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# Soft Dollars

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**Soft dollar brokerage, which uses commission dollars to subsidize research-related costs, can serve as a valuable asset to an investor. Soft dollars may advance a variety of research aims; however, the opacity surrounding soft dollar arrangements has been subject to widespread criticism. Recently established transparency requirements call for improved due diligence practices that optimize soft dollar arrangements. This paper will examine the potential benefits and risks of soft dollars and will seek to identify how soft-dollar practices can adjust to the trading industry's growing commitment to investment transparency.**

## Definition

Historically, the commission charged by a broker conducting a trade was often "bundled," meaning it included the cost of both trade execution (explicit) and research services (implicit). This "bundling" of commissions allowed a broker to post a standard price structure for investors.

Asset managers can utilize their implicit commissions in a variety of ways, including obtaining sell-side research, purchasing financial software, or subscribing to financial journals. Considered "soft dollars," the Securities and Exchange Commission (SEC) requires that these funds be used to aid in the manager's investment decision-making process, and that they cannot be used in the general operation of the investment manager's firm. If the investment manager does not have a soft-dollar relationship with the broker, any implicit fees paid to the broker and not recaptured by the investor become profit for that broker.

## History

Prior to May 1975, investment managers often purchased brokerage services in addition to ordinary trade execution, clearance, and settlement of securities transactions. Investment research, usually the largest of these additional services, was purchased using money belonging to the investors under the guise of normal trading commissions.


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In 1975, to make commission costs more transparent to fiduciaries, the SEC eliminated fixed commission rates irrespective of a trade's size. This change, in addition to creating competition among brokers to provide lowest-cost trading, pressured investment managers to disclose the breakdown of their commission dollars, separating the amount spent on pure execution costs from the amount spent on research. This policy ultimately led to the rise of a new investor class that conducted independent research.

Within one month of the elimination of fixed commission rates, the United States Congress, in an effort to address the practice of investment managers purchasing research from brokers, added Section 28(e) to the Securities Exchange Act of 1934. Section 28(e) provides a "safe harbor" to investment managers in that it declares,

*"No person who exercises investment discretion with respect to securities transactions will be deemed to have acted unlawfully or to have breached a fiduciary duty solely by reason of paying brokerage commissions for effecting a securities transaction in excess of the amount of commission another broker-dealer would have charged, if such person determined in good faith that the commission was reasonable in relation to the value of brokerage and research services provided by the broker-dealer."*[1]

It is important to note that Section 28(e) only applies to persons "who exercise investment discretion," which for most institutions is limited to their investment managers. Additionally, the scope of the protection is limited to brokerage and research services, narrowly defining the role of soft dollars.

While Section 28(e) generally only affords a safe harbor to investment managers purchasing research, it is possible to stay within the fiduciary responsibility provisions of ERISA[2] without exercising investment discretion. In a 1986 technical bulletin, the United States Department of Labor defined commissions as an asset and, therefore, trustees have a fiduciary obligation to monitor and control them.

## An evolving industry

In recent years, a multitude of brokerages have severely reduced or completely eliminated their commission costs for stocks, ETFs, and base options trades. An evolving industry paired with a decline in commission rates has changed the outlook for commission recapture brokerage[3], a form of soft-dollar arrangement, raising questions of its viability. According to Greenwich Associates, institutional equity trade commission payments in 2019 were down almost 50% from their peak in 2009.[4] Commission recapture programs have declined in volume, credited to a number of factors including, but not limited to, SEC disclosure rules, MiFID II[5], and increased trading transparency.

A 2016 study published by the CFA Institute found that transparency is a key concern among investors.[6] This concern has led to increased scrutiny of implicit commission costs. With many factors considered, new commission recapture programs have lost their consequential degree of impact and have accordingly fallen off in the past decade.

[1] US Department of Labor, *Technical Bulletin 86-1: Statement on Policies Concerning Soft Dollar and Directed Commission Arrangements*, May 22, 1986.

