Soft Dollars: *A Hot-Button Issue Ripe for Reform*

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In this time of heightened regulatory attention to potential conflicts of interest and the transparency of transaction costs in buying and selling portfolio securities, soft dollar practices have come under intense scrutiny. Regulators are asking whether the use of soft dollars should be eliminated, while some in the investment management industry have begun to restrict their own practices or even voluntarily discontinue them.

What should you be doing now? Should you be re-evaluating your soft dollar arrangements? Do you have effective soft dollar policies and procedures in place to maintain compliance with applicable regulatory requirements? Who are the primary beneficiaries of your soft dollar arrangements?

This article outlines the background and regulatory considerations applicable to soft dollar arrangements, and discusses the issues money management firms should consider in reviewing their soft dollar practices.

BACKGROUND

Almost all investment advisers use client commissions to obtain products and services other than pure execution from broker-dealers. One important service that broker-dealers provide to investment advisers is research. This research can originate from either the broker-dealer's own research department or from an independent third-party firm. Soft dollar arrangements typically are those where a money manager directs its clients' brokerage transactions to a broker-dealer for trade execution services as well as research used in making investment decisions for clients.

Because soft dollars are generated by commissions paid by an adviser's clients, they are assets of the clients. The use of commission dollars to obtain research and other services can benefit an adviser as well as its clients and therefore creates a conflict between the interests of clients and those of the adviser. When an adviser uses client commissions to buy research from a broker-dealer, it receives an economic benefit because it is relieved from the need to produce or pay for the research itself. In addition, when soft dollar transactions involve the adviser obtaining executions at inferior prices or "paying up," advisers face a conflict between their desire to acquire research and their fiduciary obligation to obtain the best available price and execution for clients.

In recognition of the value of soft dollars, some advisers place portfolio trades at the direction of clients with broker-dealers to pay for those clients' expenses. For example, a broker-dealer, in return for commissions, may pay third parties for services rendered to a client, such as custodian fees or printing bills. In addition, soft dollars may be used to reward broker-dealers that sell shares of mutual funds.[1]

As a fiduciary, an investment adviser should act in the best interests of clients and should not benefit from its position.[2] Because

of the conflict of interest that exists when an investment adviser receives investment research, products or other services through allocation of client brokerage, the Securities and Exchange Commission ("SEC") requires advisers to disclose these soft dollar arrangements fully to clients and potential clients.

Soft dollar arrangements are permissible under the securities laws if appropriate disclosure is made about the products and services for which the soft dollars will be used, as well as that the client may pay higher brokerage commissions as a result of the arrangements.[3] The SEC has recognized that providing research to clients "is a fundamental element of the brokerage function for which the *bona fide* expenditure of the beneficiary's funds is completely appropriate, whether in the form of higher commissions or outright cash payments" so long as the client obtains the best execution.[4] The SEC requires, however, that investors be advised "that their money manager is willing to exercise discretion in seeking the best information and research available and does not consider that there is an obligation to get the cheapest execution regardless of quantitative consideration."[5]

SECTION 28(e) SAFE HARBOR

In 1975, when fixed commission rates were eliminated, Congress created a safe harbor under Section 28(e) of the Securities Exchange Act of 1934 ("Exchange Act") to protect advisers from claims that they had breached their fiduciary duties by causing clients to pay more than the lowest available commission rates in exchange for research and execution. Under the fixed-rate environment, advisers typically obtained from broker-dealers research services that were paid for with portfolio brokerage. Congress was concerned that, upon the transition to negotiated commission rates, fiduciary laws would be interpreted to require advisers always to seek the lowest execution costs.[6] In addition, Congress was concerned that price competition would drive commissions so low that broker-dealers would not be able to continue to provide research services.

Section 28(e) provides that, notwithstanding any provision of law to the contrary and subject to certain conditions, an investment adviser may, in determining the reasonableness of brokerage commissions, consider the value to all of its clients of the brokerage and research services obtained. In addition, the safe harbor allows a money manager to use research and brokerage services paid for with the commission dollars of one client for the benefit of other clients.

