework. Part II discusses the benefits and drawbacks of soft dollar arrangements. Part III analyzes why the soft dollar safe harbor should be repealed. Finally, Part IV sets forth a new consent-and-reporting framework for soft dollar arrangements.

## I. BACKGROUND ON SOFT DOLLARS AND THE CURRENT REGULATORY FRAMEWORK

### A. *The History of Soft Dollars and the Development of Section 28(e)*

From the founding of the New York Stock Exchange (NYSE) in 1792<sup>26</sup> until 1975, brokers' commissions were fixed at 0.25 percent<sup>27</sup>—a rate far above the cost of executing a trade. In the years leading up to 1975, however, the securities industry underwent a period of drastic change. Prior to 1940, most securities were held by private, individual investors. But, after the Investment Company Act of 1940 implemented regulations governing mutual funds and other pooled investment vehicles, investor confidence in those products increased, spurring tremendous growth in institutional portfolio and mutual fund holdings.<sup>28</sup> As institutional holdings grew, brokerage firms began competing to win the increasing trade volume and size caused by this concentration.<sup>29</sup> Since the fixed commission rate was inflated above execution cost, brokers began to offer non-price concessions to incentivize advisers to send trades their way.<sup>30</sup> Because just a handful of full-service brokerage firms produced most of the industry's investment research,<sup>31</sup> one popular concession became the “research rebate,” whereby brokers would provide institutional advisers with in-house research, free of charge, by bundling the cost of research into

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26. PETER WYCKOFF, *WALL STREET AND THE STOCK MARKETS: A CHRONOLOGY* (1644–1971) 145 (1972).

27. James F. Jordan, “*Paying Up*” for Research: *A Regulatory and Legislative Analysis*, 1975 DUKE L.J. 1103, 1105 n.6 (1975).

28. See INV. CO. INST., 2017 INVESTMENT COMPANY FACT BOOK 170 (57th ed. 2017) (finding the number of dollars invested in mutual funds to have grown from \$0.45 billion across sixty-eight funds in 1940 to \$45.87 billion across 426 funds by 1975).

29. Johnsen, *supra* note 1, at 81.

30. *Id.*

31. D. Bruce Johnsen, *The SEC's 2006 Soft Dollar Guidance: Law and Economics*, 30 CARDOZO L. REV. 1545, 1556 (2009) [hereinafter Johnsen, *SEC's 2006 Soft Dollar Guidance*].

their fixed commissions.<sup>32</sup> Thus began the development of soft dollar arrangements.

Over time, investors came to express displeasure with the fixed-commission regime. The high fixed commission cost made it difficult for individual investors to participate in the stock market, as individuals did not trade in large enough volumes to warrant any special incentives like the research rebate.<sup>33</sup> Advances in technology and the concentrating of assets in the hands of large institutional investors prompted advisers to begin developing their own internal research, lessening their reliance on broker rebates.<sup>34</sup> And, in 1963, the Supreme Court delivered a big blow to fixed commissions when it ruled that the NYSE was not exempt from antitrust laws,<sup>35</sup> causing some to suggest that fixed commissions should be outlawed as an anticompetitive practice.<sup>36</sup>

In light of these developments, Congress and the SEC decided to make commissions fully negotiable on national securities exchanges in 1975.<sup>37</sup> With this change, brokerage commissions decreased and trading volumes surged.<sup>38</sup> Still, most broker-dealers continued to bundle their research and execution costs into a single commission.<sup>39</sup> Although many institutional advisers had begun developing their own internal research, reliance on broker-provided research remained significant.<sup>40</sup> Many advisers still depended on the research provided by

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32. *Id.* at 1557.

33. See Kenneth Silber, *The Great Unfixing*, THINKADVISOR (May 1, 2010, 4:00 AM), <https://www.thinkadvisor.com/2010/05/01/the-great-unfixing/> [<https://perma.cc/5NQ8-XQV6>] (stating that “[t]he high costs of trading discouraged broad public participation” in the stock market).

34. Johnsen, *SEC’s 2006 Soft Dollar Guidance*, *supra* note 31, at 1556.

35. *Silver v. N.Y. Stock Exch.*, 373 U.S. 341, 364–65 (1963).

36. See Silber, *supra* note 33 (noting that in the aftermath of *Silver*, the Department of Justice asked the SEC to consider whether fixed commissions should be considered an illegal anticompetitive practice).

37. See Securities Act Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97, 107–08 (1975) (codified as amended at 15 U.S.C. § 78f(e)(1) (2012)) (“[N]o national securities exchange may impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members.”).

38. Gregg A. Jarrell, *Change at the Exchange: The Causes and Effects of Deregulation*, 27 J.L. & ECON. 273, 274 (1984).

39. Johnsen, *supra* note 1, at 76.

40. S. REP. NO. 94-75, at 69 (1975), as reprinted in 1975 U.S.C.C.A.N. 179, 247–48 (“The extent to which a particular investment manager relies on brokerage research varies considerably.”).

broker-dealers and wanted to retain those research sources.<sup>41</sup> With commissions freely negotiable, however, advisers worried about breaching their fiduciary duties to their clients if they did not seek the absolute lowest execution cost for portfolio transactions.<sup>42</sup> But seeking trade execution at the discount rate would require advisers to sacrifice the opportunity to receive research benefits.

To allay these concerns, Congress enacted Section 28(e) of the Securities Exchange Act of 1934 as part of the Securities Act Amendments of 1975.<sup>43</sup> Section 28(e) provides a safe harbor against a breach of fiduciary duty for advisers who engage in soft dollar brokerage practices, provided certain criteria are met.<sup>44</sup> To take advantage of the safe harbor, the adviser must believe, in good faith, that any premium commission paid is reasonable in relation to the research or brokerage services received.<sup>45</sup> When that condition and others are met, advisers can “pay up” for research services without breaching their fiduciary duties to their clients.

### *B. The Structure of a Typical Soft Dollar Arrangement*

A typical advisory arrangement looks like this: Investors hire advisers to manage their funds. Each investor has a separate account, with separate goals, and the advisers manage each accordingly. In the case of a mutual fund, investors put their money into a single pool that the adviser manages according to the pool’s singular mandate.<sup>46</sup> A single mutual fund adviser will often manage multiple mutual funds, each according to different mandates.

Whether managing mutual funds or private accounts, advisers set up arrangements with brokers to execute their trades. These arrangements take one of two general forms. In the first iteration, the adviser and broker might agree that when the adviser sends trades to

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41. See C. Meyrick Payne, “*Follow the Money*” to Understand Soft Dollars, MUTUAL FUND GOVERNANCE CONSULTING, <http://production.mfgovern.com/content/view/32/105/> [https://perma.cc/826U-46J9] (“When the rules changed, investment managers wanted to retain their research sources.”).

42. S. REP. NO. 94-75, at 70.

43. Securities Act Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975).

44. 15 U.S.C. § 78bb(e)(1) (2012).

45. *Id.*

46. Examples of mutual fund mandates include investing only in large-capitalization-value stocks, investing only in medium-term, investment-grade, fixed-income securities, or managing a balanced portfolio while adjusting the riskiness of included securities based on a target retirement year.



the broker, the broker will credit the adviser's account with soft dollar credits—say, \$0.50 worth of credits for every \$1.00 worth of brokerage commissions.<sup>47</sup> As the adviser trades with the broker, his soft dollar credit balance increases. Later, the adviser can exchange the accumulated balance for research and brokerage services provided by the broker.

The second form is for the broker, in advance, to provide credits to pay a portion of the adviser's research bill with an independent research provider. In return, the adviser agrees to send the broker future trades at premium commission rates. For example, the broker may provide the adviser with \$200,000 of research credits up front if the adviser agrees to send the broker trades over a certain period of time to generate \$400,000 in brokerage commissions, which would be considerably more than the amount required to cover the broker's execution costs.<sup>48</sup> Notably, under this kind of arrangement, the adviser's duty to seek best execution<sup>49</sup> eliminates any obligation to continue sending trades to the broker if the adviser feels the broker is inadequately executing the trades.<sup>50</sup>

Under both types of agreement, the clients pay the brokerage commissions, not the adviser. Thus, soft dollar arrangements allow advisers to employ clients' premium commission dollars in order to obtain research and brokerage services for their own use.