[2] ERISA refers to the Employee Retirement Income Security Act of 1974, a federal law that governs for most voluntarily established retirement plans in the private sector.

[3] Commission recapture is a way of returning a portion of trading expenses back to the investor. a more detailed definition can be found in Appendix B.

[4] Greenwich Associates. Despite Long-term Decline in US Equity Trade Commissions, up to $4.4B up for Grabs Among Brokers (July 9, 2019).

[5] MiFID II refers to the Markets in Financial Instruments Directive, a series of financial regulations put in place by the European Commission in January 2018. It is described in more detail later in the paper.

[6] CFA Institute. From Trust to Loyalty: A Global Survey of What Investors Want (2016).


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Soft-dollar transactions have also met with pushback due to a changing trading industry. Issues of insufficient transparency and financial reform have kindled their widespread scrutiny. One 2021 paper cited that soft commissions enable management fees to be underreported.[7] However, unlike commission recapture, lowered commission fees have not led to soft dollar transactions' plummeting rates. A 2022 analysis of SEC data found that more advisers are using soft dollars than six years ago.[8]

[7] Patel, Keyur. To Bundle or Not to Bundle? A Review of Soft Commissions and Research Unbundling (Summary) (June 23, 2021). Financial Analysts Journal. Published by CFA Institute.

[8] Ayers, Carl. Compliance Best Practices: Lowered Commissions Don't Erase Soft Dollars Duties (March 3, 2022). Published by Regulatory Compliance Watch.

## Benefits of soft dollars

Soft dollars are utilized for the purpose of purchasing investment research. Investment research, whether third-party or in-house research, can be valuable to active investment managers, and is an integral part of any investment process. An investment manager might not be able to acquire certain forms of research without soft dollars. However, third-party investment research is of differing value to each manager, often depending on the broker providing the research. There are some investment managers who do not use soft dollars at all, either because they believe third-party research is not of any value to them, or to avoid the additional disclosures and increased trading scrutiny involved in using soft dollars.

While sell-side brokerage research is normally synonymous with security-level or industry level research reports, soft dollars can be used to purchase a host of investment related services as well. Some examples of research that can be purchased using soft dollars are Bloomberg, FactSet, and Haver Analytics, each of which is an investment-related product that is not related to any specific broker.

The CFA Institute (CFAI) defines "research" as a product or service that provides lawful and appropriate assistance to the investment manager in carrying out its investment decision-making responsibilities.[9] The CFAI Soft Dollar Standards clearly state that the services that can be purchased using soft dollars generated by investor commissions have to be investment-research related and cannot relate to the general operation of the investment management firm.

[9] CFA Institute, *CFA Institute Soft Dollar Standards*, Guidelines for Ethical Practices Involving Plan Sponsor Brokerage, © 1998 by Associate for Investment Management and Research. Updated in November 2011.

It is also worth considering that while third-party investment research benefits most investment managers, soft dollars tend to benefit smaller investment managers to a much higher degree than they benefit larger investment managers. As the staff size, investment resources, and overall scale of smaller firms are much more limited, each additional soft dollar is more valuable than it would be to a larger firm.

Any amount of implicit commission that is not either recaptured by the fund or spent on research in the form of soft dollars becomes additional revenue for the broker executing the trade. This represents a significant opportunity cost investors should try to avoid.


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## Risks involved with soft dollars

While the concept of using investor commissions to pay for research dates back to 1975, it has become a controversial topic in the past two decades. The use of soft dollars can sometimes be considered a conflict of interest between brokers and investment managers. The absence of transparency in soft-dollar brokerage is often raised as a point of concern. Without the proper disclosures by investment managers, the necessary safeguards by all fiduciaries, and frequent evaluation by investors, there is certainly the chance that less ethical investment professionals may push the envelope with their use of soft dollars.

