

SECURITIES AND EXCHANGE COMMISSION

AGENCY: Securities and Exchange Commission.

17 CFR Part 241

Securities; Brokerage and Research Services

[Release No. 34-23170]

*51 FR 16004*

April 30, 1986

**ACTION:** Interpretive Release Concerning the Scope of section 28(e) of the Securities Exchange Act of 1934 and Related Matters.

**SUMMARY:** The Commission today announced the issuance of an interpretive release under section 28(e) of the Securities Exchange Act of 1934 ("Act") which provides a safe harbor for persons who exercise investment discretion over beneficiaries' or clients' accounts to pay for research and brokerage services with commission dollars generated by account transactions. In the release, the Commission has clarified its interpretation of the phrase "brokerage and research services" in section 28(e)(3) and has reiterated the disclosure obligations of money managers under the federal securities laws concerning brokerage allocation practices and the use of commission dollars. The Commission has also expressed its views regarding best execution obligations of fiduciaries for their clients' transactions and its views and those of the United States Department of Labor regarding directed brokerage practices by sponsors of employee benefit plans. The Commission believes that the release will provide useful guidance to money managers and other persons in the securities industry.

**FOR FURTHER INFORMATION CONTACT:** Mary Chamberlin, Chief Counsel, or Kerry F. Hemond, Esq. ((202) 272-2848), Office of Chief Counsel, Division of Market Regulation, Securities and Exchange Commission, 450 5th Street, NW., Washington, DC 20549. For further information regarding the obligations imposed under the Investment Advisers Act of 1940 and the Investment Company Act of 1940, contact Thomas P. Lemke, Chief Counsel, Stephanie M. Monaco, Esq., or Gerald T. Lins, Esq. ((202) 272-2030), Office of Chief Counsel, Division of Investment Management, Securities and Exchange Commission.

**TEXT: SUPPLEMENTARY INFORMATION:**

I. Background

Section 28(e) provides a safe harbor to money managers who use the commission dollars of their advised accounts to obtain investment research and brokerage services, provided that all of the conditions in the section are met. n1 The section states that a person who exercises investment discretion with respect to an account n2 shall not be deemed to have acted unlawfully or to have breached a fiduciary duty under state or federal law solely by reason of his having caused an account to pay more than the lowest available commission if that person determines in good faith that the amount of the commission is reasonable in relation to the value of the brokerage and research services provided. Conduct outside of the safe harbor of Section 28(e) may constitute a breach of fiduciary duty as well as a violation of specific provisions of the federal securities laws, particularly under the Investment Advisers Act of 1940 ("Advisers Act") and the Investment Company Act of 1940 ("Company Act") and of the Employee Retirement Income Security Act of 1974 ("ERISA"). In addition, the section only excuses paying more than the lowest available commission and does not shield a person who exercises investment discretion from charges of violations of the antifraud provisions of the federal securities laws or from allegations, for example, that he churned an account, failed to seek the best price, or failed to make required disclosures.

n 1 Section 28(e) of the Act states in pertinent part:

No person using the mails, or any means or instrumentality of interstate commerce, in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law unless expressly provided to the contrary by a law enacted by the Congress or any State subsequent to June 4, 1975, solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion. . . .

n 2 The term "investment discretion" is defined in Section 3(a)(35) of the Act.

In connection with the abolition of fixed commission rates on May 1, 1975, money managers and broker-dealers expressed concern that, if money managers were to pay more than the lowest commission rate available to a broker-dealer in return for services other than execution, such as research, n3 they would be exposed to charges that they had breached a fiduciary duty. This concern was based on the traditional fiduciary principle that a fiduciary cannot use trust assets to benefit himself. The purchase of research with the commission dollars of a beneficiary or a client, even if used for the benefit of the beneficiary or the client, could be viewed as also benefiting the money manager in that he was being relieved of the obligation to produce the research himself or to purchase it with his own money. This concern stemmed in part from litigation during the 1960's and 1970's over whether advisers of investment companies had a duty to recapture commission dollars for the benefit of the investment company. n4 The Congress added section 28(e) of the Act n5 to make clear that money managers could consider the provision of research, as well as execution services, in evaluating the cost of brokerage services without violating their fiduciary responsibilities. In adopting section 28(e), the Congress acknowledged the important service broker-dealers provide by producing and distributing investment research to money managers and created a safe harbor to permit money managers, in certain circumstances, to continue to use commission dollars paid by managed accounts to acquire research as well as execution services. These arrangements have come to be referred to as "soft dollar" arrangements.

n 3 This practice is commonly known as "paying up" for research.

n 4 See *Tannenbaum v. Zeller*, 552 F.2d 402 (2d Cir. 1977); *Arthur Lipper Corp. v. Securities & Exchange Commission*, 547 F.2d 171 (2d Cir 1976); *Fogel v. Chestnutt*, 533 F.2d 731 (2d Cir 1975), cert. denied, 429 U.S. 824 (1976); *Moses v. Burgin*, 445 F.2d 369 (1st Cir), cert. denied, 404 U.S. 994 (1971).

n 5 *Securities Acts Amendments of 1975*, Pub. L. No. 94-29, 89 Stat. 97 (1975).

