STUDYING THE EFFECTS OF SOFT DOLLARS AND HARD DOLLARS

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Introduction

The practice of soft dollar payments is a controversial topic, while some perceive them as self-dealing, others consider them as a public good that enhances fund performance and reduces principal-agent issues. MiFID II, which includes the Directive and Regulation MiFIR, implemented restrictions on the use of soft dollar payments in the European Union in January 2018. This affected the cost and results of research in those markets. Some claimed that this had decreased the European capital markets' effectiveness for SMEs. However, recent empirical studies imply that MiFID II has increased market efficiency by decreasing redundancy and creating data that is more beneficial to investors. Here we have tried to explore the effects of soft dollars and hard dollars on the financial markets by exploiting the information and data available through various empirical studies performed by various authors and industries.

Our work mostly studies the paper -" The Law and Economics of Soft Dollars: A Review of the Literature and Evidence from MiFID II" written by Howell E. Jackson and Jeffery Zhang, Date Written: April 17, 2022)

Hard Dollars: Refers to payments made in cash by investment managers to research providers for research services, directly out of their pocket, rather than using client funds. The use of hard dollars ensures that investment managers are directly accountable for their research spending. Because hard dollar payments come directly out of the investment manager's profits, they can reduce operating margins, but they can also increase transparency and accountability.

Soft Dollars: "Soft dollars" refer to the practice in the financial industry where investment managers use commission dollars generated from securities transactions to pay for research, brokerage, and other services. Soft dollars can be used to pay for research reports, market data, investment analysis, or other services that aid in the management of the investment portfolio.

Securities firms have incentives to favor trading arrangements that include soft dollar payments, which use bundled commissions for both execution and research services. Opaque pricing allows firms to increase profitability and diminishes the incentive to move away from bundled pricing. Investment advisers face difficulties in eliminating these practices, as moving away from soft dollar payments would require increasing explicit management fees charged to clients and risk losing access to valuable proprietary research from leading securities firms.

Soft dollar payments cover more than simply exclusive research; they also cover market information and educational events like conferences and seminars. A further way that soft dollars can be used by investment advisers to prevent asset managers from moving away from soft dollar payments is to buy the opportunity to meet with business leaders. IPO allocations are connected with higher levels of order flow to securities firms acting as underwriters, despite FINRA laws prohibiting explicit costs for IPO allocations.

According to aggregate statistics from industry sources like Greenwich Associates, soft dollar payments, which make up more than 60% of all commissions and often amount to close to $6 billion annually, remained stable in the years before the adoption of MiFID II. Data services account for less than 5% of soft dollar expenditures, with conferences and seminars and corporate access ranking among the top three. The use of soft dollars is anticipated to grow much more as execution costs continue to drop.

Justification for using Soft Dollars

Various economic justifications were given for and against soft dollar practices. The three main justifications given for this prevalent soft dollar practice were that it **helps to solve principal-agent problems, improves fund performance, and provides a public good of analyst research output.** This system has **two principal-agent relationships:** the investor is the principal when hiring an investment adviser to provide a service, and the investment adviser is the principal when hiring a broker-dealer to provide trading services. **Horan and Johnsen wrote that: "soft dollar bundling effectively reduces the agency problems that plague portfolio managers and their executing brokers"** By aligning interests, eliminating information asymmetry, and enhancing investment decision-making, soft dollar bundling may be viewed as a means to lessen agency difficulties in portfolio management. It will be assumed that there will be good behavior from the broker's side; that is, they will provide valuable research or market data if they are provided with a good amount of premium, which will, in turn, be beneficial to the investment advisers and the investors.

But the argument that soft dollars can mitigate the information asymmetry was no longer valid and soft dollars can't mitigate the principal-agent problem due to changes in the capital and trading markets as investors now have access to extensive information about the execution quality of various brokers through transaction cost analytics and performance metrics. Investment managers cannot validate the quality of broker trades through payment alone. The **"experience good"** analogy which implies that consumers can only verify a good's quality after using it, does not apply to the use of soft dollars by investment advisers. The premise of the argument has also lost some of its force because of the transition away from high-touch trading towards algorithmic platforms and crossover networks, and to address the issue of information asymmetry in financial markets, third-party verification is crucial.