The CFAI, seeing the potential abuse that can occur when using soft dollars, issued the CFA Institute Soft Dollar Standards in 1998. Throughout the Standards, CFAI recommends disclosures and safeguards for both investment managers and fiduciaries so as to avoid even the slightest suggestion of impropriety. While these Standards are not legally binding, nor do they supplant any laws that conflict with them, they form voluntary guidelines within which managers and fiduciaries should comfortably be able to implement a soft dollar policy.

There are three major risks that need to be considered when implementing a soft dollar policy. All pertain primarily to the investment manager and not the investor, and all are outlined in the CFAI Standards. First, similar to commission recapture, the investment manager needs to seek and use the broker that they believe provides best execution.[10] Best execution should be the primary driver when deciding through whom to place each trade.

Second, the research being acquired needs to directly assist in the decision-making process and not in the general management of the investment firm. For items of "mixed-use," such as using a Bloomberg terminal for both investment research and for preparing investor reports, the investment manager should estimate the proportion that the Bloomberg terminal is used for each and only use soft dollars for that portion relating to research. The CFAI suggests that a good test of what can be considered research is whether or not "the manager would feel comfortable disclosing and explaining the decision in a face-to-face meeting with the investor."[11] If there is any further doubt, the investment manager should pay for the services out of pocket.

Finally, the third potential risk is whether the research being acquired benefits each investor specifically. Though there will often be instances where the research being purchased might not directly apply to the investor that generated the commission, the investment manager should endeavor to make certain that over a reasonable period of time the investor receives the commensurate benefit of research purchased with other investors' commissions. Some investors, however, require that in the case of a principal trade, the research being bought must directly benefit the investor generating the commissions. In these cases, the investment manager must be certain that the research being purchased directly influences investment decisions relating to that specific investor.

[10] "Best execution" holds a broker-dealer responsible for attentively overseeing client transactions with a client's best interests in mind. Price and speed may be two determinative factors of best execution. For further reading, see "Remarks at the SIFMA Equity Market Structure Conference: The Dynamics of our Markets and the Changing Structure on which they are Built", remarks from a speech by former SEC Commissioner Elad L. Roisman.

[11] CFA Institute, *CFA Institute Soft Dollar Standards*, Guidelines for Ethical Practices Involving Plan Sponsor Brokerage, © 1998 by Associate for Investment Management and Research. Updated in November 2011.


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## Markets in financial instruments directive

On January 2, 2018, the European Commission implemented a reform of the Markets in Financial Instruments Directive (MiFID II), a series of financial regulations established to increase market transparency and strengthen investor protections. MiFID II unbundled securities commissions for capital markets in the European Union, but also impacted the performance of global financial players, namely asset managers and investment banks, doing business in both the EU and US.[12] Unbundled commissions have gained worldwide popularity since MiFID II's enforcement, with a number of US managers following suit.

[12] Jackson, Howell Edmunds and Zhang, Jeffery, The Economics of Soft Dollars: A Review of the Literature and New Evidence from the Implementation of MiFID II (April 17, 2022). Review of Banking and Financial Law, Forthcoming.

MiFID II does not directly regulate US managers, but its execution has nonetheless affected US institutions who invest in public equities. This directive has altered the dynamics between asset managers, brokers, and research providers.[13] In Europe, MiFID II's establishment has raised the standards for investment products and set volume caps on "dark pool" trading, alongside its enforcement of strengthened disclosure measures. Domestically, US asset owners have taken note of these overseas endeavors and have become more assertive in their demands for better client brokerage disclosure. Asset managers are refining their broker research fees in their broker selection and trading decisions, while research providers are adjusting to tightened transparency regulations and toughened scrutiny of research and trading costs.[13]

[13] Allen, James, Gellasch, Tyler, and Schacht, Kurt. The Future of Research in the US after MiFID II (August 29, 2019). CFA Institute.