In 1976, the Commission issued an interpretive release concerning the scope of section 28(e). n6 The Commission stated in the release that the safe harbor did not protect "products and services which are readily and customarily available and offered to the general public on a commercial basis." The Commission issued the release as a result of a number of practices which it did not believe were within the safe harbor. Since that time, the Commission has issued a report pursuant to section 21(a) of the Act reiterating this standard. n7 The staff has generally declined, as a matter of policy, to express definitive views as to whether a money manager's receipt of any particular product or service would be protected by section 28(e), although it has provided general comments on research services through the no-action letter process. n8

n 6 Securities Exchange Act Rel. No. 12251 (Mar. 24, 1976).

n 7 *Report of Investigation in the Matter of Investors Information, Inc.*, Securities Exchange Act Rel. No. 16679 (Mar. 19, 1980) [hereinafter cited as Release 16679].

n 8 *See, e.g., The Bank of New Jersey* [1976-77 Transfer Binder] *Fed. Sec. L. Rep. (CCH) para. 80,662* (June 15, 1976); *Hugh Johnson & Co.*, [1976-77 Transfer Binder] *Fed. Sec. L. Rep. (CCH) para. 80,520* (Mar. 24, 1976).

Prompted by an increased industry focus on soft dollar practices, over the past eighteen months the staff of the Commission's Divisions of Market Regulation and Investment Management, and the staff of the Commission's regional offices, have been engaged in an examination of such practices generally and in particular in a re-evaluation of the 1976 standard as to the meaning of the phrase "brokerage and research services" in the context of section 28(e). Based on the staff's analyses and recommendations, the Commission has concluded that the 1976 standard is difficult to apply and unduly restrictive in some circumstances, and that uncertainty about the standard may have impeded money managers from obtaining, for commission dollars, goods and services they believe are important to the making of investment decisions. Accordingly, the Commission is withdrawing the 1976 standard and adopting a revised standard, as discussed below. At the same time, however, the Commission emphasizes that money managers, particularly investment advisers registered under the Advisers Act, have important fiduciary and disclosure obligations concerning soft dollar practices, as well as a duty to obtain best execution of their clients' transactions. Finally, the Commission expresses its views on the practice of many employee benefit plan sponsors of directing their money managers to execute transactions through specified broker-dealers who have agreed to rebate to the plan a portion of the commissions paid in the form of cash, goods or services.

## II. Definition of Brokerage and Research Services

### A. In General

Subparagraph (3) of section 28(e) defines the brokerage and research services that are protected. The statute states that a person provides brokerage and research services insofar as he --

(A) furnishes advice, either directly or through publications or writings, as to the value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of securities or purchasers or sellers of securities;

(B) furnishes analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts; or

(C) effects securities transactions and performs functions incidental thereto (such as clearance, settlement, and custody) or required in connection therewith by rules of the Commission or a self-regulatory organization of which such person is a member or person associated with a member or in which such person is a participant.

The legislative history of section 28(e) indicates that: The definition of brokerage and research services is intended to comprehend the subject matter in the broadest terms, subject always to the good faith standard in subsection (e)(1). Thus, for example, the reference to economic factors and trends would subsume political factors which may have economic implications which may in turn have implications in terms of the securities markets as a whole or in terms of the past, present, or future values of individual securities or groups of securities. Similarly, computer analyses of securities portfolios would also be covered. Thus, the touchstone for determining when a service is within or without the definition in section 28(e)(3) is whether it provides lawful and appropriate assistance to the money manager in the carrying out of his responsibilities. n9

n 9 *Securities Acts Amendments of 1975, Report of the Comm. on Banking, Housing and Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. 71* (1975).

The Commission relied on this legislative history in adopting the 1976 guidelines, but expressed its view that in order to rely on the section 28(e) safe harbor, the product or service must not be readily and customarily available and offered to the general public on a commercial basis. While application of this standard has in some cases been clear, in other cases it has caused substantial uncertainty and confusion on the part of money managers and others, particularly as the types of research products and their methods of delivery have proliferated and become more complex. For example, participants in the securities industry have repeatedly requested clarification as to whether the application of this standard would disqualify a product that is available for hard dollars, what is meant by "the general public," the extent to which economic, financial and statistical information conveyed through computer facilities to a money manager may be

considered to be research, and whether the computer facilities themselves can constitute research. The Commission is concerned that this lack of clarity has impeded the use by fiduciaries of appropriate research material and has acted as a disincentive to competition among broker-dealers.

*B. Revised Standard*

The Commission believes that, subject to the process discussed below of allocating payment for products or services that serve both a research and a non-research function, the controlling principle to be used to determine whether something is research is whether it provides lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities. In making this determination, the fact that a product or service is readily and customarily available and offered to the general public on a commercial basis does not dictate the conclusion that the product or service is not research, as was the case under the 1976 standard. n10 Rather, the focus should be on whether the product or service provides lawful and appropriate assistance to the money manager's investment decision-making process. What constitutes lawful and appropriate assistance in any particular case will depend on the nature of the relationships between the various parties involved and is not susceptible to hard and fast rules. Of course, section 28(e) continues to require the money manager to make a good faith determination that the value of research and brokerage services is reasonable in relation to the amount of commissions paid. n11 The legislative history of section 28(e) makes clear that the burden of proof in demonstrating this determination rests on the money manager. n12

n 10 Nevertheless, obvious overhead expenses such as office space, typewriters, furniture and clerical assistance would not constitute research.

n 11 The fact that a product is available for hard dollars or is otherwise available and used by the general public is relevant to the determination of the value of the research.

n 12 *See House Comm. on Interstate and Foreign Commerce*, H.R. Rep. No. 123, 94th Cong., 1st Sess. 95 (1975). The Report states that:

It is, of course, expected that money managers paying brokers an amount [of commissions] which is based upon the quality and reliability of the broker's services including the availability and value of research, would stand ready and be required to demonstrate that such expenditures were bona fide.