### C. *The Soft Dollar Safe Harbor's Scope*

The financial regulatory framework in the United States promotes soft dollars by providing a safe harbor for their use. Section 28(e)'s safe harbor provides that

[n]o person . . . in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law . . . solely by reason of his having caused the account to pay a . . . broker . . . an amount of commission for effecting a securities transaction in excess

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47. See, e.g., Marvin & Palmer Assocs., Inc., Investment Advisers Act Release No. 1841, 1999 WL 777443, at \*2 (Sep. 30, 1999) (describing a brokerage arrangement whereby the adviser "receives \$[0].50 in soft dollar credits for each \$1.00 in brokerage directed to the Broker.").

48. See Horan & Johnsen, *supra* note 6, at 58 (providing a similar example arrangement).

49. On the duty of best execution, see JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, *SECURITIES REGULATION: CASES AND MATERIALS* 1032–33 (7th ed. 2015) (describing the scope of the duty of best execution).

50. See Horan & Johnsen, *supra* note 6, at 58 ("[T]he manager is free to terminate the broker at any time with no legal obligation to make the promised trades.").

of the amount of the commission another . . . broker . . . would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided . . . viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion.<sup>51</sup>

Thus, if an adviser meets certain requirements when undertaking a soft dollar arrangement, the safe harbor prevents the adviser from breaching his fiduciary duties by paying premium commissions to receive soft dollar benefits. To take advantage of the safe harbor, an adviser (1) must have “investment discretion” over a client’s account,<sup>52</sup> (2) can only receive “brokerage and research services” in exchange for the premium commission<sup>53</sup> which (3) must be “provided by” the broker effecting the transaction,<sup>54</sup> and (4) must determine “in good faith” that the commission paid was “reasonable” in light of the brokerage and research services he receives.<sup>55</sup>

Only “brokerage and research services” qualify for the soft dollar safe harbor.<sup>56</sup> Section 28(e) itself defines research services as “advice,” “analyses,” or “reports.”<sup>57</sup> This research must be “the expression of reasoning or knowledge” and provide “lawful and appropriate assistance in making investment decisions,”<sup>58</sup> in addition to analyzing

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51. 15 U.S.C. § 78bb(e)(1) (2012).

52. *Id.* Section 3(a)(35) of the Securities Exchange Act of 1934 defines a person exercising investment discretion as someone “authorized to determine what securities or other property shall be purchased or sold by or for the account.” 15 U.S.C. § 78c(a)(35).

53. 15 U.S.C. § 78bb(e)(1).

54. *Id.* To “effect the transaction,” the broker executes, clears, or settles the trade. *Id.* Of course, when a broker provides an adviser with its own proprietary research or brokerage services the “provided by” requirement is met. *Id.* But the requirement can cause confusion when a broker does not provide its own proprietary research, but, rather, provides the adviser with soft dollar credits that the adviser can use to purchase third-party research. So long as the broker is legally obligated to pay for the product, the broker will be considered to have provided the research. Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Exchange Act Release No. 23170, 1986 WL 630442, at \*5–6 (Apr. 23, 1986) [hereinafter 1986 Guidance].

55. 15 U.S.C. § 78bb(e)(1). The scope of these requirements has been clarified through SEC interpretive releases, most recently in 2006. 2006 Guidance, *supra* note 16.

56. 15 U.S.C. § 78bb(e)(1).

57. *Id.* § 78bb(e)(3)(A)–(B).

58. 2006 Guidance, *supra* note 16, at \*15–16. The lawful and appropriate assistance standard focuses on how a manager uses eligible research. For example, an adviser that uses client commissions to pay for analyses of account performance would not be protected by the safe

certain subject matter<sup>59</sup> to qualify. Under this definition, verbal reports on company performance from corporate executives,<sup>60</sup> seminars and conferences relating to research, and traditional stock or economic reports may all be eligible for safe harbor protection.<sup>61</sup> Importantly, though, the travel and expenses related to obtaining research services are not protected.<sup>62</sup>

Section 28(e) defines brokerage services as the effectuation of securities transactions and “functions incidental thereto.”<sup>63</sup> These incidental functions include, among other things, clearance (reconciling orders between transacting parties), settlement (effectuating the exchange of money for securities), and custody.<sup>64</sup> To the extent that any brokerage or research services are mixed-use, where part of the service qualifies under the safe harbor and part of it does not, the adviser may only use client commission dollars to pay for the portion that qualifies.<sup>65</sup> Additionally, in order to benefit from the safe harbor, the adviser must make a good-faith effort<sup>66</sup> to determine whether any premium commission paid is reasonable in light of the products and services received.<sup>67</sup> The reasonableness of services received, as compared to the commission paid, can be “viewed in terms of *either* [the specific client] transaction or his *overall responsibilities*

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harbor if those analyses were used for marketing purposes, because marketing does not aid in investment decision making. *Id.* at \*19.

59. The statute lists “advice . . . as to the value of securities, the advisability of investing in . . . securities, and the availability of securities” or “analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts” as the research subject matters that qualify for the safe harbor. 15 U.S.C § 78bb(e)(3)(A)–(B).

60. The form the research takes—for example, whether oral or written—is irrelevant to whether it falls under the safe harbor. 2006 Guidance, *supra* note 16, at \*11.

61. *Id.* at \*12.

62. *Id.* at \*12 n.92.

63. 15 U.S.C § 78bb(e)(3)(C) (2012).

64. *Id.* The SEC applies a “temporal standard” when considering whether brokerage services are eligible under the safe harbor. 2006 Guidance, *supra* note 16, at \*17. The safe harbor encompasses brokerage “services related to execution of securities transactions begin[ning] when an order is transmitted to a broker-dealer and end[ing] at the conclusion of clearance and settlement of the transaction.” *Id.* For example, long-term custody services do not qualify under the safe harbor because they continue past the clearance and settlement of the transaction. *Id.* at \*19.

65. 2006 Guidance, *supra* note 16, at \*20.

66. The burden of proof lies with the adviser to demonstrate his good-faith determination. *Id.* at \*20–21. While good faith can be difficult to prove, research offered at an unbundled rate with a known market value can help the adviser make a good-faith determination. *Id.* at \*21.

67. 15 U.S.C § 78bb(e)(1).

with respect to the accounts as to which he exercises investment discretion.”<sup>68</sup> This allows the adviser to disregard the question of whether the soft dollar benefits he receives directly benefit the account that generated the benefits.<sup>69</sup> Instead, one client’s commissions can be used to purchase services that primarily or entirely benefit other clients’ accounts.

In short, by meeting the safe harbor’s requirements, advisers can cause their clients to pay premium commissions for soft dollar benefits—and use those benefits as they please—without breaching their fiduciary duties.<sup>70</sup> Still, if at least one requirement is not met, the adviser cannot take advantage of the safe harbor, and soft dollar use becomes regulated by the traditional fiduciary duties of care and loyalty.<sup>71</sup>

#### *D. Required Disclosures for Soft Dollar Arrangements*

As fiduciaries, advisers have a duty to disclose to their clients all material information regarding potential or actual conflicts of interest.<sup>72</sup> In addition to this general duty, advisers engaged in soft dollar arrangements must comply with all federal securities law disclosure requirements, whether or not the arrangements fall within the Section 28(e) safe harbor.<sup>73</sup> Currently, primary soft dollar disclosures are housed in Form ADV, the main disclosure document for advisers.<sup>74</sup> Advisers are required to deliver Form ADV to each

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68. *Id.* (emphasis added).

69. S. REP. NO. 94-75, at 70 (1975), *reprinted in* 1975 U.S.C.C.A.N. 179, 247 (“It is thus unnecessary for the money manager to show that specific services benefitted specific accounts.”). For example, assume Client A only trades in fixed income securities. Client A’s premium commission dollars can be used to purchase equity research, even though Client A will never benefit from that research. A similar outcome holds in the case of mutual funds managed to specific security-based mandates. However, almost all types of research will benefit mutual funds managed to target retirement dates or those that employ balanced asset allocations.

70. 15 U.S.C. § 78bb(e)(1).

71. As agents, investment advisers owe fiduciary duties to their clients. *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 471 n.11 (1977) (stating that the Supreme Court recognized “that Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers.”). The safe harbor presents only a narrow exception to those duties; if its requirements are not met, normal fiduciary duties apply.

72. 1986 Guidance, *supra* note 54, at \*6 (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191–92 (1963)).

73. *Id.*; *see also* 15 U.S.C. § 78bb(e)(2).