The general standard against which prospective Section 28(e) arrangements are measured is: "whether the product or service provides lawful and appropriate assistance to the money manager's investment decision-making process."[7] An investment adviser may claim the safe harbor protection of Section 28(e) only if it satisfies the following six conditions:

1. The adviser may use commissions only to obtain "brokerage" or "research" services, not other products or services;[8]
2. The brokerage or research must be "provided by" the particular broker-dealer to which the commission business is directed;
3. The adviser must determine in good faith that any commissions paid to a broker-dealer pursuant to a soft dollar arrangement are *reasonable* in relation to the value of the brokerage and research services received by all of the adviser's eligible accounts;
4. Only "commissions in agency transactions," not dealer markups in principal transactions, may be used to obtain such services;
5. The investment adviser must have "investment discretion" over the account; and
6. The brokerage placed must be for "securities" transactions (and thus, for example, not futures transactions).

Although Section 28(e) only applies to research and brokerage-related products and services, in many cases products and services may relate to both research and non-research functions, or so-called "mixed-use" products and services. In these circumstances, an adviser may pay with soft dollars for only that portion of the product or service relating to research and brokerage activities, and must pay for the non-research portion in "hard dollars" from its own resources.[9] The SEC has made clear that an investment adviser must make a reasonable allocation of the costs of research and non-research services according to their use. The SEC also has recognized that it can be difficult to allocate these costs in a precise manner, and has stated that it would be sufficient if investment advisers make a good faith attempt to do so.[10]

In addition, while by its terms Section 28(e) refers to brokerage and research services that are "provided by" the broker that receives the commissions, the SEC consistently has interpreted this as encompassing certain services produced by third parties.[11]

Failure to comply with the conditions of Section

"Safe" does not mean that an investment adviser has violated any law. Rather, it means that the adviser's soft dollar arrangements are subject to regulation under all applicable laws that would otherwise apply but for the Section 28(e) safe harbor.

CURRENT REGULATORY LANDSCAPE

Soft dollar arrangements, while legal and a long-standing industry practice, have become a focus of Congress and the SEC amid the quest to understand and address such arrangements as an area of potential abuse.

Congress has focused on the use of soft dollars both in the House of Representatives and the Senate. The Mutual Funds Integrity and Fee Transparency Act of 2003 ("Baker Bill") and each of the four mutual fund reform bills pending in the Senate, at a minimum, seek to require enhanced disclosure of soft dollar arrangements to mutual fund shareholders.[12] In addition, the Baker Bill would amend Section 15 of the Investment Company Act of 1940 ("Investment Company Act") to require fund advisers to report annually to a fund's board of directors on revenue sharing, directed brokerage, and soft dollar arrangements with respect to the fund. Finally, the Baker Bill and several Senate bills call for an SEC study of Section 28(e).[13]

In response to Congressional inquiries, the SEC's Division of Investment Management ("Division") has gone beyond the disclosure proposals in pending legislation and stated that it may be appropriate to reconsider Section 28(e) or, alternatively, to amend the provision to narrow the scope of its safe harbor.[14] Indeed, Chairman Donaldson has stated that, at the very least, the SEC, through the rule-making process, should consider narrowing the definition of qualifying "research" under the safe harbor so that only "real" research that has valid intellectual content qualifies.[15] The SEC staff voiced concern about the growth of soft dollar arrangements and the conflicts they present to money managers. The Division expressed frustration that the SEC twice has proposed to require advisers to give clients periodic quantitative information about the use of client brokerage, and the research and services advisers obtain from brokers. Each time, the rules were not adopted because of intractable problems in valuing the research and services that advisers receive for soft dollars, tracing the allocation of those benefits to client accounts, and quantifying the effect of the benefits on the accounts' performance. Nonetheless, the Division has stated that it intends to continue its efforts to improve disclosure and expects to recommend that the SEC propose changes to the record-keeping rule under the Investment Advisers Act of 1940 to require advisers to keep better records of the products and services they receive for soft dollars.

