Bridgeway Capital Management, Inc.

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Soft Dollars: The Bridgeway View

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Q: What are "soft dollars"?

A: "Soft dollars" is a term used to describe the payment of commission dollars generated by stock transactions in return for other services. Soft dollars allow investment managers to pay for specific items like research through commission dollars generated through trading, as opposed to a direct payment from the investment manager (i.e., "hard dollars"). As an example, a mutual fund manager might want to buy research from a brokerage firm. Rather than pay the brokerage firm directly, the manager may agree to direct a certain amount of trading — and thus a certain amount of commissions on stock transactions — to that broker in return for research generated by the broker.

Q: How common is the use of soft dollars?

A: According to the Greenwich Associates Equity Investors Study, U.S. institutions paid $10.86 billion in commissions during the 12-month period ended March 31, 2012. Of that $10.86 billion, institutions devoted 56% or $6.08 billion to pay for research/advisory services. Conversely, this means that 44% or $4.78 billion was used for execution only.

Q: What is the history behind soft dollars?

A: Investment managers have long had a safe harbor that allows the use of client funds to purchase "brokerage and research services" under certain circumstances without breaching their fiduciary duties to their clients. This was established in 1975 by Congress in amendments to the Securities Exchange Act of 1934, Section 28(e), to protect investment managers from liability for a breach of fiduciary duty solely on the basis that they paid more than the lowest commission rate available in order to receive "brokerage and research services" provided by a broker-dealer. If the managers determined in good faith that the amount of commission was reasonable in relation to the value of the brokerage and research services received, then the use of soft dollars would fall into the safe harbor.

Over the years, the Securities and Exchange Commission (SEC) has issued several releases interpreting the safe harbor. In a footnote to their July 24, 2006, final release, the SEC uses the term Client Commission Arrangements (CCAs) to "avoid confusion that may arise over the usage of the phrase soft dollars." In addition, the SEC wanted to minimize confusion with the term Commission Sharing Arrangements (CSAs) that is used in the United Kingdom. CSAs allow for payments to research vendors that are not broker-dealers, which the SEC release did not allow.

Subsequent to this release, the SEC issued a "no action letter" to Goldman Sachs on January 17, 2007, confirming that research firms that are not broker-dealers may be compensated under section 28(e). These regulatory changes, combined with technology and aggregation, have made what "the street" now calls CSAs a large percentage of the overall commission dollars spent by U.S. institutions.

Q: Why is it important to pay attention to whether investment managers are using soft dollars?

A: It is important to pay attention because the use of soft dollars and CSAs is a bit controversial. Depending on your view, they may be a very useful way to achieve clients' investment objectives and best execution or another example of hidden fees that directly reduce returns and diminish goodwill with clients. Let's examine both sides.

Those in favor of soft dollars believe that they are a legal and fully disclosed way for clients to pay for valuable research services that investment managers use to help manage clients' portfolios. In addition, they believe that best execution is not hampered by using soft dollars as perhaps it was in the past. With the introduction of CSAs, new products, and technology, buy-side traders can separate the execution decision from the research decision and trade not with the broker who is best at research, but who is best at trading and execution.

Those not in favor of soft dollars believe it is a conflict of interest and that there is nothing really "soft" about the expense — the client pays it and the investment manager receives substantial benefits by not having cash expenditures to purchase research. In addition, they believe any transaction using "other people's money" is likely to have far less due diligence concerning cost and value received as opposed to an outright cash purchase using the manager's own "hard dollars." Those that oppose soft dollars further question the lack of transparency and believe that it is difficult to know exactly how much the client is truly paying as the client never sees an exact fee or percentage amount.

Q: Do soft dollars increase or decrease costs to clients, and how do they affect portfolio performance?

A: Looking to academia, the answer to this question is not clear. Both views are defended by academic research, but ultimately the debate continues and further questions arise about vested interests, constraints in data, the need for additional research, and the very significant changes in market structure and equity trading over the last decade.

Horan and Johnsen published a paper in 2004 and concluded that there was a positive relationship between soft-dollar payments and risk-adjusted performance in institutional portfolio management. They stated that "Incentive Alignment Hypothesis" indicates that "soft dollars encourage managers to use their own labor effort, market research, and brokerage executions more efficiently than if they were required to pay for these inputs."

Conversely, Edelen, Evans, and Kadlec concluded in a paper in 2008 that soft-dollar payments are associated with lower return performance. They stated, "Overall, the impact of soft-dollar payments on performance is negative … investors would benefit from either increasing the disclosure and the accessibility of that disclosure of soft-dollars usage or … requiring that expenses previously covered by soft dollars be converted to hard dollars and included in the expense ratio."

Q: What is Bridgeway's position on the use of soft dollars?

A: Bridgeway does not participate in soft-dollar arrangements or CSAs. Our entire process begins and ends with investment stewardship and doing what is in the best long-term interest of our clients. In that respect, it simplifies much of what we do (and do not do). For our clients, we do not believe that an additional layer of poorly disclosed fees created by soft-dollar arrangements meets those goals.