In many cases, a product or service termed "research" may serve other functions that are not related to the making of investment decisions. For example, management information systems may integrate such diverse functions as trading, execution, accounting, recordkeeping and other administrative matters, such as measuring the performance of accounts. Where a product obtained with soft dollars has a mixed use, a money manager faces a conflict of interest in obtaining that product by causing his clients to pay more than competitive brokerage commission rates. Therefore, the Commission believes that where a product has a mixed use, a money manager should make a reasonable allocation of the cost of the product according to its use. The percentage of the service or specific component that provides assistance to a money manager in the investment decision-making process may be paid for in commission dollars, while those services that provide administrative or other non-research assistance to the money manager are outside the section 28(e) safe harbor and must be paid for by the money manager using his own funds. n13 The money manager must keep adequate books and records concerning allocations so as to be able to make the required good faith showing.

n 13 The allocation determination itself poses a conflict of interest for the money manager that should be disclosed to the client.

Computer hardware is another example of a product which may have a mixed use. If the hardware is dedicated exclusively to software that is used for research for a client's benefit, it may be paid for in commission dollars. On the other hand, if the computer will be used in assisting the money manager in a non-research capacity (*e.g.*, bookkeeping or other administrative functions), that portion of the cost of the computer would not be within the safe harbor. The acquisition of quotation equipment should be analyzed similarly. Such equipment generally serves a legitimate research function of pricing securities for investment and keeping a manager informed of market developments. The equipment

may also be used for a non-research purpose (*e.g.*, client reporting). Finally, where a money manager is invited to attend a research seminar or similar program, the cost of that seminar may be paid for with commission dollars. Non-research aspects of the trip, however, such as travel costs, hotel, meal and entertainment expenses, are not within the safe harbor.

The Commission recognizes that the task of properly allocating the research and non-research properties of certain goods and services provided to fiduciaries may be complex. The Commission believes the standard will be satisfied where a fiduciary can demonstrate a good faith attempt, under all the circumstances, to allocate the anticipated uses of a product.

### III. Third Party Research

Another issue raised under section 28(e) is whether research may be produced or provided by someone other than the executing broker-dealer, or so-called "third party" research. Prior to the elimination of fixed commission rates, a variety of techniques were employed that permitted money managers to purchase third party research with brokerage commissions. Although the legislative history of section 28(e) includes a strong statement that commission dollars may be paid only to the broker-dealer that "provides" both the execution and research services and that the section does not authorize the resumption of "give-ups,"<sup>n14</sup> it seems unlikely that Congress intended to forbid certain common practices that were then considered permissible and whose elimination would be anti-competitive.

<sup>n 14</sup> *Securities Acts Amendments of 1975, Conference Report to Accompany S. 249, Joint Explanatory Statement of the Comm. of Conference, H.R. Rep. No. 220, 99th Cong., 1st Sess. 108 (1975).*

In the 1976 release, the Commission indicated that section 28(e) might, under appropriate circumstances, apply to situations in which research produced by third parties is provided to a money manager by a broker. The Commission suggested that payment of a part of the commission to another broker who is a "normal and legitimate correspondent" of the executing or clearing broker would not necessarily be a give-up outside the protection of section 28(e).

In Release 16679, a report pursuant to section 21(a) of the Act,<sup>n15</sup> the Commission found that the brokers involved in the arrangement did not provide the money managers with any significant research services. They merely executed the transactions and paid 50% of the commissions to Investors Information, Inc. ("III"), who represented various research originators. All arrangements for acquiring the services were made by the money managers and the vendors of the services. III simply held the money for the money managers and paid the bills as requested. The money managers were obligated to pay the vendors for the services and the brokers generally were not aware of the specific services which the managers acquired.

<sup>n 15</sup> *See supra* note 7.

The Commission acknowledged that it is not necessary that a broker produce the research services "in-house" in order for the money manager to obtain the protection of section 28(e). The Commission emphasized, however, that the research services must be "provided by" the broker. The Commission stated that while a broker may under appropriate circumstances arrange to have research materials or services produced by a third party, it is not "providing" such research services when it pays obligations incurred by the money manager to the third party.

In approving the "Papilsky" rules,<sup>n16</sup> the Commission clarified that research provided in third-party arrangements falls within section 28(e) even if the money manager participates in selecting the research services or products to be provided to it by the broker-dealer. The Commission also stated that third-party research does not have to be shipped through the broker, but may instead be delivered directly by the third party to the manager in circumstances that otherwise qualified for the safe harbor. The Commission stated:

<sup>n 16</sup> *Securities Exchange Act Rel. No. 17371 (Dec. 12, 1980).*

. . . a broker-dealer may be deemed to have provided third party research when it has incurred a direct legal obligation to a third party producer to pay for the research (regardless of whether the research is then sent directly to the broker's fiduciary customer by the third party or instead is sent to the broker who then sends it to his customer). The Com-

mission does not believe, however, that section 28(e) would apply where the broker was merely used as an alternative means of paying obligations incurred by the fiduciary in its direct dealings with the third party . . . [citation omitted] In that regard, a broker-dealer may be deemed to have provided third party research that it is legally obligated to pay for even if its fiduciary customer participates in the selection of the research services or products to be provided to it by the broker-dealer. n17

n 17 *Id. at 24*, note 54.

