TECHNICAL BULLETIN

U.S. Department of Labor
Office of Pension and Welfare Benefit Programs
Washington, D.C., 20210

ERISA TECHNICAL RELEASE NO. 86-1

FOR RELEASE: Thursday, May 22, 1986

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STATEMENT ON POLICIES CONCERNING SOFT DOLLAR AND DIRECTED COMMISSION ARRANGEMENTS

This statement reflects the views of the Pension and Welfare Benefits Administration (PWBA) with regard to "soft dollar" and directed commission arrangements pursuant to its responsibility to administer and enforce the provisions of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). Investment managers, plan sponsors and other members of the pension community which provide services to employee plans have expressed a great deal of interest in the application of the fiduciary responsibility provisions of ERISA to these arrangements.

"Soft dollar" and directed commission arrangements typically involve situations in which an investment manager of an employee benefit plan or other plan fiduciary purchases goods or services with a portion of the brokerage commission paid by a plan to a broker for executing a securities transaction. Prior to the elimination of fixed commission rates on stock exchange transactions, investment managers often purchased additional services with commission dollars beyond simple execution, clearance and settlement of securities transactions. After the elimination of fixed commission rates in May 1975, Congress, as part of the Securities Acts Amendments of 1975, added Section 28(e) to the Securities Exchange Act of 1934 (the 1934 Act) to address the practice whereby brokers provided investment managers with brokerage and research services. The Securities and Exchange Commission (the Commission) administers the 1934 Act and has exclusive authority to interpret the scope of Section 28(e) and the terms used therein.

Section 28(e) of the 1934 Act provides generally that 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. The limited safe harbor provided by Section 28(e) is available only for the provision of brokerage and research services to persons who exercise investment discretion with respect to an account as that term is defined in Section 3(a)(35) of the 1934 Act. The Commission has indicated that if a plan fiduciary does not exercise investment discretion with respect to the securities transaction or uses "soft dollars" to pay for non-research related services, the transaction falls outside the protection afforded by Section 28(e) of the 1934 Act and may be in violation of the securities laws and the fiduciary responsibility provisions of ERISA.

It has come to the attention of PWBA that ERISA fiduciaries may be involved in several types of "soft dollar" and directed commission arrangements which do not qualify for the "safe harbor" provided by Section 28(e) of the 1934 Act. In some instances, investment managers direct a portion of a plan's securities trades through specific broker-dealers, who then apply a percentage of the brokerage commissions to pay for travel, hotel rooms and other goods and services for such investment managers which do not qualify as research within the meaning of Section 28(e). /1 In other instances, plan sponsors who do not exercise investment discretion with respect to a plan direct the plan's securities trades to one or more broker-dealers in return for research, performance evaluation, other administrative services or discounted commissions. The Commission has indicated that the safe harbor of Section 28(e) is not available for directed brokerage transactions[1].

A fiduciary for an ERISA plan, such as a trustee or investment manager, must meet the fiduciary responsibility standards set forth in part 4 of Title I of ERISA[2]. These standards are designed to help ensure that the fiduciary's decisions are made in the best interests of the plan and are not colored by self- interest.

Section 403(c)(1) provides, in part, that the assets of a plan shall be held for the exclusive purpose of providing benefits to the plan's participants and their beneficiaries and defraying reasonable expenses of administering the plan. Section 404(a)(1) sets forth a similar requirement on how a plan fiduciary must discharge his duties with respect to the plan, and provides further that such fiduciary must act prudently and solely in the interest of the participants and beneficiaries. These basic provisions are supplemented by the per se prohibitions of certain classes of transactions set forth in section 406 of ERISA.

Section 406(a)(1)(D) of ERISA prohibits a fiduciary of an ERISA plan from causing that plan to engage in a transaction if he knows or should know that the transaction would constitute a direct or indirect transfer to, or use by or for the benefit of, a party in interest, of any assets of that plan. Section 3(14) includes, within the definition of "party in interest" with respect to a plan, any fiduciary with respect to that plan. Thus, section 406(a)(1)(D) would not only prohibit a fiduciary from causing the plan to engage in a transaction which would benefit a third person who is a party in interest, but it also would prohibit the fiduciary from similarly benefiting himself. In addition, section 406(b)(1) specifically prohibits a fiduciary with respect to a plan from dealing with the assets of that plan in his own interest or for his own account. Section 406(b)(3) supplements these provisions by prohibiting a plan fiduciary from receiving any consideration for his own personal account from any party dealing with the plan in connection with a transaction involving the assets of the plan.

When investment management responsibility has been properly delegated to an investment

[1] See Securities Exchange Act Release No. 34-23170 (April 23, 1986).
[2] See Section VI of Securities Exchange Act Release No. 34-23170 (April 23, 1986).

manager, the manager is responsible for all aspects of the investment process. [3] The manager, in those cases, is required to act prudently both with respect to a decision to buy or sell securities as well as with respect to the decision concerning who will execute the transaction if such a delegation has occurred, the named fiduciary of the plan is not liable for the particular acts or omissions of the manager but has oversight responsibility to periodically review the investment manager's performance.

Where an investment manager has entered into a "soft dollar" arrangement, Section 28(e) of the 1934 Act does not relieve anyone other than the person who exercises investment discretion from the application of the fiduciary provisions of ERISA. Therefore, the fiduciary who appoints the investment manager is not relieved of his ongoing duty to monitor the investment manager to assure that the manager has secured best execution of the plan's brokerage transactions and to assure that the commissions paid on such transactions are reasonable in relation to the value of the brokerage and research services provided to the plan.[4]

It is PWBA's understanding that where a plan sponsor or other plan fiduciary directs the investment manager to execute securities trades for the plan through one or more specified broker-dealers, the direction generally requires the investment manager to execute a specific percentage of the plan's trades or a specified amount of the plan's commission business through the particular broker-dealers, consistent with the manager's duty to secure best execution for the transactions.