Both indirect and direct empirical analyses were conducted to analyze if soft dollars helped improve fund performance. Researchers didn't have a good understanding of the amount of research funded with soft dollars at the fund level, and the hypothesis of higher risk-adjusted returns by using soft dollar practices cannot be supported empirically. Indirect empirical analysis showed that the fund performance improves; this might result from **tainted alpha** or from superior execution services rather than research payments. Tainted alpha refers to investment returns that are generated through unethical or illegal means such as disguised IPO allocations or corporate access that allows for privileged but not unlawful access to insider information as argued by Bengtzen. Banks frequently provide preference in IPO allocations to investors that bring in more money, including brokerage commissions. By paying for more advantageous IPO allocations, soft dollars could perhaps enhance fund performance, which could lead to higher returns for the fund.

Direct empirical research indicated that soft dollar practices did not, on average, boost **risk-adjusted returns**, improve fund performance, and lower advisory fees contradicting the assertion that bundling commissions through soft dollars creates value for shareholders. Due to data limitations, only one actual dataset was taken to analyze the effect, and the rest proxies were devised for the empirical research. It was studied that there was a difference in the way various orders were covered by soft dollars, and that led to substantial variability in their execution costs. Some researchers also presented that soft dollars improve fund performance, but it was difficult to analyze the exact impact, and further studies were done that proposed opposite outcomes. Horan and Johsen also presented an opposing analysis to the earlier theoretical claims, suggesting that soft-dollar research benefits investors by subsidizing investment research through quality-assuring performance bonds that brokers can pay the upfront research costs. The study suggested that PCMD captures the bundling of research and execution, and their findings indicated that soft-dollar research could lead to positive outcomes for investors.

Erzurumlu and Kotomin were the first to make use of actual soft dollar data to measure their impact on fund performance. The authors collected information on soft dollar commissions, total brokerage commissions, and board members from the funds SAIs and N-SARs. According to the analysis, larger advisory fees are not linked to higher risk-adjusted fund performance but a rather higher soft dollar and total brokerage charges. These results imply that, on average, mutual fund shareholders are not benefited from the research and information provided by other parties, such as brokers, through soft dollar agreements. Soft dollar agreements may waste shareholder assets and do nothing to increase fund performance or reduce costs; however, studies have conflicting findings due to data shortages.

Arguments regarding soft dollars providing public good

Scholars and decision-makers have argued over the financial industry's bundling of commissions. The provision of a public benefit that improves social welfare by increasing the informational efficiency of capital markets, lowering the cost of capital, and funding beneficial analyst reports is one justification for the bundling of commissions.

Since a significant amount of soft dollars is spent on getting business access and attending conferences and seminars, only a small portion is allocated to research with conceivable public benefits. This type of opaque pricing is not appreciated by investors. Furthermore, there is doubt that sell-side companies would invest their funds in this socially beneficial research out of compassion and not for financial gain.

Effects of MiFID II on the financial industry and Research

The doubt of whether MiFIDII's unbundling has hurt the market's capacity to support and price SMEs is still up for dispute. European authorities relaxed the requirements in 2021 and proposed further expansion in 2022, acknowledging unintended consequences for SMEs. The unbundling of MiFID II, according to empirical evidence, has enhanced the efficiency of the

European market, although studies have shown contradictory outcomes depending on the duration of the analysis period.

Research coverage of small- and medium-sized businesses in the EMEA market has been significantly impacted by MiFID II, according to recent industry studies, with a 23% decline in small-cap coverage since 2017. In 2018 and 2019, U.S. funds outperformed their European equivalents, with the U.S. winners winning by a margin of 250–265 basis points. Reports from Bloomberg, Evercore ISI, and Oxera support these conclusions.

According to **academic research**, MiFID II has reduced the amount of information and analyst coverage available to European companies, particularly older and larger ones, but the coverage that is still available is of a better caliber and contains more precise projections and recommendations. This is supported by research by Lang, Pinto, Sul, Guo and Mota, and Fang, Hope, Huang, and Moldovan, who examined quarterly Compustat data and more than 21,000 firm-year observations from 2014 to 2018 and discovered that the increase in coverage quality coincided with the decrease in coverage quantity and that smaller firms are more likely to experience coverage losses. Research and execution services were successfully separated under MiFID II, according to Liu and Yezegel's analysis, without degrading the standard of sell-side equities research. Final point: According to the authors' examination of the bid-ask spreads and price synchrony of SMEs in the U.K. and European markets from 2010 to 2019, the implementation of MiFID II had no adverse effects on the capital market.

