Soft Dollars and the Brokerage Industry

Marshall E. Blume

Large investors frequently receive some type of research service in return for sending an equity trade to a specific brokerage firm. The commissions so directed are associated with the term "soft dollars." A survey of institutional managers and analysis of their trading records reveal something about the effects of soft dollars on the structure of the brokerage industry. The use of soft dollars has had significant effects on order flows to different types of brokers.

In particular, substantial percentages of the responding institutional managers indicated that soft dollars led them to use brokers they would not otherwise use. The evidence also indicates that the managers look to brokers providing soft-dollar research for execution of their easier trades, but continue to rely for their harder orders on traditional brokers willing to commit capital to facilitate trades. Respondents also indicated marked differences in their levels of satisfaction with trade execution according to the type of research purchased, with quality of execution for directed brokerage receiving the lowest marks.

The use of "soft dollars" to pay for "research" is a common though not widely publicized practice of institutional investors. Soft dollars trace their origin to the 1950s, when institutional investors became increasingly important players in the equity markets and minimum commission rates for trading listed equities were fixed at above competitive levels. In an environment of increasing trade size and fixed rates, brokerage firms competed for order flow by returning a portion of their commissions in the form of additional research services or even direct payments. A whole industry developed to recycle these "excess" commissions, which became known as "soft dollars."

In 1974 and 1975, Congress debated the elimination of fixed commission rates. With unfixed, competitive commission rates, a major reason for the existence of the soft-dollar industry would disappear. Moreover, many argued, fiduciary responsibility would require investment managers to use the least expensive brokerage services, without regard to other services being provided. The soft-dollar industry lobbied Congress, with the result that the 1975 amendments to the 1934 Securities Exchange Act included Section 28(e), providing a legal framework for the continued use of commissions to pay for both brokerage and "research." The provisions of this section provide investment managers with a safe harbor for using soft dollars.

This article provides some direct evidence of the effect of soft dollars on the structure of the brokerage industry. The study uses two data sources. The first consists of mail surveys of all investment managers with $100 million or more of direct equity investments under management. The second consists of the trading records of the institutions themselves, which Able/Noser Corp. obtained from its clients.

Prevalence and Use of Soft Dollars

In 1989, institutional investors generated $1.720 billion of commissions on their equity trades, of which $692 million—or roughly 40%—involved the purchase of research with soft dollars. These estimates come from Greenwich Associates, a Connecticut firm that, until 1989, interviewed large numbers of investment managers about their use of soft dollars. Greenwich’s numbers probably underestimate the use of soft dollars, because they are based only upon those commissions institutions explicitly identify as involving soft dollars, and it is likely not all soft-dollar transactions have been identified.

To learn more about the use of soft dollars, on September 16, 1991 the Rodney L. White Center for Financial Research mailed a questionnaire to 1242 investment managers identified as managing more than $100 million of equities. The response rate was 32.6%, with 405 questionnaires returned over a period of five months.

The survey questions had undergone extensive pretesting. One of the major difficulties was defining soft-dollar transactions so that the term meant the same to all investment managers. The definitions fall into three categories. The first involves commissions associated with in-house research. For example, a brokerage firm may provide a client with a particular buy or sell recommendation, with the
expectation that the client will use its brokerage services in the event it decides to act upon the recommendation.

The second category involves commissions used to obtain third-party research for the investment manager's use. For example, an investment manager might incur a commission of $200. The broker would then write a check of $111 to a third party, which provides some type of research to the investment manager.\(^{5}\) The so-called conversion rate for this specific transaction is 1.8, meaning that every $1.80 of commissions generates a payment of $1.00 to a third party. If properly structured, transactions to obtain in-house or third-party research are covered under Section 28(e).\(^ {6}\)

The third category involves commissions on orders the client, plan sponsor or trustee directs its own investment managers to send to a specific brokerage house, or group of houses, to obtain research and products for the client’s use. As with third-party research, research obtained through directed brokerage might involve the brokerage firm writing a check to another organization using a negotiated conversion rate. Alternatively, the brokerage firm itself might provide the research product directly to the client in return for the commissions. When the brokerage firm provides the product itself, the firm will frequently quote two prices—one in terms of commissions and the other in terms of real or “hard” dollars. These two prices imply a conversion rate. Typically, Section 28(e) does not cover directed brokerage, because it requires that the recipient of soft-dollar research exercise discretion over the purchases and sales of the equity investments, and a client who has hired an investment manager no longer retains such discretion. As long as the client is carrying out its fiduciary responsibility to the fund’s beneficiaries, however, it would presumably not require an explicit safe harbor.\(^ {7}\)