Although Congress has not passed any legislation affecting soft dollar arrangements, the SEC has moved on several fronts with respect to soft dollar practices. The SEC has created a Task Force on Soft Dollars in response to concerns expressed by members of Congress.[16] The Task Force's goal is to understand fully all aspects of how soft dollars are used, and the pros and cons of various alternative reform approaches. The Task Force also will consider whether Section 28(e) should be repealed.

In December 2003, the SEC issued a concept release requesting comment on measures to improve the disclosure of mutual fund transaction costs.[17] In that release, the SEC noted that the limited transparency of soft dollar commissions may provide incentives for managers to misuse soft dollar services. The SEC requested comment regarding the requirement to quantify commissions. The SEC also focused on accounting issues relating to soft dollar arrangements, and whether and to what extent costs relating to soft dollar arrangements should be disclosed in a fund's financial statements or expense ratio and fee tables.

Most recently, the SEC has proposed amendments to Rule 12b-1 under the Investment Company Act to prohibit a mutual fund from compensating a broker-dealer for promoting or selling fund shares by directing brokerage transactions to that broker.[18] The proposed amendments also would prohibit "step-out" and similar arrangements designed to compensate brokers for selling fund shares.

Aside from concerns of the SEC and Congress, there have been calls within the industry to significantly limit the use of soft dollars under Section 28(e). In December 2003, the Investment Company Institute ("ICI") petitioned the SEC to adopt a revised interpretation of Section 28(e) that would exclude certain products and services from the scope of the safe harbor.[19] The ICI also recommended that the SEC adopt a rule that would prohibit investment advisers from using client commissions to pay for services or products that fall outside the safe harbor. It stated that this step would provide greater transparency in adviser compensation and would ensure that all investors are treated equitably by all investment advisers in connection with the adviser's use of brokerage.

Some advisory firms even have taken steps volun-

tarily to ban soft dollar arrangements.[20] A number of other money managers have begun to narrow their definitions of permissible soft dollar arrangements, even though certain items remain protected by the Section 28(e) safe harbor. As a result, those advisers are determining not to use soft dollars to cover the costs of, for example, personal computers, and instead are using hard dollars to pay for these items.

FOCUSING ON COMPLIANCE

Given the current regulatory environment, investment advisers engaging in soft dollar transactions should proceed cautiously. Soft dollar regulation is complex and is an area on which the SEC has focused consistently—through enforcement actions and sweep inspections. As a result, investment advisers should carefully review their current soft dollar arrangements, and their policies and procedures addressing such arrangements.

The first step is to identify all soft dollar arrangements. These arrangements can be identified by listing the broker-dealers used to execute client securities transactions and by identifying the services paid for with client commission dollars.

Next, consideration should be given to whether the adviser's soft dollar arrangements are being implemented under the Section 28(e) safe harbor. If so, it is important to review the six conditions listed above and confirm that each condition is being met with respect to each arrangement.

The area that causes difficulty for many advisers is dealing with "mixed-use" products. An adviser may obtain a product that has both research and non-research uses, so-called mixed-use items. In order to avail itself of the safe harbor with respect to the research portion of the product, the SEC requires an adviser to make a reasonable effort to allocate the cost of mixed-use products between hard and soft dollars.

Another condition under Section 28(e) to which investment advisers should give particular attention is that the brokerage and/or research services be "provided by" the broker-dealer executing client securities transactions. As a result, investment advisers must structure contracts appropriately for research products and services to be provided by third parties. For example, the contract should make clear that the broker-dealer, not the adviser, has the obligation to pay for the third-party products or services. In evaluating its soft dollar practices, an adviser should be mindful not to be obligated to pay for the products or services if the broker-dealer is unable or unwilling to do so.