74. In the mutual fund context, Form N-1A also requires a description of how transactions in portfolio securities are processed, as well general descriptions of how brokers are selected and how the reasonableness of commissions paid is evaluated. U.S. SEC. & EXCH. COMM’N, FORM N-

client when they first contract and annually thereafter.<sup>75</sup> Form ADV contains a wealth of information, both general—statements regarding the adviser’s ownership and affiliations, and the education of its managers—and specific—disclosures on matters like soft dollar usage and disciplinary events, as well as fee schedules for the advisory services offered.<sup>76</sup> The soft dollar disclosures included in Form ADV are generally qualitative and descriptive in nature, putting clients on notice of the existence of soft dollar arrangements,<sup>77</sup> but revealing little about their advisers’ actual use of soft dollars.

Clients receive additional information about their advisers’ soft dollar usage in Form ADV’s Part II, Item 12, which houses brokerage practice disclosures. Its purpose is to help clients evaluate any conflicts of interest inherent in their advisers’ arrangements by providing material information about the advisers’ brokerage practices.<sup>78</sup> Item 12 requires disclosure of the factors considered in selecting brokers and determining their compensation.<sup>79</sup> And Item 12 requires advisers to disclose any conflicts of interest created by soft dollar benefits they receive.<sup>80</sup>

Soft dollar disclosures under Item 12 include three general statements. First, advisers must explain that they benefit when they use client brokerage commissions to obtain research or brokerage services because they do not have to pay for those products themselves.<sup>81</sup> Second, advisers must disclose that they have an incentive to select a broker based on their own interest in receiving research, rather than the client’s interest in receiving the most favorable execution terms.<sup>82</sup> And third, advisers must disclose the fact that they may cause clients

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1A, at Item 21 (2017). Mutual funds must also disclose the amount of transactions and commissions directed to certain brokers in exchange for research services. *Id.*

75. 17 C.F.R. § 275.204-3(b) (2017).

76. Form ADV, U.S. SEC. & EXCH. COMM’N (last modified Mar. 11, 2011), <https://www.sec.gov/fast-answers/answersformadvhtm.html> [<https://perma.cc/9AUB-L5P9>].

77. *See* Disclosure of Brokerage Placement Practices by Registered Investment Companies and Certain Other Issuers, Securities Act Release No. 6019, 1979 WL 405250, at \*1 (Jan. 30, 1979) [hereinafter 1979 Release] (describing Form ADV’s disclosures as “narrative, but not statistical, disclosure requirements”).

78. *See id.* at \*5–7 (discussing the background and purpose of the disclosures required in what is now Item 12 of Form ADV).

79. U.S. SEC. & EXCH. COMM’N, FORM ADV, at Part 2, Item 12 (2017).

80. *Id.*

81. *Id.*

82. *Id.*

to pay commissions greater than those charged by discount brokers in order to receive soft dollar benefits.<sup>83</sup>

Item 12 also requires some specific soft dollar disclosures. An adviser must disclose whether he uses soft dollar benefits to service all client accounts or only the accounts that paid for the benefits.<sup>84</sup> In doing so, he must disclose whether he seeks to allocate soft dollar benefits proportionally according to the credits each client account generates.<sup>85</sup> And the adviser must disclose the general types of products and services he acquired with client commissions,<sup>86</sup> as well as the procedures he used to direct client transactions to premium brokers.<sup>87</sup>

Form ADV's disclosures represent baseline, mandatory requirements. However, under current SEC guidance, more disclosures may be necessary to ensure that clients receive all material information regarding adviser brokerage placement practices.<sup>88</sup> Outside of Form ADV, advisers must quantitatively disclose the aggregate dollar amounts of brokerage commissions paid in each of the last three years to affiliated brokers.<sup>89</sup>

Even with Form ADV's disclosure requirements, clients are left with an imperfect picture of their advisers' soft dollar usage. Required disclosures are generally qualitative rather than quantitative, which inhibits clients' understanding of how their advisers' policies affect them individually and stifles effective monitoring. Furthermore, these brokerage practice disclosures are just one small part of a very lengthy document covering a multitude of topics. In this sea of information, what *is not* required to be disclosed becomes as important as what *is* required. Despite SEC Rule 204-2's requirement that the adviser

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83. *Id.*

84. *Id.*

85. *Id.*

86. The adviser must only "state the types of products . . . or services obtained with enough specificity so that clients can understand what is being obtained" and "need not list individually each product . . . or service received." 1986 Guidance, *supra* note 54, at \*7 n.29.

87. FORM ADV, *supra* note 79, at Item 12(1)(f).

88. 1979 Release, *supra* note 77, at \*4.

89. *Id.* at \*7-8. Affiliated brokers are those that have non-arm's-length relationships with advisers. For the most recent fiscal year, advisers must also disclose the percentage of total brokerage commissions paid to each affiliated broker and the percentage of transactions, in dollar value, involving each affiliated broker. *Id.* at \*8.

“make and keep true, accurate and current . . . books and records”<sup>90</sup> containing “sufficient details relating to each [soft dollar] transaction,”<sup>91</sup> there are surprisingly few quantitative disclosure requirements. Quantitative disclosure of the value of research and brokerage services received from client commissions is not required, nor is an accounting of the value of services that go to benefit specific client accounts.

Moreover, SEC Rule 31a-1 requires investment companies, like mutual funds, to maintain detailed quarterly records, including how they divide brokerage commissions on transactions, any benefits received, and the nature of those benefits.<sup>92</sup> Rules like 204-2 and 31a-1 require advisers to maintain records on their soft dollar arrangements and transactions, but specific retrospective disclosure of benefits received and the allocation of those benefits is generally not required. This inhibits clients’ ability to monitor advisers’ soft dollar arrangements and makes it easier for unscrupulous advisers to misuse or misappropriate client commission dollars.

## II. BENEFITS AND DRAWBACKS OF SOFT DOLLARS

When advisers abuse soft dollar arrangements, their clients suffer.<sup>93</sup> Recognizing this, and in contrast to the permissive approach taken by the United States, the European Union has sought to curb these abuses by restricting adviser payments for research to specific payment accounts,<sup>94</sup> in turn limiting the long-held use of commissions to obtain soft dollars.<sup>95</sup> However, following the European Union model or eliminating soft dollars entirely would be unwise: soft dollars, when used appropriately, can be highly beneficial to investors.

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90. 17 C.F.R. § 275.204-2(a) (2017). It appears that this Rule was first applied to keeping records of transactions in soft dollars in the SEC’s 1986 Guidance. 1986 Guidance, *supra* note 54, at \*8.

91. 1986 Guidance, *supra* note 54, at \*8.

92. 17 C.F.R. § 270.31a-1(b)(1) (2017).

93. See, e.g., Edward Wyatt, *Report Faults ‘Soft Dollar’ Use by Brokers*, N.Y. TIMES (Sept. 23, 1998), <https://www.nytimes.com/1998/09/23/business/report-faults-soft-dollars-use-by-brokers.html> [<https://perma.cc/MQ7T-HA55>] (presenting the criticism that advisers abuse clients’ soft dollars and do not provide adequate disclosure of their practices).

94. *SEC Issues Relief for Research Payments Under MIFID II*, FRONTLINE COMPLIANCE (Oct. 27, 2017), <https://frontlinecompliance.com/sec-issues-relief-for-research-payments-under-section-28e/> [<https://perma.cc/L94B-XJVR>].

95. *The Future of Investment Research Post-MiFID II*, BLOOMBERG INTELLIGENCE (Aug. 9, 2017), <https://www.bloomberg.com/professional/blog/future-investment-research-post-mifid-ii/> [<https://perma.cc/NW8P-2BQ2>].

This Part will explore some of the abuses that have emerged from soft dollar arrangements, while also highlighting the benefits that soft dollars can bring to investors if utilized appropriately.

*A. Conflicts of Interest and Inadequate Disclosure Requirements Can Result in Soft Dollar Abuses*

The market for soft dollars purchased with client brokerage commissions is estimated to exceed \$1 billion per year.<sup>96</sup> Although most investment advisers participate in soft dollar arrangements,<sup>97</sup> the SEC has found that advisers frequently fail to provide meaningful disclosures regarding these arrangements to their clients.<sup>98</sup> A full 2 percent of soft dollar benefits obtained by advisers are unrelated to research or brokerage services and, therefore, fall outside of the Section 28(e) safe harbor.<sup>99</sup> This constitutes approximately \$20 million per year. Soft dollars might be used to pay for advisers' office rent, salaries, travel expenses, financial certification exam review courses, or industry association dues.<sup>100</sup>

The use of soft dollars outside the safe harbor without adequate disclosure has prompted the SEC to bring administrative proceedings against a multitude of investment advisers and broker-dealers.<sup>101</sup> For example, the SEC took action against Marvin & Palmer Associates, Inc. for violating the Investment Advisers Act when it improperly directed soft dollars to friends of the firm.<sup>102</sup> There, Marvin & Palmer directed its broker, with whom it had a soft dollar arrangement, to pay invoices submitted by MacThom Associates, purportedly for research.<sup>103</sup> Although the broker paid MacThom \$920,000, MacThom only provided \$63,000 worth of research to Marvin & Palmer.<sup>104</sup> The balance was in fact paid to compensate MacThom's principal, who was a close friend of Marvin & Palmer's principal, as well as the family of a deceased business associate for their efforts in making introductions

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96. INSPECTION REPORT, *supra* note 2.