The 1975 amendments charge the SEC with defining “research,” and the SEC has on numerous occasions changed what is included under this term. Sometimes, it has done so in response to well publicized abuses, such as payments for trips to Europe with only a tangential relation to any research function.\(^ {8}\) Other times, it has responded to difficulties in enforcement. Thus, in 1986, the SEC broadened the definition to include items such as subscriptions to the Wall Street Journal and other publicly available products.

According to the survey, the three most commonly purchased third-party research products are fundamental research, data on expected earnings, and macroeconomic services (Table I). Other products include computer software, technical research, portfolio consult-

### Table 1: Type of Third-Party Research Purchased with Soft Dollars

<table>
<thead>
<tr>
<th>Product</th>
<th>Number of Respondents</th>
<th>Number of</th>
<th>Sometimes</th>
<th>Almost Always</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Never</td>
<td>Frequently</td>
<td>Always</td>
</tr>
<tr>
<td>Fundamental Research</td>
<td>342</td>
<td>19.9%</td>
<td>51.8%</td>
<td>28.4%</td>
</tr>
<tr>
<td>Data on Expected Earnings</td>
<td>340</td>
<td>22.4%</td>
<td>45.6%</td>
<td>32.1%</td>
</tr>
<tr>
<td>Macroeconomic Services</td>
<td>356</td>
<td>29.5%</td>
<td>49.7%</td>
<td>20.8%</td>
</tr>
<tr>
<td>Computer Software</td>
<td>357</td>
<td>37.4%</td>
<td>54.6%</td>
<td>8.0%</td>
</tr>
<tr>
<td>Technical Research</td>
<td>332</td>
<td>41.3%</td>
<td>44.9%</td>
<td>13.9%</td>
</tr>
<tr>
<td>Portfolio Consulting Services</td>
<td>340</td>
<td>53.5%</td>
<td>39.7%</td>
<td>6.8%</td>
</tr>
<tr>
<td>Computer Hardware</td>
<td>334</td>
<td>66.8%</td>
<td>29.0%</td>
<td>4.2%</td>
</tr>
<tr>
<td>Educational Services</td>
<td>325</td>
<td>70.5%</td>
<td>28.3%</td>
<td>1.2%</td>
</tr>
<tr>
<td>Office Support Activities</td>
<td>330</td>
<td>88.2%</td>
<td>10.9%</td>
<td>0.9%</td>
</tr>
</tbody>
</table>

Source: Wharton survey.

### Glossary

**Execution Quality:**
The SEC has pointed out that, in evaluating the execution quality of a trade of listed stock, an investor should look at several factors. From an institutional standpoint, the most important factor is the cost of the execution, which involves both commissions and possible price impacts. A non-exhaustive list of other factors includes speed of execution, the clerical activities associated with the trade and the willingness of the broker to correct mistakes.

**Pretesting:**
One of the preliminary steps in developing a questionnaire. A limited number of individuals fill out the questionnaire, and in the case of this study indicate orally what they thought each question meant. The questionnaire is then revised and pretested again until the researcher is satisfied with the design of the questionnaire.

**Price Impact:**
The very act of buying (selling) a common stock can temporarily drive the price up (down) adding to the cost of trading. Such costs are likely to be greater for large institutional-size orders and for trades of small stocks with little volume.

**Soft Dollars:**
Brokage firms sometimes furnish research services to their clients, treating a portion of their commission income as compensation for these services. The commissions used to obtain research have been loosely termed “soft dollars.” Research can be provided directly by the broker or indirectly through cash payments to a third party.
ing services, computer hardware, educational services and office support activities. The survey did not inquire as to the type of in-house research purchased with soft dollars, because the author thought at the time of the design of the questionnaire that this type of research represented for the most part traditional research reports on individual companies, industries and the economy. In retrospect, it would have been desirable to obtain information on the specific types of in-house research that investment managers obtain.

The survey of investment managers asked about the products their clients obtain through directed brokerage. The most commonly obtained services are portfolio consulting services and transaction cost analyses (Table II). The third most common use of soft dollars is for refund of a portion of the commissions to the plan itself.9 Other products or services include actuarial and accounting services, custodial fees, trading and quotation services, educational services, computer software, computer hardware and office support activities.

