BLK Consulting
Enhancing your fiduciary compliance

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FIDUCIARIES AND SOFT DOLLARS

A pension or trust fund fiduciary is responsible for committing the fund to investments and using a portion of the fund's assets to pay various types of fees and expenses. From a legal point of view, the decisions on what services or investments to buy, from whom, and at what cost are governed by the principles of loyalty and prudence, often reinforced by law and regulation.

However, the fiduciary does not operate in a vacuum, but rather in a highly competitive business world. The fiduciary will frequently be pressured or offered inducements to select a service, a provider, or an investment at a given price for reasons that have little to do with the best interest of the beneficiaries. Some of the business arrangements for providing these products and services may be presented in such a way that the fiduciary has difficulty recognizing the conflict of interest or imprudent use of fund assets inherent in the deal. The pressure, often from the fiduciary's own firm or firm affiliates, or the temptation to take the benefits offered to the fiduciary is difficult to resist.

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A fundamental premise of the securities laws is that detailed, accurate information on securities should be made available to prospective investors who will then use this information to analyze the nature and quality of the securities and make investment decisions. The securities laws require the production and disclosure of basic information on registered securities and registered participants in the securities industry. In addition, investors and the investment advisers and managers who assist them are constantly seeking new and better information and analytical tools. As a result, an enormous industry based on the production and sale of information has developed. Part of the information market involves visible, direct transactions, such as the sale of research or investment evaluation products for a stated cash price. Like an iceberg, however, much of the information services market is less visible, paid for in so-called "soft dollars," often through complex, multiparty transactions that are difficult to track.

When an investor or investment manager buys or sells stock, the price of executing the transaction includes the price paid or received for the stock and the brokerage commission. The commission covers the actual cost of the trading function, principally executing the trade, clearing, settling, custody, and an additional sum representing the broker's profit. The broker may be willing to give up part of this latter sum to provide credits to the investment manager or some other party that may be used to pay for research or other costs associated with the investment process. The commission dollars that a broker relinquishes in this manner are termed "soft dollars." Investment managers of pension funds, mutual funds, and other trust funds often use the soft dollar method of purchasing services.

Soft dollar transactions raise fiduciary issues in several ways. Under principles of fiduciary law, a fiduciary should use the assets of a fund solely in the interest of the beneficiaries. The fiduciary should receive no benefit other than the agreed upon compensation, and the fiduciary should not seek to further her own interests or those of any other party through the use of fund assets. In a soft dollar arrangement, a fundamental conflict of interest exists because the investment manager, investment adviser or trustee uses the client's money to obtain benefits—research and other services—which she would otherwise have had to purchase herself. Her judgment on the quality and price of the brokerage services of a given broker may be colored by soft dollar deals she has made with the broker. The investment manager or other fiduciary may buy more services than necessary because she is using the client's money, rather than her own, to make the purchases. The information the manager obtains from one account's brokerage commissions serve not only that account, but the manager's other accounts, so that a fund's assets are used to benefit other parties. The investment manager may well be affiliated or have other relationships with the broker-dealer or provider of research that encourage her to make more soft dollar purchases or purchase services not appropriate for a particular fund. Relying on the broker-dealer to select services may affect the quality or bias of the services purchased. The broker may have arrangements with third party providers of services that affect the broker's recommendations of consultants or other service providers. The investment manager may not negotiate as hard to reduce trading costs or get the best prices for research, because it is difficult to distinguish the costs attributable to the several components of a soft dollar deal. Conflicts arising from soft dollar arrangements affect fiduciaries at several levels, for example, the named fiduciary of a pension fund, the trustees of pension or other trust funds, directors of mutual and charitable funds, investment managers, advisers, and brokers.

Excerpt from *Fiduciary Standards in Pension and Trust Fund Management*
by Betty L. Krikorian, Esq.