Though US investor attitudes have been influenced, the SEC has not fully adopted MiFID II's unbundling initiatives. Concern for the efficiency of small and medium-size enterprises (SMEs) has been expressed in the wake of MiFID II, as independent research feeds into their optimal performance and overall operational growth.

The market upheaval caused by the COVID pandemic has led the European Union to consider amending MiFID II's regulations on SMEs. Companies with a market capitalization threshold of one billion or under would be allowed to re-bundle payments for research, but transparency for research costs would be retained.[14] In March 2021, the European Securities and Markets Authority (ESMA) published a review of MiFID II's impact for SMEs, with the intent to make capital markets more accessible and efficient for SMEs.[15] This Final Report, submitted to the European Commission, includes "recommendations to help promote the concentration of liquidity on SME growth markets."[15]

[14] Jackson, Howell Edmunds and Zhang, Jeffery, The Economics of Soft Dollars: A Review of the Literature and New Evidence from the Implementation of MiFID II (April 17, 2022). Review of Banking and Financial Law, Forthcoming.

[15] European Securities and Markets Authority. MiFID II Review Report (March 25, 2021).



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## Transparency and disclosure

To maximize investor protections in soft-dollar arrangements, there should be transparency into the implicit costs for all involved. The CFAI requires asset managers to disclose involvement in soft-dollar arrangements when using their client's account. Investors should be proactive in the manager hiring process, entering into full discussion with their selected manager(s) about how their soft dollars are going to be used. Asset managers should be able to justify the products and services acquired with soft-dollar funds.

The CFAI recommends asset managers assure investors that they are receiving due benefits of research purchased with client brokerage. It is required for investment managers to clearly disclose, in "plain language," their soft-dollar policies to investors.[16] Asset managers must disclose whether or not the research they purchase will benefit other clients beyond the immediate soft-dollar arrangement, as well as the types of research received, the extent of use, and the involvement of any affiliated broker.[16] Asset managers must also provide their client with a statement, at least annually, detailing that the soft-dollar arrangement is compliant with the established Soft-Dollar Standards. It is imperative that record-keeping should be dutifully maintained.

[16] CFA Institute, *CFA Institute Soft Dollar Standards*, Guidelines for Ethical Practices Involving Plan Sponsor Brokerage, © 1998 by Associate for Investment Management and Research. Updated in November 2011.

## Summary and recommendation

Soft dollar brokerage remains commonplace in the investment industry. This is because soft dollar research provides a viable option for investors to reduce the cost of trading and, indirectly, asset management.

Soft dollar research, while not a direct cash benefit to the investor, is an efficient way an investor can assist asset managers in their investment decision-making process. Investment research, and information in general, is perhaps the most valuable asset an investment manager possesses. If commission dollars are going to be spent regardless, soft dollar research represents a potential way to enhance portfolio performance. Still, attention must be given to full disclosure of soft-dollar practices.

Soft dollar brokerage should be a secondary consideration when managers select through whom they are going to trade, as best execution and reasonableness of commission should always be the priority. Investors should ensure that no agreement or relationship could potentially interfere with this fiduciary duty.


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# Appendix A

## Glossary

**Best execution |** The rule that requires brokers to carry out a deal on behalf of an investor at the best price available in the market. Best execution is the concept that a broker not only searches for the lowest commission price, but also takes into account the opportunity costs associated with making the trade in a timely manner.

**Commission |** Payment to a broker/dealer when a security is purchased or sold. Total commissions encompass both the cost of execution and an implicit cost to cover research services.

**Explicit cost |** The portion of total commission fees that go towards the execution of a trade. Represents the minimum commission rate charged by a broker/dealer to cover the cost of the trade.

**Implicit costs |** The portion of total commission fees that go towards research services, advisory fees, etc. In the case of institutional brokerage commissions, this amount can either be recaptured or used by investment managers for soft dollar research.

**Soft dollars |** Payment to a broker by a customer by way of commission charges for services provided rather than a fee (known as hard dollars).