Of the total commissions used to purchase research, the survey responses indicate that, on average, 45.7% were used to obtain in-house research, 30.9% were used to purchase third-party research, and 23.4% were associated with directed brokerage. These percentages varied widely from one investment manager to another, however. Additionally, 47.2% of the respondents placed some limits on the amount of commissions they allow a client to direct (see Section D of the appendix).

**Effect on the Brokerage Industry**

The existence of soft dollars has had a significant impact on the structure of the brokerage industry. This conclusion is based in part upon the responses to the questionnaire, but also upon an analysis of the actual trading records of the institutional clients of Abel/Noser Corp. for the first quarter of 1990.10 There is always some concern in accepting at face value subjective responses to any questionnaire, but when the responses are consistent with objective data, one can be more confident. The Abel/Noser data provide this additional confirmation.

Abel/Noser is a brokerage firm in New York that, as part of its business, analyzes the trading costs incurred by its institutional clients. Abel/Noser receives in machine-readable form a daily list of all orders executed for each of its clients (primarily plan sponsors).11 If an order requires only one trade, the price reported is the price of that trade; if the order requires more than one trade, the price reported is the volume-weighted average price.12 Unfortunately, these records do not contain the times of any of the trades—information that would be of great value in analyzing the price impact of a specific trade.

For this study, Abel/Noser made available all the trading records of its clients, as well as pricing data, for the first quarter of 1990. From these data, we selected all transactions for NYSE-listed common stock and discarded all other transactions. To use these data, we had to rearrange the records by broker, and this proved to be an extremely tedious task. The custodians of Abel/Noser’s clients identified the brokerage houses in a variety of ways, some including the broker’s full name and others using only an abbreviation. Some of the abbreviations were so abbreviated that it was not possible to identify any brokerage firm, and these records were discarded. The final file contained 125,378 trading records.

It is important to note that the sample includes only those who have taken the initiative to have the costs of their trades analyzed.13 Abel/Noser’s clients are clearly aware of trading costs, hence the trading costs in this sample may underestimate the average trading costs of all institutional investors. The median daily commission per share in the Abel/Noser data, for example, was 5.0 cents per share—considerably less than the average commission of 9.1 cents per share reported by Greenwich Associates in their 1989 survey. The Abel/Noser sample is also probably biased towards larger funds.

To classify the brokerage firm by type of business, we used the classification system of SEI, a consulting firm in Wayne, Pennsylvania. SEI classifies brokerage firms into three types—capital brokers, specialty brokers and service brokers. Capital brokers include large block trading firms, such as Goldman Sachs, which some-

---

**Table II Type of Research Purchased with Directed Brokerage**

<table>
<thead>
<tr>
<th>Product</th>
<th>Number of Respondents</th>
<th>Never</th>
<th>Sometimes/ Frequently</th>
<th>Almost Always/ Always</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portfolio Consulting Services</td>
<td>273</td>
<td>21.6%</td>
<td>60.1%</td>
<td>18.3%</td>
</tr>
<tr>
<td>Product or Service Not Known</td>
<td>274</td>
<td>43.1%</td>
<td>38.0%</td>
<td>19.0%</td>
</tr>
<tr>
<td>Transaction Cost Analysis</td>
<td>232</td>
<td>50.0%</td>
<td>47.8%</td>
<td>2.2%</td>
</tr>
<tr>
<td>Commission Refunds</td>
<td>234</td>
<td>54.7%</td>
<td>44.4%</td>
<td>0.9%</td>
</tr>
<tr>
<td>Actuarial and Accounting Services</td>
<td>215</td>
<td>62.3%</td>
<td>36.5%</td>
<td>1.4%</td>
</tr>
<tr>
<td>Custodial Fees</td>
<td>225</td>
<td>64.9%</td>
<td>33.8%</td>
<td>1.3%</td>
</tr>
<tr>
<td>Trading and Quotation Services</td>
<td>209</td>
<td>70.8%</td>
<td>26.3%</td>
<td>2.9%</td>
</tr>
<tr>
<td>Educational Services</td>
<td>201</td>
<td>83.1%</td>
<td>15.9%</td>
<td>1.0%</td>
</tr>
<tr>
<td>Computer Software</td>
<td>199</td>
<td>84.4%</td>
<td>14.6%</td>
<td>1.0%</td>
</tr>
<tr>
<td>Computer Hardware</td>
<td>196</td>
<td>91.3%</td>
<td>7.7%</td>
<td>1.0%</td>
</tr>
<tr>
<td>Office Support Activities</td>
<td>194</td>
<td>92.3%</td>
<td>6.2%</td>
<td>1.5%</td>
</tr>
</tbody>
</table>