The staff also has expressed the opinion that section 28(e) was not intended to exclude from its coverage the payment of commissions made in good faith to an introducing broker for execution and clearing services performed in whole or in part by the introducing broker's normal and legitimate correspondent. The staff added that the protection of section 28(e) would not be lost merely because the fiduciary by-passed the order desk of the introducing broker and called its orders directly into the clearing broker. n18 More recently, the staff has stated that its views concerning correspondent relationships contemplate that the "introducing broker would be engaged in securities activities of a more extensive nature than merely the receipt of commissions paid to it by other broker-dealers for 'research services' provided to money managers." n19

n 18 *Becker Securities Corp.* [1976 Transfer Binder] *Fed. Sec. L. Rep. (CCH) para. 80,641* (May 28, 1976).

n 19 *Data Exchange Securities*, [1981-82 Transfer Binder] *Fed. Sec. L. Rep. (CCH) para. 77,016* (Apr. 20, 1981). *See also SEI Financial Services* (pub. avail. Dec. 14, 1983), in which the staff reviewed a specific broker correspondent relationship focusing on the services provided and concluded the nature of the relationship did not preclude reliance on section 28(e).

#### IV. Disclosure and Other Obligations Under the Investment Advisers Act of 1940 and the Investment Company Act of 1940 Applicable to Money Managers Engaging in Soft Dollar Arrangements

Money managers engaging in soft dollar arrangements must comply with all applicable disclosure requirements under the federal securities laws, and registered investment advisers and others should pay particular attention to the disclosure and books and records requirements under the Advisers Act and the Company Act. Disclosure is required even if an arrangement is within the safe harbor provided by section 28(e). n20 In addition, money managers must comply with any other laws imposing fiduciary or other obligations with respect to their participation in such arrangements. Set forth below is a discussion of the principal provisions of the Advisers Act and Company Act and rules and forms thereunder which, depending on the facts and circumstances involved, impose disclosure and other obligations on money managers and related persons.

n 20 As the Commission stated in a 1979 release adopting rule and form amendments designed to require registered investment companies to provide investors with disclosure about brokerage placement practices and policies, "[t]hese disclosure requirements reflect a longstanding policy of the Commission that brokerage placement practices of investment managers may take into consideration research and brokerage services, *provided, however, that such practices are disclosed to investors.*" Securities Act Rel. No. 6019 (Jan. 30, 1979) (emphasis added) [hereinafter cited as Release 6019]. *See* "Applicability of the Commission's Policy Statement on the Future Structure of the Securities Markets To Selections of Brokers and Payments of Commissions By Institutional Managers," Securities Act Rel. No. 5250 (May 9, 1972) [hereinafter cited as Release 5250].

##### A. Advisers Act

###### 1. Form ADV

Fundamental to the Advisers Act is the concept that an investment adviser has a fiduciary obligation to act in the best interests of clients. As a fiduciary, an adviser has a duty to disclose to clients all material information which is intended "to eliminate, or at least expose," all potential or actual conflicts of interest "which might incline an investment

adviser consciously or unconsciously -- to render advice which was not disinterested." n21 Due to the potential conflict of interest when an adviser receives research as a result of allocating brokerage on behalf of clients' accounts, the Commission has long maintained that an adviser must disclose soft dollar arrangements to clients. The Commission has adopted mandatory disclosure standards for advisers involved in such arrangements, n22 as discussed below.

n 21 *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92 (1963); See also Section 206 of the Advisers Act; Rule 204-3 under the Advisers Act.

n 22 *E.g.*, Release 6019, *supra* note 20.

Pursuant to its authority in section 28(e)(2) to adopt rules governing a money manager's disclosure of brokerage policies and practices, the Commission proposed disclosure rules in 1976, n23 but later determined to "incorporate more comprehensive brokerage placement practice disclosure requirements" within the registration process for investment advisers under the Advisers Act. n24 One of these provisions is the so-called "brochure rule," which was adopted in 1979 and is set forth in Rule 204-3 under the Advisers Act. This rule requires generally that an adviser furnish each advisory client and each prospective advisory client with a written disclosure statement containing certain information regarding the adviser's business background and practices. n25 The disclosure statement may be either a copy of Part II of the adviser's Form ADV, n26 the registration form for investment advisers, or a written document containing at least the information required by Part II of the Form ADV. n27

n 23 Securities Act Rel. No. 5772 (Nov. 30, 1976).

n 24 Investment Advisers Act Rel. No. 664 (Jan. 30, 1979).

n 25 The specific delivery requirements applicable to the brochure are set forth in paragraphs (b) and (c) of Rule 204-3.

n 26 Recently the Commission adopted a new, uniform Form ADV, the uniform application form for advisers registered with the Commission and the forty states that require advisers to register. Investment Advisers Act Rel. No. 991 (Oct. 15, 1985). The form was developed jointly by the Commission and the North American Securities Administrators Association.

New Form ADV retains the two part format for the earlier form. Part I requires disclosure primarily for use by regulatory agencies. Part II of the form, which serves as the basis for the brochure rule, requires disclosure primarily for use by clients.

n 27 See Rule 204-3(a).

Item 12 of Part II of Form ADV requires disclosure to clients regarding investment or brokerage discretion. The purpose of this disclosure is to provide clients with material information about the adviser's brokerage allocation policies and practices which may be important to them in deciding to hire an adviser or continue a contract with an adviser and which will permit them to evaluate any conflicts of interest inherent in the adviser's arrangements for allocating brokerage. n28 Because brokerage policies and practices vary greatly, the disclosure made in response to Item 12 should provide sufficient information to enable a client or potential client to understand such policies and practices. This item requires disclosure regarding (1) whether the adviser or a related person has authority to determine, without specific client consent, the broker-dealer to be used in any securities transaction or the commission rate to be paid, or (2) whether the adviser or a related person suggests broker-dealers to clients. If the adviser engages in either of these practices, whether or not pursuant to a written agreement, it must describe the factors considered in selecting broker-dealers and in determining the reasonableness of commissions charged. If the value of products, research, and services given to the adviser or a related person is a factor in those decisions, the adviser must describe the following:

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n 28 A general discussion of the background, purpose, and effect of the disclosure required in what is now Item 12 of Form ADV may be found in Release 6019, *supra* note 20.