If an adviser determines to make soft dollar arrangements outside of the Section 28(e) safe harbor, it must be careful not to violate any applicable statutory provisions. For investment company clients, Section 17(e)(1) of the Investment Company Act precludes an investment adviser, or an affiliated person of the adviser, from receiving "any compensation" (other than usual and ordinary brokerage commissions) when purchasing or selling any property as agent to or for a fund. In the SEC's view, unless the Section 28(e) safe harbor is available, the "receipt by an investment adviser of any compensation pursuant to a soft dollar arrangement in connection with the purchase or sale of . . . securities to or for the investment company arguably would violate Section 17(e)(1)."[21] Also, the Employee Retirement Income Security Act of 1974 generally prohibits fiduciaries from profiting from the use of plan assets outside of the Section 28(e) safe harbor.[22]

Regardless of whether a brokerage allocation arrangement is protected by Section 28(e), the fiduciary duty of an investment adviser to obtain "best execution" for its clients remains intact. For any client, an investment adviser's obligation to obtain the best execution of its client's transaction is paramount. Research is just one factor that an adviser should consider in determining whether best execution is being obtained. Consideration also should be given to the quality of the execution, the broker's execution capability with respect to the particular transaction, and the responsiveness of the broker to the adviser's needs. Consequently, an adviser should evaluate the best execution performance of broker-dealers with which it has entered into soft dollar arrangements.[23]

Third, investment advisers need to ensure that there is proper disclosure of their soft dollar arrangements. Disclosure is required even if the arrangement is within the Section 28(e) safe harbor. Soft dollar arrangements must be disclosed to an adviser's clients and prospective clients and to the SEC. Specifically, investment advisers are required to disclose their soft dollar practices to investors in response to Item 12 of Form ADV, Part II.

Is the disclosure of soft dollar practices adequate? The SEC has brought several administrative proceedings against investment advisers based on their failure to disclose their soft dollar practices adequately to clients. Boilerplate language describing the receipt of research products and services may not be sufficient. An adviser should describe the products, practices, and services that it receives for soft dollars in enough detail so that clients or potential clients can understand the adviser's practices. Also, an

adviser must disclose whether clients may be paying higher commissions in soft dollar arrangements and the conflicts. In addition, advisers must disclose that one client's commissions may be used to obtain a service that benefits other clients. Finally, advisers must provide full and complete disclosure concerning their practices of allocating costs in mixed-use situations.

Fourth, an adviser engaging in soft dollar transactions should maintain adequate records documenting its soft dollar activities, regardless of whether those arrangements meet the conditions of the Section 28(e) safe harbor. Rule 204-2 under the Investment Advisers Act of 1940 requires that an adviser maintain records of the "details relating to each participant in a particular [soft dollar] transaction." In addition, Rule 31a-1(b)(9) of the Investment Company Act requires an investment company to maintain records reflecting soft dollar transactions, including the bases upon which the allocation of orders to brokers are made.

Fifth, an adviser should maintain comprehensive soft dollar controls that address disclosure to clients, the use of soft dollars for research and non-research purposes, compliance with Section 28(e), mixed-use allocations, and record keeping. These policies and procedures typically establish methods for review and oversight of soft dollar arrangements. The SEC's examination staff is scrutinizing soft dollar arrangements closely, and has consistently emphasized the need to establish and implement appropriate policies and procedures.[24]

Finally, in addition to reviewing soft dollar arrangements and policies and procedures, it is important for an investment adviser to assess who is the primary beneficiary of the arrangements. Client brokerage dollars are assets of an adviser's clients. As such, they should be used for the primary benefit of clients. Careful consideration should be given in each instance to whether the firm's clients are the primary beneficiaries of its soft dollar arrangements. If this standard cannot be reasonably assured for any arrangement, then that arrangement should be appropriately curtailed or terminated.

ENDNOTES

[1]NASD Conduct Rule 2830(k)(7)(B). The National Association of Securities Dealers, Inc. recently proposed amendments that would eliminate this practice. *Proposed Amendment to Rule Relating to Execution of Investment Company Portfolio Transactions*, NASD Rule Filing 2004-027 (Feb. 10, 2004).

[2]*See, e.g.*, Restatement (Second) of Trusts § 203 (1959).

[3]SEC, *Policy Statement on Future Structure of Securities Market*, CCH Fed. Sec. L. Rep. Special Rep. No. 409, 36-37 (1972) ("1972 Policy Statement"); SEC, *Clarifying Statement of SEC Policy Statement on Future Structure of Securities Markets*, Investment Company Act Release No. 7170 (1972).