Source: Wharton survey.
Table III

<table>
<thead>
<tr>
<th>Broker Category</th>
<th>1%</th>
<th>5%</th>
<th>25%</th>
<th>50%</th>
<th>75%</th>
<th>95%</th>
<th>99%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Brokers</td>
<td>0.5</td>
<td>2.0</td>
<td>5.0</td>
<td>6.0</td>
<td>8.0</td>
<td>9.0</td>
<td></td>
</tr>
<tr>
<td>Specialty Brokers</td>
<td>3.0</td>
<td>5.0</td>
<td>6.0</td>
<td>7.0</td>
<td>10.0</td>
<td>10.0</td>
<td></td>
</tr>
<tr>
<td>Service Brokers</td>
<td>2.0</td>
<td>3.0</td>
<td>5.0</td>
<td>6.0</td>
<td>8.0</td>
<td>10.0</td>
<td></td>
</tr>
<tr>
<td>Instinet</td>
<td>1.0</td>
<td>2.0</td>
<td>5.0</td>
<td>6.0</td>
<td>8.0</td>
<td>10.0</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>1.0</td>
<td>2.0</td>
<td>5.0</td>
<td>6.0</td>
<td>8.0</td>
<td>10.0</td>
<td></td>
</tr>
</tbody>
</table>

Source: Abel/Noser Corp.

Commission Rates

Interestingly, the distribution of commissions does not differ much across these three types of brokers, except at the lowest commission levels (Table III). The commissions per share that capital brokers charged were 8 cents or less for 95% of their orders—the same number as the service brokers. At the lowest commissions, however, capital brokers executed their trades at lower commissions than service brokers: 1% of the total number of orders executed by capital brokers carried a commission of less than 0.5 cents per share, while the corresponding number for service firms was 2.0 cents per share. As expected, the commissions per share for Instinet were consistently lower than those for the other brokerage firms.

Allocation of Brokerage

The existence of soft dollars has had a significant impact on the allocation of brokerage to different types of brokers. According to the survey, 36.2% of the respondents almost always or always used a broker they would not normally use for directed brokerage; 21.8% almost always or always used a broker they would not normally use for third-party research; and 17.1% almost always or always used a broker they would not normally use for inhouse research (see Section A of the appendix).

Table IV

<table>
<thead>
<tr>
<th>Broker Category</th>
<th>All Orders</th>
<th>Top 1% of All Orders in Terms of Dollar Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Brokers</td>
<td>56.3%</td>
<td>69.1%</td>
</tr>
<tr>
<td>Specialty Brokers</td>
<td>15.7%</td>
<td>10.2%</td>
</tr>
<tr>
<td>Service Brokers</td>
<td>17.7%</td>
<td>12.9%</td>
</tr>
<tr>
<td>Instinet</td>
<td>7.2%</td>
<td>7.8%</td>
</tr>
</tbody>
</table>

Source: Abel/Noser Corp.

a. The total value of all orders in the sample is $24.2 billion.
b. The total value of the largest 1% of all orders in the sample is $3.2 billion.
to the volume of the stock on the
day of the order; and the standard
deviation of daily returns. With
any of these four variables,
greater values suggest greater dif-
ficulty (Table V).

If capital brokers obtain a differ-
ent mix of orders from other
types of brokers, there may be
differences in the market or price
impact of orders by type of bro-
kers. The Abel/Noser data allow
an analysis of such potential dif-
fences.