The impact of MiFID II on financial research is a contentious issue, with industry studies and non-industry studies offering different interpretations. Industry studies claimed that MiFID II had a disruptive effect; however, academic research demonstrated that the effect varies depending on the research technique, sample size, and time horizon. The UK's FCA found that MiFID II led to a decrease in expenditures on externally produced equity research, encouraging efficiency and selectivity in research use. ESMA concluded that SMEs were not disproportionately impacted and that research quality improved due to remaining analysts' higher quality and favorable market conditions. During COVID-19, the EU lifted MiFID II limits on SMEs, allowing payments to be bundled for research on firms with a market cap of under €1 billion and recommended additional rollbacks for firms with a market cap of under €10 billion. Despite the concerns raised by industry reports about the impact of MiFID II unbundling on independent research providers, it's unbundling of commissions has improved European market efficiency by increasing the quality of analyst coverage and eliminating redundancy. Policymakers should take into account the various factors when making decisions and consider more comprehensive analysis.

Through studies on two widely-used measures, price synchronization and bid-ask spreads, the effect of MiFID II on the market operation was investigated. When the bid-ask spreads of large and small companies in the FTSE 100 and FTSE Small Cap Index and the same for the Euro Stoxx 50 and Stoxx Europe 200 were compared before and after MiFID II's introduction, it was discovered that they stayed on the same course. For businesses with a market capitalization of less than €1 billion, market liquidity also remained consistent, and following the unbundling, bid-ask spreads did not considerably change. **Share price synchronicity** of companies in the FTSE 100 versus that of companies in the FTSE Small Cap, and of companies in the Euro Stoxx 50 versus that of companies in the Stoxx Europe Small 200 were examined using the regression model.

$$r_{i,t} = \alpha + \beta r_{m,t} + \varepsilon_i,$$

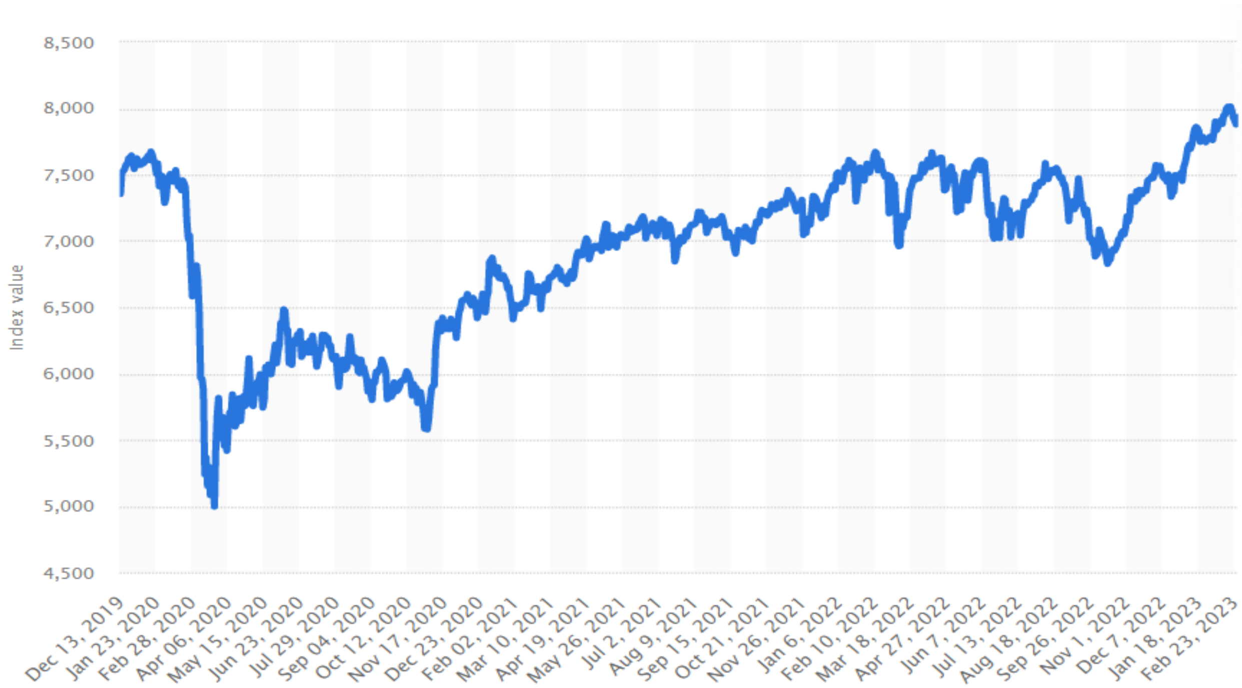
Where $r_{i,t}$ =the return of stock i on trading day t