97. *Id.*

98. *Id.*

99. *Id.*

100. *Id.*

101. See 2006 Guidance, *supra* note 16 (listing administrative proceedings initiated by the SEC).

102. Marvin & Palmer Assocs., Inc., Investment Advisers Act Release No. 1841, 1999 WL 777443, at \*1 (Sept. 30, 1999).

103. *Id.* at \*2.

104. *Id.*



and business referrals early in the firm's existence.<sup>105</sup> Neither the existence nor the terms of Marvin & Palmer's soft dollar arrangement were disclosed to its clients,<sup>106</sup> and, aside from the \$63,000 of research, no benefit accrued to Marvin & Palmer's clients from the payments to MacThom.<sup>107</sup> The SEC found Marvin & Palmer to have violated the Investment Advisers Act through its improper soft dollar practices and disclosures.<sup>108</sup>

In another recent, egregious example of soft dollar abuse, the advisory firm J.S. Oliver used over \$1.1 million in soft dollars to pay expenses that benefited its principal and others.<sup>109</sup> This included (1) a \$482,381 soft dollar payment to a former employee for operating its soft dollar program, (2) a \$329,365 payment to its principal's former spouse in connection with a marital settlement agreement, (3) \$300,000 in rent payments to a company owned by its principal on a building the principal sometimes used as his personal residence, and (4) \$40,000 to the St. Regis Residence Club in New York City for a timeshare its principal maintained there.<sup>110</sup> J.S. Oliver disclosed on Form ADV that it might use soft dollars for research and brokerage services, but did not disclose that soft dollars would be used for the four above payments, which violated federal securities laws.<sup>111</sup> The SEC found that J.S. Oliver violated the Securities Exchange Act and Investment Advisers Act,<sup>112</sup> ordered that the firm pay \$6,625,000 in civil monetary penalties and disgorge \$1,376,440, and banned its principal from the securities industry.<sup>113</sup>

As these stories and others illustrate, soft dollars provide an avenue for advisers to use client commissions to unjustly enrich themselves. Inadequate disclosure requirements contribute to these abuses. The lack of required reporting on the advisers' actual *use* of soft dollars allows unscrupulous advisers, as in both examples above,

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105. *Id.*

106. In fact, Marvin & Palmer's Form ADV responded "no" to the question whether it "receiv[ed] some economic benefit . . . from a non-client in connection with giving advice to clients." *Id.*

107. *Id.*

108. *Id.* at \*3-4.

109. J.S. Oliver Capital Mgmt., LP, Securities Act Release No. 10100, 2016 WL 3361166, at \*6 (June 17, 2016).

110. *Id.* at \*7.

111. *Id.* at \*8.

112. *Id.*

113. *Id.* at \*10.

to hide behind general Form ADV disclosures while actually using client-generated soft dollars in ways inconsistent with the advisers' disclosed policies. Disclosure requirements mandating that advisers account specifically for their actual uses of soft dollars may deter these abuses outright by enabling better client monitoring. At a minimum, quantitative reporting requirements would be an additional hurdle over which unscrupulous advisers would have to jump to successfully misuse client commissions.<sup>114</sup> Any mistake, however small, in preparing false quantitative reports would make client detection of abuses more likely by increasing clients' ability to track soft dollar use across time periods and categories.

Soft dollar arrangements invite abuses and conflicts of interest. This is a strong reason for restricting or eliminating their use. But soft dollars can provide benefits to investors, too. These benefits, discussed immediately below, caution against an outright ban as the best solution to the soft dollar problem.

### *B. The Benefits of Soft Dollars*

When employed effectively, soft dollars can benefit client accounts. Soft dollars provide managers with the opportunity to obtain more and differentiated research, which can help them make better decisions in managing client accounts.<sup>115</sup> Soft dollars can also work to bind both the broker's and the adviser's interests to those of the client, reducing agency costs.<sup>116</sup> Presumably due to these benefits, empirical

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114. The proposed requirements would force those advisers still willing to lie on quantitative, *ex post* disclosures to create fake ledgers and keep corresponding false reports in order to avoid detection by clients.

115. See D. Bruce Johnsen, *Using Bond Trades to Pay for Third-Party Research*, \*14–16 (George Mason Univ. Law and Econ. Research Paper No. 10–33), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1647277](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1647277) [<https://perma.cc/GHF7-NUSP>] (noting that active managers' returns from stock-picking can be persistently successful, and that private money managers can use investment research to increase client returns). Maintaining the availability of research was an important reason for implementing the safe harbor in the first place. See U.S. Sec. & Exch. Comm'n, *Future Structure of the Securities Markets*, 37 Fed. Reg. 5286, 5290 (Feb. 4, 1972) [hereinafter *Future Structure of the Securities Markets*] (noting that "it is . . . essential that . . . the viability of the process by which research is produced and disseminated not be impaired").

116. See Johnsen, *supra* note 1, at 87, which discusses how advisers, brokers, and clients can increase their wealth by structuring their relationships more efficiently through the use of soft dollars. Soft dollars can also bind the broker and adviser to the client, thereby decreasing agency costs across multiple dimensions, including quality, timeliness, and price. *Id.*

research has shown that accounts managed by advisers that participate in soft dollar arrangements earn higher risk-adjusted returns.<sup>117</sup>

Soft dollars also benefit client accounts by increasing the total availability of research on the market and facilitating its transfer.<sup>118</sup> Simply put, when more information is available, advisers can make better decisions in allocating client capital to its most efficient uses. The more varied and broad the information an adviser can receive, the more informed an adviser can be in making investment decisions for his clients.<sup>119</sup> Without soft dollars, broker-dealers would be less likely to invest in the capacity to produce investment research,<sup>120</sup> which has not been historically profitable for full-service brokerages. Soft dollar arrangements incentivize brokers to invest in research services, thus providing advisers “with a continuous flow of information and opinions on securities, thereby leading in theory to confidence and better judgments.”<sup>121</sup>

Soft dollars can also work to align the adviser’s incentives with the client’s interests. As with most principal-agent relationships, there exists in the adviser-client relationship the possibility of “shirking,” where the adviser exerts less effort than the client would prefer.<sup>122</sup> Because the adviser’s fee is typically based on assets under management, his compensation is only indirectly dependent on his ability to create investment gains for his clients.<sup>123</sup> This fee structure

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117. See Horan & Johnsen, *supra* note 6, at 71 (finding that increasing the use of premium commissions to obtain soft dollars “increases performance by 4.3 basis points per quarter, or about 13 basis points annually”).

118. Future Structure of the Securities Markets, *supra* note 115 (“[T]he general availability of information concerning virtually every aspect of operations and prospects of corporate issuers has been one of the most important elements . . . contribut[ing] to phenomenal growth [in the American capital markets].”).

119. See THOMAS P. LEMKE & GERALD T. LINS, *SOFT DOLLARS AND OTHER TRADING ACTIVITIES* § 1:20, Westlaw (database updated Nov. 2017) (stating that additional research “should result in the most effective management of client accounts”).

120. See *id.* (engaging the argument that, if research were only available via hard dollars, a significant number of institutions would choose not to develop research capabilities, given how difficult it is to make research a profitable line of business).

121. *Id.*

122. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 309 (1976) (noting that agency costs, which arise in any principal-agent relationship, are closely related to the problem of shirking).