Price impact is measured as fol-
lows:

\[ \frac{p - \bar{p}}{\bar{p}} \]
for a purchase and

\[ \frac{\bar{p} - p}{\bar{p}} \]
for a sale, where \( p \) is the average
transaction price and \( \bar{p} \) is a refer-
ence or base price. Positive values
of these ratios indicate an adverse
price impact. Qualitative conclu-
sions do not change much
whether the reference price is
defined as the opening price, the
closing price, the daily volume-
weighted price, or the average of
the open and close. We also
tested an adjusted price—the
average of a calculated opening
price and a calculated closing
price based upon the stock's clos-
ing price of the prior day. Specif-
ically, the calculated opening
price is the stock's closing price
for the prior day, adjusted up-
ward or downward by the return
of the average NYSE stock from
the prior close to the open, and
the calculated close is the stock's
closing price for the prior day,
adjusted upward or downward by
the return of the average NYSE
stock from the prior close to the
current close. This adjusted price
takes into account general mar-
et, but not firm-specific, move-
ments.

Using the opening price as the
reference price, the capital bro-
kers executed 78.5% of the dollar
value of orders with a market
impact measure in the top 1%
This compares with the previ-
ously reported 56.3% of the mar-
ket value of all orders capital bro-
kers receive (Table VI). Other
reference prices also point to a
similar finding of a dispropor-
tionately larger price impact for
orders submitted to capital bro-
kers.

This analysis of price impact
should be interpreted with great
cautions. In view of the prior evi-
dence that capital brokers receive
disproportionate share of the
larger orders, a natural inter-
pretation of the finding that capital
brokers' executions on average

Table V  Distribution by Broker Category of the Total Dollar Order Value for All Orders and Most
Difficult Orders (first quarter 1990)

<table>
<thead>
<tr>
<th>Broker Category</th>
<th>All Orders</th>
<th>Ratio of Stock's Daily Volume to Average Daily Volume</th>
<th>Ratio of Order Size to Average Daily Volume</th>
<th>Ratio of Order Size to Daily Volume</th>
<th>Standard Deviation of Stock's Daily Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Brokers</td>
<td>56.3%</td>
<td>79.9%</td>
<td>77.2%</td>
<td>68.3%</td>
<td>61.3%</td>
</tr>
<tr>
<td>Specialty Brokers</td>
<td>15.7</td>
<td>53.2</td>
<td>11.3</td>
<td>4.9</td>
<td>19.2</td>
</tr>
<tr>
<td>Service Brokers</td>
<td>17.7</td>
<td>2.9</td>
<td>8.9</td>
<td>13.0</td>
<td>13.2</td>
</tr>
<tr>
<td>Instinet</td>
<td>6.8</td>
<td>0.4</td>
<td>2.3</td>
<td>2.3</td>
<td>2.3</td>
</tr>
</tbody>
</table>

Source: Abel/Noser Corp.

Table VI  Distribution by Broker Category of the Total Dollar Order Value for All Orders and Orders
with the Greatest Market Impact (first quarter 1990)

<table>
<thead>
<tr>
<th>Broker Category</th>
<th>All Orders</th>
<th>Opening Price</th>
<th>Closing Price</th>
<th>Average of Open and Close</th>
<th>Volume-Weighted Price</th>
<th>Adjusted Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Brokers</td>
<td>56.3%</td>
<td>78.5%</td>
<td>66.7%</td>
<td>78.7%</td>
<td>62.8%</td>
<td>70.4%</td>
</tr>
<tr>
<td>Specialty Brokers</td>
<td>15.7</td>
<td>11.2</td>
<td>11.0</td>
<td>7.5</td>
<td>10.3</td>
<td>7.5</td>
</tr>
<tr>
<td>Service Brokers</td>
<td>17.7</td>
<td>8.7</td>
<td>13.1</td>
<td>8.9</td>
<td>10.0</td>
<td>18.5</td>
</tr>
<tr>
<td>Instinet</td>
<td>7.2</td>
<td>0.4</td>
<td>6.4</td>
<td>2.8</td>
<td>14.5</td>
<td>2.3</td>
</tr>
</tbody>
</table>

Source: Abel/Noser Corp.
have greater price impact is that these brokers tend to receive the more difficult orders; these more difficult orders would be expected to have a larger market impact. What the analysis does not imply is that service brokers or specialty brokers are less able than capital brokers to execute hard orders. It may simply be that service or specialty brokers receive a greater proportion of the easier orders, as the survey responses suggest.

The questionnaire provides some tangential evidence of the relation between quality of execution and the commitment of capital to facilitate a trade. Fully 87.0% of the investment managers stated that the commitment of capital on occasion improved the quality of execution (see Section F of the appendix). Nonetheless, they were much less willing to ask third-party brokers to commit capital than they were to ask brokers who provide in-house research or no research at all. Roughly half the investment managers stated that they do on occasion ask those who provide in-house or no research at all to commit capital, while less than 20% said they asked third-party brokers to commit capital (see Section E of the appendix).