-- The products, research, and services; n29

n 29 An adviser need not list individually each product, item of research, or service received, but rather can state the types of products, research, or services obtained with enough specificity so that clients can understand what is being obtained. Disclosure to the effect that various research reports and products are obtained would not provide the specificity required.

-- Whether clients may pay commissions higher than those obtainable from other brokers in return for those products and services;

-- Whether research is used to service all of the adviser's accounts or just those accounts paying for it; and

-- Any procedures the adviser used during the last fiscal year to direct client transactions to a particular broker in return for products and research services received. n30

n 30 The adviser should disclose any practices, including informal ones and whether or not they involve "paying up," to allocate brokerage to particular brokers in recognition of research products and services received. In this connection, the Commission notes that a money manager that obligated itself formally to generate a specified amount of commissions would be faced with a heavy burden of demonstrating that he was consistently obtaining best execution.

In its release discussing the concurrent adoption of Form ADV disclosure requirements n31 and the brochure rule, the Commission pointed out that:

n 31 Item 12 of the new uniform Form ADV mirrors Item 11 of the superseded form and has remained substantively the same since its adoption in 1979.

the amended rule and forms represent mandatory disclosure standards. More detailed or additional information and explanatory material could and should be provided where necessary, because of circumstances in particular cases, to ensure that all material information regarding brokerage placement practices and policies will be disclosed to investors. n32

n 32 Release 6019, *supra* note 20, 14 SEC Docket 839. In addition to the disclosure required by Item 12 of Part II of Form ADV, Item 13 of Part II requires disclosure that may be relevant to soft dollar arrangements. That item requires an adviser to describe any oral or written arrangements where it or any related person receives some economic benefit from a non-client, including a benefit in the form of non-research services, in connection with giving advice to clients.

An investment adviser should be particularly aware of the fact that the Advisers Act disclosure requirements apply to all soft dollar arrangements, whether or not they are within the safe harbor of section 28(e). n33 Moreover, compliance with Advisers Act disclosure requirements does not relieve an adviser from other disclosure obligations under federal or state law.

n 33 See, e.g., Release 16679, *supra* note 7; Release 6019, *supra* note 20.

## 2. Section 204

Section 204 of the Adviser Acts authorizes the Commission to adopt rules prescribing the books and records a registered adviser must maintain. Pursuant to this authority, the Commission has adopted Rule 204-2, which requires an adviser to keep true, accurate, and current books and records relating to its advisory business. n34 In the case of securi-



ties transactions, particularly those which may involve soft dollars, the adviser's books and records should contain sufficient details relating to each participant in a particular transaction.

n 34 *E.g.*, Rule 204-2 (a)(1), (a)(2), and (a)(3).

### 3. Best Execution

The Commission's staff has stated that an adviser, as a fiduciary, owes its clients a duty of obtaining the best execution on securities transactions. n35 For further discussion of best execution, see Section V of this release.

n 35 *E.g.*, *Interfinancial Corp.* (pub. avail. Mar. 18, 1985). *See also* Release 5250, *supra* note 20 (in selecting a broker-dealer, a money manager "is not required to seek the service which carries the lowest cost so long as the difference in cost is reasonably justified by the quality of the service offered"); Securities Exchange Act Rel. No. 12251 (Mar. 24, 1976).

### B. Company Act

The Company Act and rules and forms thereunder impose various disclosure and other obligations on registered investment companies, investment advisers of registered investment companies, and related persons in connection with soft dollar arrangements.

#### 1. Form N-1A

Form N-1A is the integrated registration form used by most open-end management investment companies to register under the Company Act and to register their securities under the Securities Act of 1933. Its disclosure requirements form the basis of the two-part prospectus used by these investment companies. Part B of the form, termed the "Statement of Additional Information," requires disclosure about the company's brokerage allocation practices. 3 n6 Specifically, Item 17 requires a description of how transactions in portfolio securities are effected, including a general statement about brokerage commissions. Investment companies also must describe how broker-dealers will be selected to effect securities transactions and how the overall reasonableness of commissions paid will be evaluated, 3 n7 including the factors considered in connection with these determinations. The instructions to this item further require that:

n 3 6 Registered investment companies must make the Statement of Additional Information available free of charge to shareholders and potential investors upon request.

n 3 7 Where an investment manager, in return for research services, pays an affiliated broker-dealer more than normal charges for execution of brokerage transactions, the manager "would be under a heavy burden to show that such payments were appropriate." Release 6019, *supra* note 20, 16 *SEC Docket* 844.

-- If the receipt of products or services other than brokerage or research is a factor in selecting brokers, the products and services should be described;

-- If the receipt of research services is a factor in selecting brokers, the nature of such research services should be described;

-- The registrant must state if persons acting on its behalf are authorized to pay a commission in excess of that which another broker might have charged for the same transaction in recognition of brokerage or research services provided by the broker;

-- If applicable, the registrant should explain that research services provided by brokers may be used by the adviser in servicing all of its accounts or described other practices applicable to the registrant regarding allocation of research services provided by brokers; and

-- The registrant must state the amount of transactions and related commissions paid as a result of directing the registrant's brokerage transactions to a broker because of research services provided pursuant to an agreement or understanding with a broker or otherwise through an internal allocation procedure. 3 n8

n 3 8 Disclosure about brokerage allocation practices also is required by other registration and reporting forms used by investment companies. *E.g.*, Form N-2 (Item 9); Form N-3 (Item 22); and Form N-SAR (Item 26).