123. Typically, when an investment adviser creates gains for a client, the adviser’s compensation grows in tandem with the base of assets under management. However, most advisers do not receive compensation based on a portion of the gains themselves. For this reason, “even the highest-paid fund managers receive just a small share of any wealth increase they generate for the fund.” Johnsen, *supra* note 1, at 87.

disincentivizes advisers from exerting sufficient effort to research securities and make profitable trades for clients, as they do not directly reap the benefits of those activities.<sup>124</sup> Further, if the adviser's contract states that he must bear all the costs of inputs into the investment process, such as research, he will likely shirk by devoting fewer resources to research, thereby reducing his costs and increasing his profitability.<sup>125</sup>

Soft dollar arrangements counteract shirking by binding advisers' interests to those of their clients. By tying transaction execution to research at a fixed ratio, advisers' incentives become tied to their clients' incentives.<sup>126</sup> Soft dollar arrangements allow advisers to increase their access to investment research by upping the number of transactions in their clients' accounts—more transactions, more research—which reduces shirking. But because brokerage commission costs are larger than the soft dollar benefits received in each transaction, and commissions come directly out of clients' holdings, advisers must only increase trading when the corresponding research will justify the costs by increasing returns on future trades.<sup>127</sup> Otherwise, the research earned through overtrading would result in a drag on client returns, causing the market to punish the adviser through fleeing clients. Ultimately, soft dollar arrangements cause advisers to be more proactive in managing client accounts, but only when the potential to benefit the client's portfolio exists.

While compensating the adviser based on performance could also help alleviate shirking, fees based on assets under management are an industry norm. Threatening this norm would likely generate substantial pushback from advisers looking for low-risk revenue. Further, it could deter advisers from contracting with young investors, who have a greater capacity for risk, or force the cost of advisory services to prohibitively high levels. But another avenue—subsidizing

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124. *See id.* (asserting that advisers will have too little incentive to perform well-researched trades if they do not benefit directly from research-related gains).

125. *See id.* (maintaining that advisers will have too little incentive to perform well-researched trades if they have to pay for research out of their own pockets).

126. *See id.* at 99 (explaining that tying investment research to execution at a fixed rate requires the adviser to “use investment research and executions in equal proportions,” leading the adviser to “devote an even greater level of inputs to identifying profitable portfolio trades”).

127. *See id.* (observing that tying research availability to portfolio executions at a fixed rate aligns the client and adviser's interests to promote beneficial trading).

the adviser's costs of generating profitable trades—can prevent shirking.<sup>128</sup>

Soft dollar arrangements also tie the interests of broker-dealers to those of the client. Like advisers, brokers are also prone to shirk. For instance, a broker might search haphazardly for better prices, thus leaking information on impending trades, or simply execute a trade carelessly, rather than working hard to ensure the price impact of the trade works in the client's favor.<sup>129</sup> Compounding this problem is the fact that the true costs of effecting a trade are virtually impossible to measure in the short run—the value of a broker can typically only be seen over time through repeated trading.<sup>130</sup>

However, soft dollar arrangements can discourage broker shirking by giving advisers discretion over transaction volume. Recall that it is common for brokers to provide *up-front* research credits to advisers with the expectation that the advisers will cover the costs of that research by directing trades at premium commissions to the broker in the future.<sup>131</sup> The adviser, though, is under no *obligation* to continue to direct trades to the broker and can walk away at any time, retaining the research.<sup>132</sup> This arrangement helps to decrease broker shirking and to tie brokers' interests to those of the client. In these situations, the broker has effectively fronted a performance bond to the adviser, ensuring the adviser that the broker's trading execution will be successful,<sup>133</sup> lest it lose both its investment in the fronted soft dollars and future business from the adviser. The result is that the soft dollar arrangement incentivizes the broker to effectively execute client trades to protect its investment in the adviser.<sup>134</sup> This decreased agency cost should benefit the client's portfolio through more favorable trade

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128. *Id.* at 96.

129. *See* Horan & Johnsen, *supra* note 6, at 62 (discussing agency problems in broker executions and listing examples of shirking).

130. *See* Johnsen, *supra* note 1, at 87 (“[E]xecution quality, and especially ‘price impact,’ are notoriously difficult to assess in the short run.”); Horan & Johnsen, *supra* note 6, at 62 (“In noisy security markets the quality of broker executions is impossible for the manager to know *ex ante* and difficult to determine even *ex post* except over an extended course of trading.”).

131. *See supra* text accompanying notes 48–50.

132. Horan & Johnsen, *supra* note 6, at 58 (“[T]he manager is free to terminate the broker at any time with no legal obligation to make the promised trades.”).

133. *Id.* at 59 (“[T]he broker's up-front provision of research constitutes a . . . performance bond that benefits investors by assuring the quality of broker executions.”).

134. *See id.* at 64 (explaining that an up-front soft dollar payment is a “nonsalvageable capital investment” that works to ensure quality performance).

execution and better price impact, resulting in greater portfolio returns.

In sum, conflicts of interest may—and often do—result in advisers abusing soft dollars to the detriment of their clients. Soft dollar arrangements, however, can actually help to mitigate conflicts of interest and compel brokers and advisers to act in the best interests of their clients. Furthermore, soft dollar arrangements work to increase the universe of investment information available to advisers, allowing advisers to be better informed and make decisions that lead to greater risk-adjusted returns for their clients.<sup>135</sup> In light of these benefits, the United States should not follow the European Union model or ban soft dollars entirely. Instead, less drastic changes in the regulatory framework to deter or eliminate abuses are appropriate.

### III. WHY THE SOFT DOLLAR SAFE HARBOR SHOULD BE REPEALED

The federal government has chosen to provide a safe harbor for the use of soft dollars, protecting their use in the vast majority of circumstances. But this safe harbor, combined with lackluster disclosure requirements, has enabled some advisers to misuse their clients' commission dollars. Abuses persist, and advisers' actions are often hidden from view. Moreover, the safe harbor's original rationales—promoting the availability of investment research and protecting advisers that use soft dollar arrangements but lack sufficient technology to prove compliance with their fiduciary duties—no longer hold, and the safe harbor runs contrary to general principles of agency law and fiduciary duties. Thus, a reinvigorated regulatory framework is necessary. The safe harbor should be repealed and replaced.

#### A. *The Original Rationales for the Safe Harbor No Longer Hold*

As the Supreme Court has explained, the primary purpose of the Securities Act of 1933 and the Securities and Exchange Act of 1934 is to “deter fraud and manipulative practices in the securities market, and to ensure full disclosure of information material to investment decisions.”<sup>136</sup> Congress maintained this purpose when it created the soft dollar safe harbor as part of the Securities Act Amendments in

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135. *See id.* at 71 (explaining that account performance improves when advisers increase the use of premium commissions).

136. *Randall v. Loftsgaarden*, 478 U.S. 647, 664 (1986); *see also Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (“One of [the Exchange Act’s] central purposes is to protect investors through the requirement of full disclosure by issuers of securities . . .”).

1975, which sought to promote both consumer protection and strong capital markets.<sup>137</sup> But while the safe harbor may have been the best available mechanism at the time to further those objectives, its rationales no longer hold today.

The legislative history surrounding the creation of the soft dollar safe harbor reveals two primary concerns underlying its enactment. First, the safe harbor alleviated adviser concerns that, without the safe harbor, brokerage houses would find it unprofitable to continue to produce the research that many advisers relied on.<sup>138</sup> Second, the safe harbor dispelled concerns that fiduciary duties would force advisers to accept the lowest available execution-only commission rate, forgoing premium broker agreements that included research benefits.<sup>139</sup> Relatedly, advisers worried that their technological inability to maintain records verifying that premium commissions benefitted a specific client would make it difficult to demonstrate that they had not breached their fiduciary duties.<sup>140</sup>

In hearings before the Subcommittee on Securities of the Commission on Banking, Housing and Urban Affairs, four brokerage firms issued a joint statement supporting the safe harbor.<sup>141</sup> Without the safe harbor, they concluded, there “would be a material reduction in research services, particularly for smaller and medium-sized financial institutions, and, in our view, a concurrent damaging of our capital markets.”<sup>142</sup> Ray Garrett, Jr., the Chairman of the SEC, reiterated these concerns, noting that most advisers obtained some, if

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137. H.R. REP. NO. 94-229, at 91 (1975) (Conf. Rep.), as reprinted in 1975 U.S.C.C.A.N. 321, 322 (explaining that the purpose of the amendments was “to provide greater investor protection and bolster sagging investor confidence” while preserving an efficient market for capital).

138. See S. REP. NO. 94-75, at 69 (1975), as reprinted in 1975 U.S.C.C.A.N. 179, 247 (stating that investment managers “have relied on the fact that portfolio activity would generate a supply of research and analysis from the brokerage industry” and that “the future availability and quality of research . . . could be jeopardized” without the safe harbor).

139. *Id.* at 70.