A plan sponsor's decision to direct brokerage transactions must be made prudently and solely in the interest of the participants and beneficiaries. In directing a plan's brokerage transactions, the sponsor has an initial responsibility to determine that the broker-dealer is capable of providing best execution for the plan's brokerage transactions. In addition, the sponsor has an ongoing responsibility to monitor the services provided by the broker- dealer so as to assure that the manager has secured best execution of the plan's brokerage transactions and that the commissions paid are reasonable in relation to the value of the brokerage and other services received by the plan.

In considering "soft dollar" and directed commission arrangements, ERISA's prohibited transaction provisions also must be taken into account. A fiduciary with respect to an ERISA plan is generally prohibited, by section 406(b)(1) from causing the plan to engage in a transaction if the fiduciary has an interest in the matter which may affect the fiduciary's best judgment as a fiduciary. For example, an employer which is the named fiduciary for its plan and which does not exercise investment discretion would normally be prohibited from directing the plan's brokerage transactions through a designated broker-dealer who agrees to utilize a portion of the brokerage commissions received from the plan to procure goods or services for the benefit of the employer. (As previously noted, section 28(e) is unavailable for

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[3] Section 405 of ERISA limits the liability of certain plan fiduciaries if management of plan assets has been properly delegated to an investment manager.

[4] In PWBA's view, an investment manager's responsibility to seek best execution under the circumstances requires the manager to consider not only the cost of the commissions for the transaction but the quality reliability of the execution.

such brokerage transactions.) Each use of the broker-dealer that results in the receipt of goods and services by the employer following that designation would create an additional violation of sections 406(a)(1)(D) and 406(b)(1) of ERISA. In addition, where the relief provided by Section 28(e) is unavailable, the receipt by a fiduciary (i.e., the employer) of goods or services for its own personal account from a party (i.e., the broker-dealer) dealing with a plan in connection with a transaction involving the assets of the plan would, in the opinion of PW8A, constitute a violation of section 406(b)(3). Such an arrangement would also violate sections 403(c)(1) and 404(a)(1) to the extent that the employer is benefiting from its use of its position.

However, where an investment manager directs brokerage transactions through a designated broker-dealer to procure goods and services on behalf of the plan, and for which the plan would be otherwise obligated to pay, such use of brokerage commissions ordinarily would not violate the fiduciary provisions of ERISA, provided that the amount paid for the brokerage and other goods and services is reasonable, and the investment manager has fulfilled its fiduciary duty to obtain best execution for the plan's securities transactions. This result does not depend on the availability of the "safe harbor," under Section 28(e) for these transactions.

In applying the fiduciary responsibility provisions of ERISA to the various "soft dollar" and directed commission arrangements that fall outside of the protection of Section 28(e), it is apparent to PWBA that issues are raised under section 406 of ERISA whenever there is an inducement for the investment manager or other plan fiduciary to direct plan brokerage transactions through particular broker-dealers. The following examples illustrate the application of the fiduciary responsibility provisions of ERISA to "soft dollar" and directed commission arrangements:

(1) Employer X instructs the master trustee of its plan to direct all plan brokerage transactions through Broker-Dealer B. Part of the commissions are rebated to the master trustee to reduce its fees. The plan provides that administrative costs, including the fees of the master-trustee, are to be paid by the plan. Under these circumstances, this transaction would not, in itself, constitute a violation of the prohibited transaction provisions of ERISA since the “soft dollars" are being used for the exclusive benefit of the plan which generated the commissions. However, in order to act prudently under section 404(a)(1) of ERISA, Employer X would be obligated to initially determine that Broker-Dealer D is capable of providing best execution of the plan's brokerage transactions. In addition, Employer X must also periodically monitor the execution of the plan's brokerage transactions and evaluate whether the brokerage commissions paid by the plan are reasonable in light of the total services received by the plan. Moreover, Employer X would be obligated to assure that the arrangement does not result in the payment of unreasonable compensation to the master trustee.

(2) Money Manager A enters into an arrangement with Broker- Dealer B whereby Money Manager A would direct brokerage on behalf of its managed plan accounts which would generate fees of $500,000 per year to Broker-Dealer B. In return, Broker- Dealer B would provide bookkeeping services that do not constitute

research under Section 28(e) for the general corporate purposes of Money Manager A. Money Manager A has engaged in an act prohibited by sections 406(a)(1)(D), 406(b)(1) and 406(b)(3) of ERISA since Money Manager A has exercised its fiduciary authority over plan assets to benefit itself. Such a transaction would also violate the exclusive purpose provisions of sections 403(c)(1) and 404(a)(1) of ERISA. In these circumstances, the relief provided by Section 28(e) would not be available because the "soft dollars" are paid for services other than research.

(3) The named fiduciaries of Plan P retain Money Manager C to manage part of the assets of Plan P. Money Manager C directs the plan's brokerage transactions through Broker-Dealer D. In return, Broker-Dealer D will provide research on tax-exempt securities to Money Manager C. Although tax-exempt securities would not be a suitable investment for Plan P, Money Manager C has determined that this research would be useful to his managed accounts as a whole. Money Manager C's arrangement with Broker-Dealer D is therefore encompassed by Section 28(e) of the 1934 Act. However, in retaining Money Manager C, the named fiduciaries of Plan P are required under section 404(a)(1) of ERISA to periodically review the execution secured by Money Manager C and ensure that the brokerage commissions paid by Plan P to Broker-Dealer D are reasonable.

The foregoing discussion is intended to provide general guidance as to the nature of the analysis applicable to these situations. The discussion should not be viewed as expressing an opinion with respect to any specific case.