Respondents’ Views

The last set of questions for the investment managers inquired about their attitudes toward some type of government prohibition on the use of soft dollars. The questionnaire first asked about in-house research: “Taking into account all factors, using soft dollars to obtain in-house research should be prohibited.” 82.5% disagreed or strongly disagreed with this statement, while only 11.6% agreed or strongly agreed (see Section H of the appendix). With directed research, it is not surprising that the greatest sentiment for prohibiting soft dollars occurred with this type of transaction.

Unresolved Issues

Both the subjective and objective evidence of this study confirms that soft dollars have had a significant impact on the structure of the brokerage industry, to the extent that the allocation of trading across brokerage firms differs from the allocation that would have occurred if only cash or hard dollars were used to buy research. In short, soft dollars are an extremely effective marketing tool. There is also evidence, though less strong, that investment managers are more inclined to send their easier orders to brokers providing third-party research and their tougher orders to capital brokers.

The respondents’ expressed level of satisfaction with the quality of execution differs according to the type of soft dollars involved. They are least satisfied with transactions involving directed brokerage, somewhat more satisfied with transactions for third-party research, and most satisfied with transactions involving in-house research. The survey explicitly asked the respondents to take into account the difficulty of the execution. There is no obvious reason to believe that the quality of execution for a small order submitted electronically to the floor of an exchange through systems such as SuperDOT would differ according to which brokerage firm keyed in the order. An investment manager should thus receive the same quality of execution for a relatively easy, SuperDOT-type order, regardless of which firm transmits the order. The subjective responses on satisfaction may not have properly factored in the difficulty of execution, but rather have expressed a more general perception of the overall ability of different types of firms to execute more difficult orders.

Let’s assume for the moment that the respondents did not properly adjust for the difficulty of the transactions and that, if they had, they would have been equally satisfied with all the different types of firms. In this case, the capital firms would receive only the more difficult trades, with the other more profitable trades being skimmed off by other firms. At least two major brokerage firms, which often commit their capital, have suggested that this phenomenon would reduce the liquidity of the market. But would it?

The simple form of this argument is that a capital firm uses the excess profits on easier orders to offset losses on harder orders. In the usual competitive model, however, the capital firm can always charge more for executing hard orders than for executing soft orders. In fact, the pattern of nominal commission rates charged by capital firms and service firms is consistent with this scenario, in that the service brokers return a portion of the commission through soft dollars, reducing their net commission, while the capital firms retain the entire commission. Of course, capital firms could compete with service brokers for the easier orders by providing soft dollars on easier trades.

A more subtle argument, and one that the data in this paper do not address, is that there are some synergistic effects of having both easy and hard orders go through the same brokerage house. If a firm only comes to the market with hard orders, other traders will soon learn this, and the firm will find it increasingly difficult to
### Appendix

#### Survey Responses

<table>
<thead>
<tr>
<th>Number of Respondents</th>
<th>Never (%)</th>
<th>Sometimes (%)</th>
<th>Frequently (%)</th>
<th>Almost (%)</th>
<th>Always (%)</th>
</tr>
</thead>
</table>

#### A. Mix of Brokers

| Has the availability of in-house research caused the mix of brokers you use to be different from the mix that you would use were it not for this type of research? | 338 | 24.3 | 32.5 | 26.0 | 11.5 | 5.6 |
| Has the availability of third-party research caused the mix of brokers you use to be different from the mix that you would use were it not for this type of research? | 339 | 17.4 | 35.7 | 25.1 | 14.7 | 7.1 |
| Do transactions by brokers whom your clients designate for directed brokerage cause you to use brokers that you normally would not use? | 304 | 6.9 | 31.3 | 25.7 | 25.7 | 10.5 |

#### B. Satisfaction with Execution Quality

| Taking into account the difficulty of execution, are you generally satisfied that transactions to obtain in-house research are as well executed as other transactions? | 340 | 2.6 | 7.6 | 14.7 | 47.9 | 27.1 |
| Taking into account the difficulty of execution, are you generally satisfied that transactions to obtain third-party research are as well executed as other transactions? | 339 | 4.1 | 21.5 | 17.4 | 36.6 | 20.4 |
| Taking into account the difficulty of execution, are you generally satisfied that transactions by brokers whom your clients designate for directed brokerage are as well executed as your other transactions? | 305 | 8.5 | 45.6 | 20.0 | 19.3 | 6.6 |