## 2. Section 20(a)

Section 20(a) of the Company Act makes it unlawful for any person to solicit proxies regarding the securities of any registered investment company in contravention of Commission rules. Pursuant to this provision, the Commission has adopted two rules that may be relevant to soft dollar arrangements. First, where a proxy solicitation is made on behalf of the management of the investment company, Rule 20a-1(b) requires the adviser of the investment company to furnish promptly to management, upon request, all information necessary for management to comply with the proxy rules, including information about soft dollar arrangements.

In addition to this general obligation, Rule 20a-2 requires disclosure of specific information about the adviser and its investment advisory contract in certain proxy solicitations, n 3 n9 including information about brokerage placement practices. Specifically, paragraph (b)(7) of the rule requires disclosure of, among other things, the following:

n 3 9 The requirements of Rule 20a-2 are applicable to any solicitation made by or on behalf of management or the adviser involving action with respect to the election of directors of the investment company. *See* Rule 20a-2(a).

-- A description of how brokers are selected to effect securities transactions for the company and how the reasonableness of overall brokerage commissions paid will be evaluated, including the factors considered in these determinations;

-- If the receipt of products or services other than research or brokerage is a factor in selecting brokers, a description of these products or services;

-- If the receipt of research services is a factor in selecting brokers, the nature of such services;

-- Whether persons acting on behalf of the company are authorized to pay a broker a commission in excess of that which another broker might have charged for the same transaction in recognition of brokerage or research services provided by the broker;

-- If applicable, an explanation that research services furnished by the company's brokers may be used by the adviser in servicing all of its accounts and that not all such services may be used by the adviser in connection with the company, or an explanation of other policies or practices applicable to the company regarding the allocation of research services provided by brokers; and

-- The amount of transactions and related commissions directed to a broker or brokers pursuant to an agreement or understanding or otherwise through an internal allocation procedure.

## 3. Section 15(c)

Section 15(c) makes it unlawful for any investment company to enter into or renew any investment advisory contract unless it is approved by a majority of the company's disinterested directors. In approving such a contract, this provision imposes on directors a duty to request and evaluate such information as may reasonably be necessary for the directors to evaluate the terms of the contract. This provision also imposes on the company's adviser a duty to furnish such information to the directors. 4 n0

n 4 0 In addition to paragraph (c) of section 15, paragraph (a)(1) of that provision may be applicable to a soft dollar arrangement. This provision makes it unlawful for any person to serve as an investment adviser of a registered investment company except pursuant to a written contract which has been approved by a majority vote of shareholders and which "precisely describes all compensation" to be paid under that contract. As to what constitutes "compensation," *see infra* note 46.

The Supreme Court has defined the Congressional purpose in enacting section 15(c) and related provisions of the Company Act as placing "the unaffiliated directors in the role of 'independent watchdogs' " 4 n1 entrusted with "the primary responsibility for looking after the interest of the funds' shareholders." 4 n2 Disinterested directors are required to "exercise informed discretion, and the responsibility for keeping the independent directors informed lies with management, *i.e.*, the investment adviser and interested directors." 4 n3 Depending on the facts involved, the responsibility of the disinterested directors may include monitoring of the adviser's soft dollar arrangements.

n 4 1 *Burks v. Lasker*, 441 U.S. 471, 484 (1979), citing *Tannenbaum v. Zeller*, *supra* note 4.

n 4 2 *Burks*, *supra* note 41, at 485.

n 4 3 *Tannenbaum*, *supra* note 4, at 417-18.

#### 4. Section 31

Section 31 of the Company Act authorizes the Commission to adopt rules prescribing the books and records to be maintained by a registered investment company or by others, on its behalf, including investment advisers. n44 Pursuant to this authority, the Commission adopted Rule 31a-1. Paragraph (b)(9) of that rule requires an investment company to maintain a record for each fiscal quarter describing in detail the basis or bases upon which it allocated orders for the purchase or sale of portfolio securities and divided brokerage commissions or other compensation on such orders. n45 The record also must indicate the consideration given to services or benefits supplied by broker-dealers to the investment company or adviser and show the nature of such services or benefits made available.

n 44 *See* Rule 31a-3.

n 45 Rule 31a-1(b)(9) requires this record to be completed within ten days after the end of the quarter.