[4]1972 Policy Statement at 36-37.

[5]*Id.*

[6]Congress feared that there would be "potentially harmful consequences to all investors" as a result of these restrictions. S. Rep. No. 75, 94th Cong., 1st Sess. 69-70 (1975).

[7]Securities Exchange Act Release No. 23170 (Apr. 23, 1986) ("1986 Interpretive Release").

[8]Overhead or administrative expenses, such as rent, furniture, and secretarial support, do not constitute research. In addition, travel, food, and lodging incident to attendance at a research-oriented meeting are not in and of themselves research. *Id.*

[9]*Id.*

[10]*See* SEC Office of Compliance Inspections and Examinations, *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds* (Sept. 22, 1998) ("Soft Dollar Report"); 1986 Interpretive Release.

[11]*See, e.g., Report on the Investigation in the Matter of Investment Information, Inc.*, Securities Exchange Act Release No. 16679 (Mar. 19, 1980); Securities Exchange Act Release No. 12251 (Mar. 24, 1976).

[12]*The Mutual Funds Integrity and Fee Transparency Act of 2003*, H.R. 2420 (sponsored by Richard H. Baker, Chairman of the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises) (passed the House of Representatives on Nov. 19, 2003); *Mutual Fund Transparency Act of 2003*, S. 1822 (sponsored by Senator Akaka) (introduced Nov. 5, 2003); *Mutual Fund Investor Protection Act of 2003*, S. 1958 (sponsored by Senators Kerry and Kennedy) (introduced Nov. 25, 2003); *Mutual Fund Investor Confidence Restoration Act of 2003*, S. 1971 (sponsored by Senators Dodd and Corzine) (introduced Nov. 25, 2003); *Mutual Fund Reform Act of 2004*, S. 2059 (sponsored by Senator Fitzgerald) (introduced Feb. 10, 2004).

[13]For example, the Baker Bill requires that a study address the following issues: 1) the trends in the average amounts of soft dollar commissions paid by investment advisers and funds in the past three years; 2) the types of services provided through soft dollar arrangements; 3) the extent to which use of soft dollar arrangements impairs the ability of mutual fund investors to evaluate and compare the expenses of different mutual funds; 4) the conflicts of interest created by soft dollar arrangements; 5) the transparency of such soft dollar arrangements to fund shareholders and investment advisory clients of investment advisers; and 6) whether Section 28(e) should be repealed or modified.

[14]Memorandum from Paul F. Roye, Director of the Division of Investment Management, Securities and Exchange Commission, to Richard H. Baker, Chairman of the House

Subcommittee on Capital Markets at 41 (June 10, 2003).

[15]Testimony Concerning Investor Protection Issues Regarding the Regulation of the Mutual Fund Industry, by William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs (Apr. 8, 2004).

[16]*See Id.*

[17]SEC, *Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs* (Dec. 19, 2003).

[18]*Proposed Rule, Prohibition on the Use of Brokerage Commissions to Finance Distribution*, Investment Company Act Release No. 26356 (Feb. 24, 2004).

[19]Request for Rulemaking Concerning Soft Dollars and Directed Brokerage, submitted by Matthew Fink, President, Investment Company Institute (Dec. 16, 2003) (File No. 4-490). The ICI stated that such changes would clarify the application of the safe harbor in areas where guidance is needed, would make it easier for investors to understand the costs of various investment advisory products, would reduce incentives for money managers to engage in unnecessary trading, and would interpret Section 28(e) in a manner that would more closely reflect its original purpose.

[20]Robert C. Pozen, *The MFS Perspective on Soft Dollars*, NICSA News (May 7, 2004); *Merrill Narrows Soft Dollar Definition*, Fund Action (May 3, 2004).

[21]*See* 1986 Interpretive Release.

[22]*See Statement of Policies Concerning Soft Dollar and Directed Commission Arrangements*, Department of Labor, ERISA Technical Release No. 86-1, [1986-1986 Decisions] Fed. Sec. L. Rep. (CCH) ¶ 84,009 (May 22, 1986).

[23]1986 Interpretive Release.

[24]*See* Soft Dollar Report.