140. See 1979 Release, *supra* note 77, at \*6 (stating that “a disclosure requirement of the extent to which research was or will be obtained to benefit specific or all accounts of an investment manager would be unreasonably complicated” and that, since research often benefits many clients, it is “impracticable to ‘allocate’ specifically this benefit among those accounts”).

141. *To Amend the Securities Exchange Act of 1934, and for Other Purposes: Hearing on S. 249 Before the Subcomm. on Securities of the S. Comm. on Banking, Housing and Urban Affairs*, 94th Cong. 329–31 (1975) (statement of Charles H. Mott, President, Baker, Weeks & Co.; Richard H. Jenrette, President, Donaldson, Lufkin & Jenrette Securities Corp.; Donald B. Marron, President, Mitchell, Hutchins, Inc.; and Bernard H. Garil, Vice President, Assistant to the Managing Partner, Oppenheimer & Co.).

142. *Id.* at 330.

not all of their research from brokerage firms executing their transactions.<sup>143</sup> Garrett worried that, without the safe harbor, broker-provided research would become unprofitable,<sup>144</sup> in turn leading to a reduction in available research, which would harm those advisers that were too small to develop their own research outfits.<sup>145</sup> The Senate agreed with this assessment and adopted the safe harbor.<sup>146</sup>

In a world where brokerage houses produced the vast majority of investment research,<sup>147</sup> Congress's motivations for creating the soft dollar safe harbor were well founded. But two developments since 1975 have weakened the safe harbor's research-availability rationale. First, assets have increasingly concentrated in the hands of large institutional advisers that can afford in-house research systems.<sup>148</sup> As discussed above, one of the initial goals of the safe harbor was to protect research availability for small advisers. Although institutionalization has led many of these shops to disappear,<sup>149</sup> the asset management industry was once dominated by small managers that offered active portfolio management services.<sup>150</sup> Since 1975, however, "the largest institutional investors have quadrupled their holdings in the equity market."<sup>151</sup> Economies of scale have allowed these large institutional investors to develop their in-house research services, decreasing their reliance on broker-provided research. Today, where small managers in need of protection are fewer and further between, the harms resulting from the

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143. *Id.* at 201 (statement of Ray Garrett, Jr., Chairman, SEC).

144. *Id.*

145. *Id.* at 202.

146. S. REP. NO. 94-75, at 70 (1975), *as reprinted in* 1975 U.S.C.C.A.N. 179, 248 (concluding that "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").

147. *See* Johnsen, *supra* note 31, at 1556 (stating that "the small number of full-service brokerage houses that dominated the NYSE produced most of the investment research").

148. *See, e.g., What We Do*, BLACKROCK, (last visited Aug. 27, 2018), <https://www.blackrock.com/corporate/insights/blackrock-investment-institute/what-we-do> [<https://perma.cc/9DWP-EV95>] (noting that the BlackRock Investment Institute "originate[s] research on markets, economics, portfolio construction and cross-asset themes such as geopolitics").

149. *See* Itzhak Ben-David, *Developments in the Asset Management Industry*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (July 20, 2017), <https://corpgov.law.harvard.edu/2017/07/20/developments-in-the-asset-management-industry/> [<https://perma.cc/6KA5-MQDY>] (finding that, in 1980, the top ten asset managers owned about 5 percent of the U.S. market, but, by 2016, the top ten managers owned about 23 percent).

150. *Id.*

151. Itzhak Ben-David, *The Granular Nature of Large Institutional Investors*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Aug. 1, 2016), <https://corpgov.law.harvard.edu/2016/08/01/the-granular-nature-of-large-institutional-investors/> [<https://perma.cc/P6WD-ZWXD>].



safe harbor far outweigh its potential benefits. This institutionalization eliminates one of the original justifications for the safe harbor.

Second, independent research providers—companies that do not act as brokers, but provide research reports and conclusions for a direct fee—have taken a greater share of the research market. Access to independent research allows smaller advisers to purchase research outside of a soft dollar arrangement, obviating the need to bolster broker-provided research via the safe harbor. Independent researchers have been growing and are expected to reach twenty percent market share soon.<sup>152</sup>

Technological advancements have also weakened the safe harbor's fiduciary-duty rationale. Advisers have a duty "to act primarily for the benefit of [the client] in matters connected with [their] undertaking."<sup>153</sup> There is no reason that this duty cannot be met while still directing client trades to premium brokers in exchange for research and execution.<sup>154</sup> However, actually *proving* that premium commissions primarily benefit individual clients can pose a challenge. In 1975, advisers did not have the technology to accurately record, track, and store the multitude of soft dollar transactions they undertook in order to prove that the research benefitted the clients whose commissions generated it.<sup>155</sup> Today, widely-available record-

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152. Robin Wigglesworth, *Final Call for the Research Analyst?*, FIN. TIMES (Feb. 7, 2017), <https://www.ft.com/content/85ee225a-ec4e-11e6-930f-061b01e23655> [https://perma.cc/MR27-XZJV].

153. RESTATEMENT (SECOND) OF AGENCY § 13 cmt. a (AM. LAW INST. 1958).

154. Many advisers believed that the safe harbor was necessary to satisfy the fiduciary rule that a principal cannot receive a benefit from its relationship with an agent. See RESTATEMENT (SECOND) OF TRUSTS § 170(1) (AM. LAW INST. 1959) ("The trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary."); Jorden, *supra* note 27, at 1108 (stating the "general rule" that a fiduciary "is not entitled to receive a benefit from the administration of the trust property . . . other than as compensation for services"). This is likely mistaken. The better way to view soft dollars is simply as a different form of compensation for advisers' services. Advisers do not receive separate benefits from soft dollars; they simply receive a subsidy for their expenses in managing their clients' accounts. Without the soft dollar safe harbor, advisers would have to use soft dollars to benefit commission-paying clients. Further, if soft dollars were prohibited, advisers would likely just charge higher management fees to cover the cost of research. See Letter from Kurt N. Schacht & Jonathan J. Stokes, CFA Ctr. for Fin. Mkt. Integrity, to Florence E. Harmon, U.S. Sec. & Exch. Comm'n (Oct. 6, 2008), <https://www.sec.gov/comments/s7-22-08/s72208-26.pdf> [https://perma.cc/UW39-CT8Z] (stating the argument that advisers paying hard dollars for research would lead to increased fees for the investors). Even if soft dollar arrangements are seen as conferring a separate benefit, advisers can avoid breaching their fiduciary duties by gaining clients' consent and fully disclosing the material facts surrounding the transaction. See *infra* Part IV.

155. See 1979 Release, *supra* note 77, at \*6, \*8 (explaining that disclosure of the extent to which research was obtained to benefit specific accounts would be "unreasonably complicated")

keeping and storage technology enables advisers to track with ease client commissions, the soft dollars generated from those commissions, and whether soft dollars benefit the clients paying for them. With this technology, advisers no longer need to worry about being unable to prove adherence to their fiduciary duties when using soft dollars.

Taken together, the institutionalization of the investment industry, along with advances in available investment management technology since 1975, have significantly weakened the main rationales for enacting the safe harbor.

*B. The Safe Harbor Conflicts with General Principles of Agency Law and Fiduciary Duties*

Modern federal securities regulations have codified common-law fiduciary duties for investment advisers. While, on its face, Section 206 of the Investment Advisers Act of 1940<sup>156</sup> appears to be a general prohibition against fraud and deceit, courts have construed the law to apply broad fiduciary duties to advisers.<sup>157</sup> Under these fiduciary duties, advisers must act in their clients' best interests,<sup>158</sup> must fully disclose to clients all material facts affecting their relationship,<sup>159</sup> and must seek best execution for the client's trades.<sup>160</sup> In short, investors should be able to expect that advisers will put client interests first when

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and prohibitively costly, especially for smaller advisers who would have to make computations manually).

156. 15 U.S.C. § 80b-6 (2012).

157. *E.g.*, *Belmont v. MB Inv. Partners, Inc.*, 708 F.3d 470, 501 (3d Cir. 2013); *see Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 471 n.11 (1977) (understanding that the Court in *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), established "federal fiduciary standards for investment advisers").

158. *E.g.*, *SEC v. Nutmeg Grp., LLC*, 162 F. Supp. 3d 754, 778 (N.D. Ill. 2016); *Belmont*, 708 F.3d at 503.