#### 5. Section 36(b)

Under Section 36(b) of the Company Act, an investment adviser to a registered investment company has a fiduciary duty with respect to the receipt of compensation for services, n46 or of payments of a material nature, from the investment company or its shareholders. However, with respect to any such amount received by an adviser, no violation of section 36(b) could occur for a soft dollar arrangement falling within the safe harbor of section 28(e). n47 Where an adviser received amounts outside of the safe harbor of section 28(e) such amounts would have to be analyzed under section 36(b) to determine if they were consistent with that provision.

n 46 The term "compensation" under Section 36(b) and other provisions of the Company Act has been broadly construed to include any economic benefit paid directly or indirectly to an adviser. *E.g.*, *Steadman Securities Corporation*, *Securities Exchange Act Rel. No. 13695 at 12 SEC Docket 1042, 1052* (June 29, 1977) *rev'd on other grounds sub. nom. Steadman v. Securities and Exchange Commission*, 603 F.2d 1126 (5th Cir. 1979), *aff'd*, 450 U.S. 91 (1981). *In re Investor Research Corporation, et al.*, 12 SEC Docket 102 (1978), *aff'd in part and vacated in part, Investors Research Corporation and Stouers v. Securities and Exchange Commission*, 628 F.2d 168 (D.C. Cir. 1980), *cert. denied*, 449 U.S. 919 (1981) [hereinafter cited as *Investors Research*]. *Investors Research Corporation*, *Investment Advisers Act Rel. No. 627* (May 1, 1978), *aff'd in part and vacated in part* 628 F.2d 168 (D.C. Cir. 1980), *cert. denied* 449 U.S. 919 (1981); *Imperial Financial Services*, 42 SEC 717 (1965); Release 5250, *supra* note 20; *Accord Investment Advisers Act Rel. No. 770* (Aug. 13, 1981) (the element of "compensation" in the definition of an investment adviser in Section 202(a) (11) of the Advisers Act "is satisfied by the receipt of any economic benefit \* \* \*").

n 47 *Securities Acts Amendments of 1975, Conference Report to Accompany S. 249, Joint Explanatory Statement of the Comm. of Conference*, H.R. Rep. No. 229, 94th Cong., 1st Sess. 108 (1975). Although both the Senate and House versions of the section 28(e) legislation contained provisions protecting money managers

against breach of fiduciary duty claims, the Conference Report makes clear that the Senate version was selected for the final legislation because it "more clearly preempted both statutory and common law." *Id.*

#### 6. Section 17(e)(1)

As relevant here, Section 17(e)(1) of the Company Act makes it unlawful for an affiliated person of a registered investment company n48 to receive any compensation n49 for the purchase or sale of any property to or for the investment company when that person is acting as an agent n50 for the company other than in the course of that person's business as a broker-dealer. n51 The Court of Appeals for the Second Circuit has held that the objective of section 17(e)(1) "is to prevent affiliated persons [of investment companies] from having their judgment and fidelity impaired by conflicts of interest" n52 in situations where the benefit of a reciprocal relationship between the affiliated person and another person is diverted to the affiliated person while the burden of that relationship is borne by the investment company. n53

n 48 The phrase "affiliated person" of an investment company is defined in section 2(a)(3)(E) of the Company Act and includes, among others, an investment adviser to an investment company. The proscription of section 17(e)(1) also applies to any affiliated person of an affiliated person of the investment company.

n 49 *See supra* note 46.

n 50 As the Second Circuit stated in *United States v. Deutsch*, 451 F.2d 98, 111 (2d Cir. 1971), cert. denied, 404 U.S. 1019 (1972), an affiliated person of an investment company is acting as an "agent" in connection with the purchase or sale of property for purposes of Section 17(e)(1) "in all cases when he is not acting as broker for the investment company." *See Provident Management Corp.*, 44 SEC 442, 448 (1970) [hereinafter cited as *Provident*].

n 51 Where an adviser is acting as "broker" in connection with the purchase or sale of securities to or for an investment company, its activities would be governed by section 17(e)(2) of the Company Act.

n 52 *Deutsch*, *supra* note 50, at 109.

n 53 *See Investors Research*, *supra* note 45, at 173.

It is important to emphasize that receipt by an investment adviser of any compensation n54 pursuant to a soft dollar arrangement in connection with the purchase or sale of any property, including securities, to or for the investment company arguably would violate section 17(e)(1). To the extent that compensation is received by an affiliated person of a fund pursuant to a soft dollar arrangement within the safe harbor of section 28(e), however, the prohibition of section 17(e)(1) would not apply. n55

n 54 *See supra* note 46, and accompanying text.

n 55 The fact that a soft dollar arrangement outside of section 28(e) is disclosed would not cure a violation of section 17(e)(1) because that provision reflects the Congressional determination that disclosure alone is not adequate protection in the investment company field. *Investors Research*, *supra* note 46.

Finally, it is not necessary to show that the person receiving compensation prohibited by section 17(e)(1) influenced the actions of the investment company, n56 nor must economic injury to the investment company be shown. n57 Rather, the essence of a violation of section 17(e)(1) is the mere receipt of compensation in connection with the purchase or sale of property to or from the investment company.

n 56 *Deutsch*, *supra* note 50, at 109.

n 57 *Id.* "No showing of actual impairment need be made. This is a prophylactic statute. Its aim is not to redress harm but to prevent it." *Investors Research, supra* note 46, at 1023. *See also Provident, supra* note 50.

#### V. Best Execution Obligations

As a fiduciary, a money manager has an obligation to obtain "best execution" of clients' transactions under the circumstances of the particular transaction. The money manager must:

execute securities transactions for clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances. n58

n 58 Securities Exchange Act Rel. Act No. 9598 [1971-72 Transfer Binder] *Fed. Sec. L. Rep. (CCH) para. 78,776 (1972); Kidder, Peabody & Co., Inc., Investment Advisers Act Rel. No. 232 (Oct. 16, 1968).*

A money manager should consider the full range and quality of a broker's services in placing brokerage including, among other things, the value of research provided as well as execution capability, commission rate, financial responsibility, and responsiveness to the money manager. The Commission wishes to remind money managers that the determinative factor is not the lowest possible commission cost but whether the transaction represents the best qualitative execution for the managed account. In this connection, money managers should periodically and systematically evaluate the execution performance of broker-dealers executing their transactions.