$r_{m,t}$ is the return of market index m on trading day t

The authors derive a simple version of share price synchronicity by running a regression using daily data within a particular calendar year. They used FTSE 100 Index return for the FTSE 100 companies and FTSE Small Cap Index return for the FTSE Small Cap companies in the sample. **The R^2 obtained from this regression was a measure of share price synchronicity.** A high R2 means a higher level of price synchronicity between the stock and the market index. The findings revealed that share price synchronicity had a considerable decline in 2017, a full year before the implementation of MiFID II. This decline was followed by a rebound in 2018 and a slight decline in 2019, which are consistent with previous norms since 2014. Both the FTSE 100 and FTSE Small Cap samples, as well as the Euro Stoxx 50 and Stoxx Europe Small 200 samples, share these metrics. The authors drew the conclusion that, when considered for a decade, MiFID II has not significantly disrupted the markets.

As of February 27, 2023, the FTSE index stood at 7,935.11 points - well above its average value of around 7,500 points in early 2020. On the 12th of March 2020, amid the escalating crisis surrounding the coronavirus and fears of a global recession, the FTSE 100 suffered the second-largest one-day crash in its history and the biggest since the 1987 market crash.

On the 23rd of March, the FTSE index saw its lowest value this year to date at 4,993.89 but has since begun a tentative recovery. With the continuation of the pandemic, the FTSE 100 the index was making a tentative recovery between late March 2020 and early June 2020. Since then, the FTSE 100 index had plateaued towards the end of July before starting a tentative upward trend in November.



FTSE 100 Index UK 2019-2023

STOXX EUROPE 600 INDEX FOR LAST 3 YRS

FTSE 100 TOTAL RETURN FOR THE LAST 5YRS

8,190.37+29.68(+0.36%)

Recent Developments and Changes on MiFiD II

Payment for investment research has long been a contentious topic The sector expressed anxiety over the MiFID II regulations, which demanded that research payments be separately priced and unbundled from execution fees. The U.S. SEC issued a no-action letter in 2017 to remedy the problem, allowing broker-dealers to be compensated in hard currency for research services rendered to EU investment managers subject to MiFID II rules. The SEC Staff declared in July 2022 that it would not further prolong this relief, but it has been extended until July 3, 2023. In this area, both the EU and the UK are proposing reforms due to unforeseen consequences of the current system. Broker-dealers who are compensated with "hard dollars" research may be subject to investment adviser regulation, thus it is important to think about potential fixes. The European Commission proposed an amendment to EU MiFID II rules on unbundled research due to their failure in achieving all objectives. The existing exemption from the rules for research on issuers with a market capitalization below EUR 1 billion would be extended to below EUR 10 billion, subject to other EU MiFID II rules on conflicts of interest. The proposal aims to improve small and medium-sized enterprises' research coverage.

Following the goals of the **European Green Deal**, **ESMA(European Security and Markets Authority)** is working to ensure effective implementation of the EU framework that places sustainability considerations at the center of the financial system. A set of guidelines have been prepared to seek to ensure that the supervision of the product governance standards takes a convergent approach, which would increase investor protection and benefit consumers. These guidelines reduce the risk of miss-selling and its associated financial repercussions, improve process harmonization and standardization, reduce the risk of greenwashing, and improve harmonization and standardization for competent authorities.

As part of the **Edinburgh Reforms**, the government eliminates the 10% depreciation reporting requirement from MiFID II. It will remove the requirement for DFMs to report to a retail client where the value of their portfolio drops by 10% and introduces measures such as an amendment to the rules on how investment firms should provide information and a requirement for information to be provided to all clients in an electronic format and these measures will take effect from 7 June 2023.

Conclusion

In conclusion, the unbundling of commissions under MiFID II has had a substantial impact on the provision of sell-side research services and the creation of alternatives. Empirical data demonstrates that the regulation has increased market efficiency in Europe by decreasing redundancy and creating more useful information for investors, although some may see the drop in sell-side research and the concerns from businesses about profitability as negative impacts. There are winners and losers with each significant regulatory change, but overall, the benefits of MiFID II's reforms appear to outweigh the costs.