159. *E.g.*, *Capital Gains Research Bureau, Inc.*, 375 U.S. at 197. The standard of materiality is whether a reasonable client or prospective client would have considered the information important in deciding to invest with the adviser. *SEC v. Steadman*, 967 F.2d 636, 643 (D.C. Cir. 1992); *see also Basic Inc. v. Levinson* 485 U.S. 224, 231–32 (1988) (clarifying that, for an omitted fact to be material, there must be a substantial likelihood that disclosure would have significantly altered a reasonable investor's view of the available information). Soft dollar arrangements are material because of the conflicts of interest that can arise from an adviser's receipt of a benefit in exchange for directing client trades to a broker and, thus, must be disclosed. *Renaissance Capital Advisers, Inc.*, Investment Advisers Act Release No. 1688, 1997 WL 794479, at \*3 (Dec. 22, 1997).

160. *See In re Hughes*, Exchange Act Release No. 4048, 1948 WL 29537, at \*5 (1948) ("A corollary of the fiduciary's duty of loyalty to his principal is his duty to obtain . . . the best price discoverable in the exercise of reasonable diligence."), *aff'd sub nom. Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949).

managing portfolios,<sup>161</sup> acting with the care and loyalty required of a fiduciary.<sup>162</sup>

The soft dollar safe harbor runs contrary to these general principles. The safe harbor allows an adviser to consider the reasonableness of a trade transaction in terms of “his *overall responsibilities* with respect to the accounts”<sup>163</sup> he manages. Thus, the adviser need not “show that specific services benefited specific accounts.”<sup>164</sup> This allows the adviser to put the interests of third-party clients—and those of his advisory business as a whole—ahead of the interests of the client paying for the trade, contrary to the adviser’s common law duty “not to use property of the principal for the agent’s own purposes or those of a third party.”<sup>165</sup> Moreover, by allowing advisers to use the research generated from one client’s trades to aid other clients, the safe harbor relieves advisers of the common-law duty not to acquire material benefits from third parties through transactions conducted for the principal.<sup>166</sup>

In this regard, the soft dollar safe harbor is somewhat unique. In other dealings with the client, advisers must adhere to fiduciary duties and the general principles of agency law. They must make full disclosure of all material facts affecting the adviser-client relationship,<sup>167</sup> take reasonable care to avoid misleading clients,<sup>168</sup> seek best execution of client trades,<sup>169</sup> and act “at all times in the best

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161. See *id.* at \*4 (stating that “[t]he very function of furnishing investment counsel on a fee basis . . . cultivates a confidential and intimate relationship and imposes a duty upon [the adviser] to act in the best interests of her clients and to make only such recommendations as will best serve such interests.”).

162. See Robert J. Moran & Cathy G. O’Kelly, *Soft Dollars and Other Traps for the Investment Adviser: An Analysis of Brokerage Placement Practices*, 1 DEPAUL BUS. L.J. 45, 55 (1989) (stating that “clients can reasonably expect that their Advisers will adhere to the industry standards for the duties of care, skill, loyalty and any other duties . . . imputed to an Adviser.”).

163. 15 U.S.C. § 78bb(e)(1) (2012) (emphasis added).

164. S. REP. NO. 94-75, at 70 (1975), as reprinted in 1975 U.S.C.C.A.N. 179, 248.

165. RESTATEMENT (THIRD) OF AGENCY § 8.05(1) (AM. LAW INST. 2006).

166. See Jorden, *supra* note 27, at 1108 (stating the “general rule” that a fiduciary “is not entitled to receive a benefit from the administration of the trust property . . . other than as compensation for services”); RESTATEMENT (SECOND) OF TRUSTS § 170(1) (AM. LAW INST. 1959).

167. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963).

168. *Id.*

169. See *In re Hughes*, Exchange Act Release No. 4048, 1948 WL 29537, at \*5 (1948) (“A corollary of the fiduciary’s duty of loyalty to his principal is his duty to obtain . . . the best price discoverable in the exercise of reasonable diligence.”), *aff’d sub nom.* *Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949).

interest” of the investor.<sup>170</sup> Because these agency and fiduciary principles are present in all other aspects of the adviser-client relationship, the safe harbor appears out of place in the overall adviser regulatory scheme.

There does not appear to be any principled reason to maintain the safe harbor in the adviser regulatory scheme. The safe harbor conflicts with fiduciary duties, and its original justifications no longer hold. In addition, repealing the safe harbor would remove the air of leniency surrounding advisers’ use of soft dollars, thus deterring abuses.

In lieu of the safe harbor, Congress and the SEC should adopt increased and particularized reporting standards that require advisers to show clients their specific allocations and uses of soft dollars. By making transgressions more easily discoverable and, presumably, punishable by clients, such requirements would provide a strong incentive to avoid self-dealing and adhere to fiduciary duties.

#### IV. A CONSENT AND REPORTING FRAMEWORK FOR SOFT DOLLARS

Beginning with the Securities Act of 1933<sup>171</sup> and the Securities Exchange Act of 1934,<sup>172</sup> the federal government has primarily regulated securities markets through disclosure requirements.<sup>173</sup> Disclosure is meant to “allow[] investors to make fully informed investment decisions,” thereby increasing efficiency and deterring adviser misconduct.<sup>174</sup> The current mandatory disclosures regarding soft dollar arrangements, however, do not enable investors to make intelligent, informed decisions in evaluating whether to retain investment advisers. As discussed above, investment advisers are generally not required to make detailed quantitative disclosures about their procurement and use of soft dollars. Whereas many entities, like public companies, must periodically disclose the financial results of operations, thereby reporting to the investor what the company *actually did* with the invested funds, advisers must only describe their *general* soft dollar policies. This lack of detailed disclosure hinders the main goals of the disclosure regime.

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170. SEC v. Tambone, 550 F.3d 106, 146 (1st Cir. 2008), *rev’d on other grounds en banc* 597 F.3d 436 (2010).

171. 15 U.S.C. §§ 77a–77aa (2012).

172. *Id.* §§ 78a–78qq.

173. Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 151 (2006).

174. *Id.* at 153–54.

Mandated detailed disclosures of soft dollar use would force advisers to periodically recount and relay their activities to their clients, deterring potential misconduct and promoting honest and competent behavior.<sup>175</sup> Congress should repeal the Section 28(e) soft dollar safe harbor<sup>176</sup> but permit advisers to use soft dollar arrangements subject to general fiduciary duties. This would require advisers to gain client consent to soft dollar arrangements and disclose the results of their use.<sup>177</sup> Furthermore, the SEC, a body with greater flexibility to adapt its rules to developments in the soft dollar landscape,<sup>178</sup> should promulgate regulations requiring more substantive disclosure of advisers' soft dollar arrangements and the benefits flowing therefrom. This middle-ground scheme should allow investors to reap the benefits of soft dollar arrangements while limiting the costs of monitoring their advisers, resulting in fewer abuses.

New regulations on soft dollar use should take the form of a two-pronged consent and reporting framework. First, to promote client awareness about soft dollar arrangements and their potential for conflicts of interest, advisers should be required to obtain consent from all clients to engage in soft dollar arrangements before transacting on their behalf. This consent should be required at the time the adviser enters into an advisory relationship with the client, taking the simple form of a written document describing what soft dollar arrangements are, how advisers use them to benefit clients, and how the arrangements may create conflicts of interest. The document should prompt clients to assent to the adviser paying premium commissions when transacting on behalf of the client and receiving soft dollar benefits in return. Aside from the request for consent, the document should include many of the same disclosures about soft dollars that are currently required by Form ADV.<sup>179</sup> Since advisers provide other documentation to their clients at the outset of their relationship,

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175. See Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What You Measure*, 96 COLUM. L. REV. 1335, 1339 (1996) (stating that corporate executives “behave more honestly, diligently, and competently” with mandatory periodic disclosures).

176. See *supra* Part III.

177. See Jordan, *supra* note 27; see also text accompanying note 159.

178. See, e.g., Garrett F. Bishop & Michael A. Coffee, Note, *A Tale of Two Commissions: A Compendium of the Cost-Benefit Analysis Requirements Faced by the SEC & CFTC*, 32 REV. BANKING & FIN. L. 565, 566 (2013) (“Instead of specifying the precise parameters of reform within the [Dodd-Frank] Act itself, Congress delegated this responsibility to myriad regulatory agencies better equipped with the requisite expertise to shape financial reform.”).