#### VI. Employee Benefit Plans and Plan Sponsor Directed Brokerage

During the past year the practice of plan sponsor directed brokerage has drawn considerable attention. This phrase refers to an arrangement whereby an employee benefit plan sponsor requests its money manager, subject to the manager's satisfaction that it is receiving best execution, to direct commission business to a particular broker-dealer who has agreed to provide services, pay obligations or make cash rebates to the plan.

At the outset, the Commission wishes to emphasize that directed brokerage transactions clearly do not fall within the safe harbor of section 28(e). The safe harbor is available only to persons who are exercising investment discretion, as that term is defined in section 3(a)(35) of the Act. n59 A pension plan sponsor that has retained a money manager to make investment decisions, as is the case in directed brokerage arrangements, is not exercising investment discretion. n60 Accordingly, neither the plan sponsor, the money manager, nor the broker-dealer participating in the transactions can rely on section 28(e).

n 59 Section 3(a)(35) provides that a person exercises "investment discretion" with respect to an account if, directly or indirectly, such person (A) is authorized to determine what securities or other property shall be purchased or sold to or for the account, (B) makes decisions as to what securities or other property shall be purchased or sold by or for the account even though some other person may have responsibility for such investment decisions, or (C) otherwise exercises such influence with respect to the purchase and sale of securities or other property by or for the account as the Commission, by rule, determines, in the public interest or for the protection of investors, should be subject to the operation of the provisions of this title and the rules and regulations thereunder.

n 60 *See Foley & Lardner* [1976-77 Transfer Binder] *Fed. Sec. L. Rep. (CCH) para. 80,925 (Dec. 3, 1976); Capital Institutional Services, Inc.* [Current] *Fed. Sec. L. Rep. (CCH) para. 78,107 (May 1, 1985).*

Section 28(e), however, cannot by its terms be violated. Thus, the fact that sponsor directed brokerage transactions are outside its protections does not necessarily mean that such transactions are illegal. Nevertheless, each participant in the transaction may be exposed to liability unless certain aspects of the transaction are carefully handled. The Commis-

sion does not administer ERISA, but sponsor directed brokerage in connection with plans covered by ERISA may involve violations of that Act and may violate the antifraud provisions of the federal securities laws.

The Department of Labor has indicated that if the cash rebate, goods or services provided by the broker to the plan is not for a purpose that exclusively benefits the plan, the transaction would constitute a *per se* violation of ERISA. The Commission understands that many money managers and brokers who are engaging in directed brokerage transactions have required the pension plan to represent in writing at the initiation of such transactions that the rebate will be used for the exclusive benefit of the plan and its beneficiaries.

A second concern arises regarding the broker's obligation to accurately confirm transactions with customers pursuant to Rule 10b-10 under the Securities Exchange Act and to maintain books and records pursuant to Rule 17a-3. Rule 10b-10(a)(7)(ii) requires a broker to disclose the amount of remuneration received or to be received by him from a customer in connection with an agency transaction. In sponsor directed brokerage arrangements the broker-dealer has agreed to charge specified commissions but at the same time has agreed to rebate a portion of the commissions. At least in the case of a cash rebate, the confirmation is false if it does not at a minimum provide disclosure that a portion of the commission was returned to the plan. The Commission has emphasized in the past improper nature of this rebating practice without disclosure. n61 Rule 17a-3(a)(8) requires the broker to keep copies of confirmations of all purchases and sales of securities and copies of notices of all other debits and credits for securities, cash and other items for the account of customers. This provision would require that the broker document any rebating arrangements that it had entered into with plan sponsors.

n 61 See *Securities Exchange Act Rel. No. 16679, supra* note 7; *Securities Exchange Act Rel. No. 11629* (Sept. 3, 1975).

Third, section 28(e) allows a money manager in making his good faith determination as to the reasonableness of commissions paid to consider not only the benefit to be derived by the account paying the commissions, but also the benefits derived by other accounts. Since sponsor directed brokerage transactions are outside of the safe harbor, this additional element of protection is unavailable. Stated differently, the Commission believes that it is illegal, from a securities law fraud perspective, for a money manager or a broker-dealer to use one client's commissions to fund an undisclosed rebate to another client. This problem is particularly acute where a money manager aggregates orders for managed accounts. In this connection, the Commission believes that serious concerns are raised under the antifraud provisions of the securities laws where a money manager or broker-dealer aggregates directed and non-directed orders unless the money manager or broker-dealer can demonstrate that it has not disadvantaged one client's account in order to fund a rebate to another client. This means that the money manager and the broker-dealer must have a system of controls and a system of records to assure that this commingling does not occur.

## VII. Conclusion

The Commission believes that this release will provide useful guidance to money managers and other persons in the securities industry. It believes that the new standard comports fully with Congressional intent in the enactment of the section, while at the same time is responsive to concerns raised in response to a changing array of research products and the impact of new technology on brokerage practices. The Commission believes that the issue is ultimately one of good faith on the part of the money manager and that the disclosure obligations will allow clients to satisfy themselves that their money manager is in fact acting in their best interest.

List of Subjects in 17 CFR Part 241

Reporting and recordkeeping requirements, Securities.

PART 241 -- [AMENDED]

Part 241 of Title 17 of the Code of Federal Regulations is amended by adding this Interpretive Release Concerning the Scope of section 28(e) of the Securities Exchange Act of 1934 (Release No. 34-23170) to the list of Interpretive Releases.

Dated: April 23, 1986.

51 FR 16004

By the Commission.

John Wheeler,

Secretary.

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