► **Greycourt White Paper**

White Paper No. 4 – *Soft Dollars: Greycourt's Position*

Background

Clients, money managers, investment bankers and brokers often ask why Greycourt adamantly refuses to accept soft dollar payments for its consulting services. This white paper explores the issue of soft dollar commissions and explains why we are opposed both to the practice and to accepting soft dollars as part of our fee.

Discussion

What are soft dollars?

The phrase "soft dollars" refers to several related activities, all involving the practice of paying for services other than securities trades with commission dollars. In a typical case a money manager will direct trades to a particular broker and be charged a negotiated commission, typically $0.05 - $0.06 per share for large institutional managers. For this payment the manager receives in return a bundle of services, including (a) the trade itself, (b) a "kickback" (euphemistically referred to in the industry as "payment for order flow") from the broker, (c) proprietary research generated by the brokerage firm, (d) a capital commitment from the broker,[1] (e) IPO allocations, and (f) computer equipment and services.[2]

Another use of soft dollars occurs when the client instructs money managers to direct commissions to a broker who has pre-arranged to kick back some portion of the commissions to the client. This practice is most common among pension funds and occurs mainly because fund trustees fail to approve budgets large enough for the pension plan staff to operate effectively. Directed commissions augment the operating budget "off-line," as it were.

A final use of soft dollars occurs via so-called "commission recapture programs" used by investment consulting firms. This practice is discussed below.

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[1] When a manager sends a large order to a broker (typically >$5 million), the broker may commit to a price and then work the order, in effect putting his own capital at risk in the transaction.

[2] Until recently, managers often received more outrageous services, including free vacations, for directing soft dollar orders to brokers. The SEC has cracked down on this practice, but estimates that 30% of money managers continue to employ soft dollars for non-research products and services. *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisors and Mutual Funds* (SEC, Washington, DC, September 1998)

Soft dollar practices originated in the pre-1972 days of fixed brokerage commissions, when brokers could not compete on price. Though they are "legal,"[3] they have effectively placed a limit on how low commission rates can go, namely, about five cents per share. The industry estimates that the services bundled around soft dollar trading constitute about 60% of the total value of the commission payment, or $0.03 - $0.35 per share. Roughly one-half of all commissions in the U.S. are paid in soft dollars, as part of an explicit agreement between the fund and the broker.[4]

How do investment consultants receive soft dollars?

Most investment consulting firms have set up affiliated broker/dealers to operate "commission recapture" programs. The consultant's client instructs its managers to direct trades to that broker/dealer and the consulting firm credits all or part of the commissions received against the client's fee.[5]

As a matter of policy, Greycourt has no broker/dealer affiliate and hence cannot receive directed trades. This policy exists in part because of our opposition to the practice of soft dollar payments and also because the existence of a broker/dealer affiliate corrupts consulting firms in other ways. For example, mutual funds and money managers often pay consultants trailing commissions or 12b-1 fees when a consultant recommends a particular fund. More fundamentally, an investment consultant should always be motivated solely by what is best for the client and should never have its advice corrupted by hidden payments, transaction-oriented income, or other conflicts of interest.

What's wrong with soft dollar payments?

A lot. Here are the main concerns:

- *Soft dollars corrupt the efficiency of the capital markets*. A manager who trades in soft dollars is paying far more for its trades than it would pay if the soft dollar services were unbundled. True, he is receiving other services, but because these services and the commissions are bundled together, he has no idea how much he is paying for each service. This lack of transparency of important costs represents perhaps the most anachronistic and inefficient aspect of American capital markets practices.

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[3] Section 28(e) of the Securities Exchange Act of 1934 was amended in 1975 to permit soft dollar agreements where "the commissions paid are reasonable in relation to the value of the brokerage and research services provided." SEC regulations have expanded on this "safe harbor" somewhat, but the area remains murky.

[4] The Economist (July 7, 2001).

[5] Some firms claim to pass 100% of the commissions back to the client but actually charge an "administration fee," representing an additional profit center for the consulting firm.

- *The value of soft services varies materially from manager to manager*. All institutional managers pay about the same commission, but the value of the "soft" services varies dramatically from manager to manager. IPO allocations, for example, may be highly prized by a small cap growth manager, but they will be of no interest to a large cap value manager.[6]

- *Quality of execution is impaired*. Because the broker isn't competing for the orders (the fund has already committed to direct them to him), the quality of execution of soft dollar trades is materially worse than the quality of execution of non-directed trades.[7] In particular, trades executed by a small broker/dealer associated with a consulting firm are likely to be poorly executed.[8]

- *The value of soft dollars belongs to the client, not the fund manager*. Most important of all, fund managers are allocating trades on behalf of assets owned by their clients. Consequently, the value of soft dollar services belongs to the client, not the manager. By accepting financial kickbacks and goods and services, and in return paying higher commissions and accepting poorer execution, the manager is effectively increasing its own fee and decreasing the client's return. Managers get away with this practice only because most clients don't understand what is happening with their commission dollars.

What's to be done?

The Schwartz/Steil study cited above found that 51% of chief investment officers at major money management firms felt it would be "desirable" or "highly desirable" for commissions to be unbundled. (Only 8% felt it would be "undesirable" or "highly undesirable.") A survey of sophisticated clients would surely find that a far larger majority would want to see the practice abolished. For example, David Swensen, who manages the Yale endowment, refers to soft dollar practices as "odious." According to Swensen, "Soft dollar activity flies in the face of reasonable governance. * * * Soft dollars and directed brokerage, the slimy underbelly of the brokerage world, ought to be banned."[9] Yet nothing happens.[10] The reasons nothing happens are (i) money managers and brokers are locked into cozy arrangements that benefit both at the expense of investors, (ii)

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[6] Why would the large cap manager stand for this unequal treatment? Because his commission costs will be the same whether he accepts the soft services or not.

[7] A recent study estimated the explicit costs of soft dollar trades to be four times the costs of trades channeled through non-intermediated electronic systems and the implicit costs to be three times greater. Robert Schwartz and Benn Steil, *Controlling Institutional Trading Costs: We Have Met the Enemy and They Are Us*, Journal of Portfolio Management (forthcoming).

[8] Former SEC Chairman Arthur Levitt has stated that soft dollar arrangements may "result in inferior executions when advisors direct trades to the wrong broker to satisfy a soft-dollar obligation." Wall Street Journal (February 15, 1995)

[9] Swensen, David F., *Pioneering Portfolio Management* (The Free Press, 2000), pp. 272,277.

[10] A commission in the United Kingdom recently recommended that soft dollar arrangements be abolished in the U.K. See the Myners Report, available at www.treasury.gov.uk/docs/2001/myners_report0602.html.

funds that refuse to enter into soft dollar arrangements will not pay less, and hence it is difficult for any individual manager to refuse to play the game, (iii) clients don't understand the obscure practice and how much it works to their disadvantage, and (iv) the SEC, supposedly the investors' watchdog, is asleep at the switch.

Clearly, Greycourt is in no position to abolish soft dollars, but until the industry or the regulators react we can take several positive steps. First, we can set an example for other consulting firms by refusing to accept soft dollar payments. Second, we can educate our clients about the perils of soft dollars. Finally, we can use our negotiating clout with managers to seize as much of the value of soft dollar payments for our clients as possible. For example, managers who enter into soft dollar arrangements could reduce their fees by an amount estimated to equal the value of the soft dollar services received by the manager.

We will be happy to discuss this issue further with you.

GREYCOURT & CO., INC.
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(This paper was written by Gregory Curtis, Greycourt's Chairman.)