#### C. Direction of Easier Trades

| Do you tend to send easier trades to brokers who provide in-house research? | 336 | 45.5 | 39.9 | 8.0 | 4.8 | 1.8 |
| Do you tend to send easier trades to brokers who provide third-party research? | 338 | 32.0 | 30.2 | 18.9 | 16.3 | 2.7 |
| Do you tend to send easier trades to brokers whom your clients designate for directed brokerage? | 309 | 29.4 | 22.0 | 18.8 | 21.4 | 8.4 |

#### D. Limits on Directed Commissions

| Do you have limits on the amount that you allow clients to direct? | 302 | 52.6 | 14.2 | 6.6 | 8.9 | 17.5 |

#### E. Commitment of Capital

| Do you ever ask brokers who provide in-house research to commit capital to facilitate a trade? | 338 | 47.6 | 39.1 | 10.7 | 2.7 | 0.0 |
| Do you ever ask brokers who provide third-party research to commit capital to facilitate a trade? | 340 | 80.6 | 17.6 | 1.8 | 0.0 | 0.0 |
| Do you ever ask other brokers who do not provide research to commit capital to facilitate a trade? | 346 | 54.6 | 33.8 | 9.0 | 2.3 | 0.3 |

#### F. Value of Capital Commitment

| When a broker commits capital to facilitate a transaction, do you obtain a better execution? | 291 | 13.1 | 79.4 | 7.6 |

#### G. Procedures to Measure Trading Costs

| Does your typical client have a formal procedure for measuring total transaction costs? | 342 | 33.3 | 64.3 | 2.3 |
Appendix (continued)

H. Overall View of Soft Dollars

| Taking into account all factors, using soft dollars to obtain in-house research should be prohibited. | 371 | 49.3 | 33.2 | 5.9 | 4.9 | 6.7 |
| Taking into account all factors, using soft dollars to obtain third-party research should be prohibited. | 374 | 39.6 | 37.2 | 8.0 | 6.1 | 9.1 |
| Taking into account all factors, directed brokerage to obtain research should be prohibited. | 367 | 24.8 | 34.3 | 16.6 | 11.4 | 12.8 |

trade hard orders, with the result that the overall liquidity of the marketplace is reduced. In the terminology of an economist, the private costs and benefits for a trade might be different from the social costs and benefits. Put in a slightly different context, some traders may decide it is to their advantage not to report their trades; but if every trader did this, the quality of information in the market would deteriorate, to the detriment of all. It is through such subtle, synergistic effects that the existence of soft dollars and the safe harbor provisions of Section 28(e) may reduce the liquidity of the market. This article has not addressed this more fundamental issue, but has accomplished the more modest objective of showing that soft dollars have had a significant effect on the structure of the brokerage industry.18

Footnotes

1. That commission rates immediately declined when they became negotiable in May 1975 suggests they were above competitive levels.

2. Services and direct payments took many forms. Some investment managers received additional research services, which presumably improved their investment performance. Assuming the managers would have purchased these services anyway, the effect was to reduce the managers’ expenses, hence increase their profit—at the expense of the client. As an example of a direct payment, a manager of a mutual fund whose fees were determined by the size of the fund would often direct a broker who executed a trade on behalf of the fund to “give up” a portion of the commission to a third party as a reward for selling shares in the mutual fund to new investors. The Report of the Special Study of Securities Markets of the Securities and Exchange Commission (Washington, DC: U.S. Government Printing Office, 1963) documents many of the arrangements used to rebate a portion of the excess commissions through additional services or outright payments, but ultimately concludes there were so many arrangements that no one would ever know the true extent of the practice.