179. See *supra* Part I.D (discussing the disclosure requirements of soft dollars generally and those required on Form ADV specifically).

including the consent form is an inexpensive way to raise investor awareness about soft dollar arrangements. Ultimately, requiring consent puts the decision on how to manage soft dollars' potential conflicts of interest in the hands of the client himself, and helps the adviser better understand what the client believes is in his best interest.<sup>180</sup>

After receiving consent to engage in soft dollar arrangements, the SEC should require advisers to provide periodic reports to each consenting client, quantitatively detailing client commissions paid and the benefits generated and qualitatively describing the procedures used over the latest period to allocate trades to broker-dealers. The quantitative disclosures should include at the very least: (1) the total amount of premium commission dollars the client paid over the period, (2) the total premium commission dollars paid over the period across all consenting client accounts, (3) the total amount that would have been spent had the adviser directed the individual client's trades to a discount broker, as well as the aggregate figure for all consenting accounts, (4) the total dollar value of soft dollar benefits the adviser received over the period and a breakdown of those benefits by category,<sup>181</sup> and (5) the value of any brokerage services received by the individual client over the period. These individualized reports on soft dollar usage should be included in the adviser's normal periodic reports on investment performance. With these five required disclosures, clients would be better able to monitor advisers' soft dollar practices and ensure that the benefits received and commissions paid are in their best interest.

It is worth noting that, because soft dollar arrangements work on a fungible credit system, it is not always possible for advisers to list the specific research services received in exchange for specific premium trading commissions.<sup>182</sup> However, this fact does not diminish the value of required disclosures. The five proposed disclosures would still allow

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180. It is possible that, for potential clients with small portfolios, some advisers would treat the consent requirement as a contract of adhesion, allowing them to turn non-consenting clients away. However, this should not be overly concerning: these rejections would create a market for advisers who appreciate the decision to forgo premium commission arrangements. And, more fundamentally, it is unlikely that advisers would choose to miss out on the revenue that new clients—even those wishing to avoid soft dollar arrangements—present.

181. These categories could include: domestic economic research, international economic research, small/mid/large capitalization value or growth equity research, or certain types of fixed-income research. Regardless of breakdown, the categories would be required to cover all types of research received and include one for brokerage services.

182. *See supra* Part I.B.

advisers to demonstrate that each client received a share of research and/or brokerage services *proportional* to their share of the aggregate premium commissions the adviser directed over the period.

By comparing individual commissions paid with aggregate commissions paid, clients could calculate their shares of the aggregate premium commissions over the period. Then, by comparing those figures to the amount that would have been spent had the adviser used discount brokers, clients could determine how much of their premium commissions went toward research or brokerage services. Finally, clients could cross-check whether they were receiving at least a proportional share of the adviser's accrued soft dollar benefits by comparing these figures with the amount and type of soft dollar benefits received.<sup>183</sup> Thus, with a bit of arithmetic, these five reported metrics would empower clients to better police their advisers, ensure their adherence to the law and the client's interests, and determine whether or not to continue employing them.

In addition to periodic, individualized client reports, the SEC should require a similar public filing. A publicly filed form with aggregated quantitative disclosures would be helpful to clients and prospective clients in three ways. First, public disclosures supplement policing by providing individual clients and consumer protection groups—especially unsophisticated investors that are unable to make use of the individualized quantitative disclosures themselves—with the means to ensure adviser compliance. Second, public disclosures enable potential clients to investigate an adviser's soft dollar usage prior to entering into an advisory relationship. Third, requiring quantitative disclosure of the rates advisers pay in premium commissions may spur market competition, resulting in decreases in the average premium commission rate in the market.

Compared to their value to clients, the cost of these public disclosures would be minor. If the proposed individualized reporting requirements are implemented, public disclosure, which would utilize the same data, would only amount to a minor incremental expense.

Of course, quantitative disclosure requirements are still a weak defense against advisers that are willing to simply lie to their clients. In all likelihood, the Marvin & Palmer adviser who lied to his clients on

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183. Because it is possible for many clients to benefit from a single research report, the aggregate client value of soft dollar benefits might exceed one hundred percent of the dollar value of those benefits. For example, a report on the U.S. economic outlook would be valuable to most investors.

Form ADV<sup>184</sup> would still have found a way to manipulate the data behind the suggested reporting framework's required metrics. However, under the proposed reporting requirements, only the most brazen would attempt such deception. It is easy to check a "no" box on Form ADV, as Marvin & Palmer did, but it is much more difficult to craft consistently false quantitative reports, especially across multiple clients and time periods. There is only so much the law can do to prevent illegal behavior before it occurs, but the proposed quantitative reporting requirements would make misrepresentations that much harder.

For disclosures and reporting to be effective, the client must read and be able to understand the provided information.<sup>185</sup> The large amounts of information contained in disclosure forms can be difficult to process, and many clients are unsophisticated investors.<sup>186</sup> To encourage reading and understanding, then, the above suggested soft dollar reporting requirements limit the data provided to five easily defined figures.<sup>187</sup> Further, most of these figures are amenable to graphical presentation, which could enhance client understanding and increase the odds that clients actually read the reports. It is true that, after leading the client to water, the SEC cannot make him drink. But the simplicity and clarity of the five suggested metrics increase the chance that the client quenches his thirst and monitors his adviser.

Although the costs of complying with mandatory disclosures can be enormous, the proposed reporting requirements are unlikely to be prohibitively expensive. It is true that "[c]reating, gathering, analyzing, summarizing, and drafting all the information necessary to generate the required disclosures involves extensive time and effort."<sup>188</sup> And once compiled and drafted, the costs of disseminating information to

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184. See *supra* Part II.A.

185. See Jay T. Brandi, *Securities Practitioners and Blue Sky Laws: A Survey of Comments and a Ranking of States by Stringency of Regulation*, 10 J. CORP. L. 689, 692 (1985) (stating that an "assumption underlying . . . required disclosure[s] is that the information . . . is both read and comprehended").

186. See Ripken, *supra* note 173, at 160 (noting that "people are boundedly rational and have only limited cognitive abilities to process vast amounts of complex information at once").

187. See *id.* at 160–62 (discussing the information overload problem in required disclosures); Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 451–52 (2003) (encouraging consideration of how information will be used before including it in required disclosures and concluding that "[m]ore information is not per se better than less").

188. Ripken, *supra* note 173, at 188.



clients can also be substantial.<sup>189</sup> However, as previously mentioned, advisers are required to “make and keep true, accurate and current . . . books and records”<sup>190</sup> containing “sufficient details relating to each [soft dollar] transaction.”<sup>191</sup> Because of this requirement, advisers are already obligated to maintain records of the many transactions they take on behalf of client accounts—records that provide the data that underlies each of the five proposed metrics. Accordingly, the proposed reporting requirements do nothing to increase the cost of creating and gathering information. Analyzing, summarizing, and drafting reports does still generate some costs, but the same software an adviser uses for recordkeeping can easily analyze and summarize individual client reports. Tools like these make a reporting framework for soft dollar uses relatively inexpensive.

A mandatory consent and reporting framework would expose improper soft dollar uses, or at least make them harder to conceal. It would also make advisers think twice before abusing client commission dollars and assure clients that their commission dollars are being spent in their best interest. While there is no firm data on the cost savings that would accrue to clients by limiting the misuse of their commission dollars, we can guess that, given size of the industry,<sup>192</sup> the savings would likely be substantial. Independent of those savings, the benefits of increased transparency, deterrence, and easier monitoring support implementing a mandatory reporting framework. For these reasons, the framework offers a workable alternative to an outright ban on soft dollar arrangements, ensuring that advisers use soft dollars appropriately for their clients’ benefit.

## CONCLUSION

The soft dollar safe harbor and inadequate reporting requirements have encouraged abuses of soft dollar arrangements. The safe harbor is outdated and runs contrary to agency and fiduciary principles. It should be repealed. Instead, the use of soft dollars should be governed by traditional fiduciary duties. To bolster these duties, the SEC should implement a consent and reporting framework—requiring advisers to

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189. See Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 707–08 (1984) (discussing the direct costs of required disclosures and noting that these direct costs are in the billions of dollars per year).

190. 17 C.F.R. § 275.204-2(a) (2017).

191. 1986 Guidance, *supra* note 54, at \*8.

192. See *supra* note 2 and accompanying text.

gain client consent before engaging in soft dollar arrangements and implementing periodic reporting requirements regarding the use of soft dollars. As Louis Brandeis famously said, “[s]unlight is said to be the best of disinfectants.”<sup>193</sup> By raising awareness of the use of soft dollars and exposing advisers’ practices to the light of day, this framework would deter advisers from using soft dollars improperly and empower clients to more easily monitor their agents.

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193. LOUIS D. BRANDEIS, *OTHER PEOPLE’S MONEY AND HOW THE BANKERS USE IT* 92 (Frederick A. Stokes Co. 1914).