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## Appendix B

### An overview of commission recapture

One form of soft dollar arrangement is "directed brokerage," alternatively known as "commission recapture". Commission recapture is a way of returning a portion of trading expenses back to the investor. More specifically, this term refers to a brokerage house setting aside, as a rebate to the fund, the implicit portion of the total commission paid. These rebates normally come in the form of monthly cash payments directly to the fund, which can then be used to pay for custody expenses, actuarial fees, legal or consulting retainers, or other expenses. It is important to note that the money has to be used for the exclusive benefit of the fund and its beneficiaries.

As aforementioned, the significance of commission recapture has diminished amid shrinking commission costs and increasing emphasis upon cost transparency. MiFID's II directives on commission allocation have also decreased the popularity of this practice. Though no longer particularly conducive for best execution, commission recapture has historically created direct cost savings for funds.

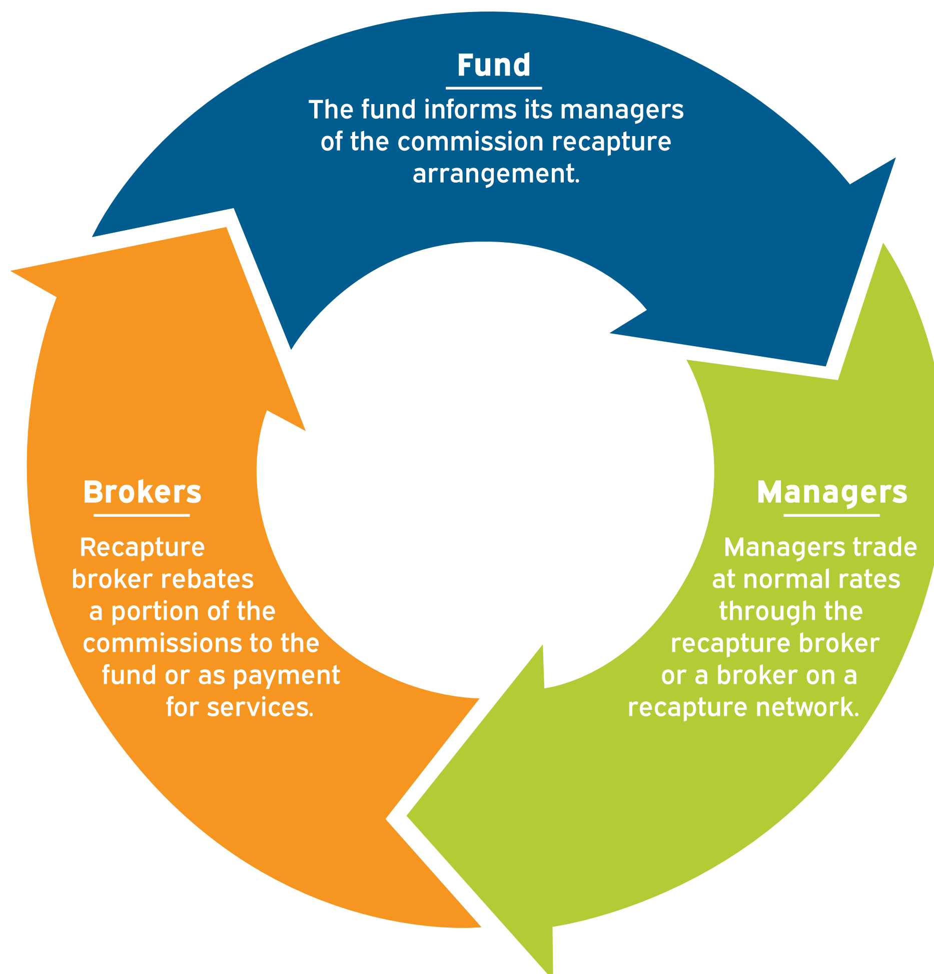


**FIGURE 1**
**Commission Recapture**
Source: Meketa Investment Group.


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