3. Section 28(e) contains six provisions, some of which have very little economic significance, to qualify for a safe harbor. (1) Commissions can be used only for brokerage and research. The SEC is charged with the important task of defining research, and in practice has changed the definition over time. (2) The brokerage firm must provide the research. This provision currently has no economic substance, but it has to be abided by in form. (3) The person or organization receiving soft dollars must have investment discretion. (4) The commissions, considering both execution and research, must be reasonable. (5) Section 28(e) applies only to commissions. In a July 1990 letter, the SEC staff clarified this provision by excluding “principal transactions” in which an investment manager buys a security at more than the cheapest price or sells a security at less than the best price, with the difference attributable to soft dollars. (6) Section 28(e) applies to security transactions. In a July 1990 letter, the SEC staff clarified this provision by indicating that it does not cover commodities, including financial futures. The following two papers provide greater detail about soft dollars and more general practices to induce order flow. “The Roundtable on Commission Payment for Order Flow Practices” (Proceedings of a conference held at the Securities and Exchange Commission on July 24, 1989) and Inducements for Order Flow: A Report to the Board of Governors (Washington, DC: National Association of Securities Dealers, Inc., July 1991).

4. The survey used two techniques to elicit responses. Thirteen companies and organizations with substantial pension assets agreed to send the survey to their investment managers under their letterheads. In total, 153 investment managers received surveys in this way, and 109 completed the questionnaire. The remaining 1089 investment managers received a letter from the dean of the Wharton School soliciting their participation, and 396 completed the questionnaire. Overall, there was no apparent relation between the value of the equities managed and the response rate. Moreover, the pattern of responses to specific items did not differ much between the two groups.

5. The third-party payment is often made before any trades take place. In this case, the broker has no legal enforceable contract to obtain the agreed-upon commissions, but as a practical matter, an investment manager who wants to continue to obtain third-party research has an incentive to honor the commitment.

6. Interviews with some providers of in-house research revealed that they did not want to associate the term...
soft dollars with in-house research. Nonetheless, they did understand the difference between the two categories.


8. The lead article of the Wall Street Journal of October 4, 1984 described in great detail some of these abuses. To quote only one example: "ABD, owned by two German banks, runs 'research trips' to Europe, Japan and Australia, including air fares, hotels, and even dinner parties, for $15,000 to $25,000 in soft-dollar commissions."

9. One might ask why the investment manager does not just pay less commissions in the first place. A possible explanation is that a brokerage firm wants to charge a nominal commission rate of at least some specific amount so that it can assure all its customers that they are receiving the lowest rate charged.

10. Abel/Noser made these records available with the understanding that they would remain confidential and that only summary statistics would be published.

11. For a plan sponsor with multiple managers, the volume given in the trading records may understate the true order size if one manager is selling a stock and another buying it on the same day and if, as sometimes happens, the trading records give the net volume. Similarly, if a manager has several clients and executes a single trade on behalf of their accounts, the trading record for an individual plan sponsor will underestimate the true size of the order the manager executes.

12. A large order is frequently "worked" over a period of time, hence its execution may involve more than one trade, often at more than one price.

13. According to the survey, roughly two-thirds of the investment managers analyze their trading costs on occasion or always (Section G of the appendix). The survey did not ask whether the sponsors or investment advisers initiated these analyses.

14. In testing the questionnaire, we learned of one company that is so dissatisfied with the quality of the execution of trades for third-party research and directed brokerage that it executes these types of trades at very high commission rates, such as 25 cents per share, in order to generate the required soft dollars—thereby reducing the number of trades required to generate a specific amount of soft dollars and thus reducing the effect of any poor execution of these trades on the total performance of the plan.

15. Another interpretation of the investment managers’ dissatisfaction with the execution quality of trades involving directed commissions and their inclination to send their easier orders for these types of execution is that investment managers resent being forced by their clients to use specific brokers, regardless of how good the brokers are.

16. As noted, the Abel/Noser data contain for the most part data on the orders of sponsors and not the orders of the investment managers, which on occasion are allocated to the investment managers’ clients. Thus the proportion of the top 1% of orders going to capital brokers may be understated.


18. The New York Stock Exchange provided a generous research grant to the Rodney L. White Center of the Wharton School of the University of Pennsylvania to undertake this study. A large number of firms and organizations participated in the testing of the questionnaire, and 13 organizations used their own letterheads to solicit responses. Although these organizations were instrumental in the success of the survey, assurances of confidentiality preclude me thanking them explicitly. I thank Abel/Noser Corporation for allowing analysis of the trading records of its clients in ways that preserved the confidentiality of the clients. I thank Bruce Johnson, Donald Klein, Dennis Logue and Eugene Noser for their helpful comments and the research and support staff of the Rodney L. White Center, including Darren Klein, Keith Noreika, Todd Rosentover, Betsey Schmidt and Yun Kuen Wong.