

SOFT DOLLARS: LEGAL ISSUES AND BEST PRACTICES FOR INVESTMENT ADVISERS

By

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INTRODUCTION

Soft dollars have created both regulatory consternation and adviser confusion for decades now. Critics advocating that soft dollars be banned altogether lost another round in the battle in 2006, when the SEC issued a new interpretive release on the use of soft dollars.¹ Although the release offers new guidance on soft dollars, consternation and confusion persist.

This outline is divided into two parts. Part 1 discusses the definition of soft dollars, along with the key legal issues that arise when an adviser uses soft dollars. Part 2 discusses best practices advisers should consider in managing their soft dollar practices.

This outline focuses on soft dollar issues under the federal securities laws from the perspective of an investment adviser. However, it also refers to relevant issues and authority governing the use of soft dollars for fund accounts, as well as some of the authority applicable to broker-dealers who participate in soft dollar arrangements with advisers.

Part 1: The Legal Issues

1. What Are “Soft Dollars”? What Does it Mean to be “Doing Soft Dollars”?

There is no legal definition of “soft dollars” in the federal securities laws. Indeed, use of the term soft dollars varies depending on the source and at times has been used to describe a wide variety of brokerage trading practices. Interestingly, there is so much confusion over the meaning and scope of the term that the SEC astutely avoided using the term “soft dollars” in connection with its 2006 Interpretive Release on soft dollars, where it instead chose to use the phrase “use of client commissions.”

Most sources use the term “soft dollars” to mean – in its most basic form -- an adviser’s use of client commissions to get something in exchange or to reward or compensate for something, such as a product or service. Stated another way, soft dollars are client commissions used by an adviser to receive products or services from the broker above and beyond mere execution.²

Generally speaking, then, advisers are “doing soft dollars” if they engage in an arrangement of the type described, or engage in practices that can be interpreted as the equivalent. Sometimes, advisers are “doing soft dollars” in arrangements that are more formalized, meaning that the adviser and a soft dollar broker agree on “ratios” which specify the amount of commissions the adviser must generate by trading through that broker in order to receive products or services of a particular value in return. For example, for every \$1.50 in commissions received by the broker, the adviser might receive “credit” for \$1 worth of products or services from the broker. In these more formalized arrangements, soft dollar “credits” are often tracked over a period of time with the aim of ensuring that enough commissions are generated to compensate for the products or services provided by the broker to the adviser. Even though these more formalized arrangements may not rise to the level of binding contracts,³ the parties often exchange periodic statements and reconciliations that track the status of the adviser’s credits over time.

In contrast, some soft dollar brokers provide products or services to an adviser on a more informal basis, without setting “ratios” and tracking a system of “credits.” Rather, the broker will simply expect the adviser to execute a sufficient amount of client transactions through the broker over a particular time period. Indeed some brokers, particularly full-service brokers, may provide research to an adviser that trades through those brokers without the adviser having asked for the research or even having a need for it. Nonetheless, because the adviser receives a product or service in connection with

client transactions, these arrangements or practices may also be viewed as “doing soft dollars,” at least for some purposes.

Note that “soft dollars” as described here are distinguishable from “directed brokerage” arrangements. Confusingly, directed brokerage is often considered under the same umbrella as soft dollars because directed brokerage involves the use of client commissions. However, in directed brokerage, the client is directing the adviser to place its brokerage with a particular broker in order to receive something (for example, commission rebates or expense offsets) that benefits the client. This contrasts with the typical soft dollar arrangement where the adviser has discretion to place the client’s brokerage and in return receives products or services that benefit the adviser, and may or may not benefit the client at all. As a result, the conflicts of interest inherent in soft dollars are not present in directed brokerage, and directed brokerage is therefore viewed and treated differently under the law.

2. What Potential Legal Claims Can Arise from Using Soft Dollars?

Soft dollars raise concerns on several fronts.

Fiduciary Duty: First, soft dollars raise the question of whether the adviser has breached its fiduciary duty to its client. An adviser has a fiduciary duty to seek best execution when executing discretionary client trades.⁴ The topic of soft dollars should not be viewed in isolation but rather should be considered in the context of best execution. When an adviser uses soft dollars to obtain products or services, the client is paying for more than mere execution and, accordingly, using soft dollars might result in the client paying a higher commission on the trade. Higher commissions, of course, would mean a less favorable net result for the trade. This is at odds with an adviser’s duty to seek best execution.

In addition, an adviser has a fiduciary duty of loyalty and to act in its client’s best interests.⁵ Issues are therefore raised if the products or services obtained for use of a client’s commissions – such as research – benefit the adviser by relieving the adviser from having to purchase that product or service out of its own resources with “hard dollars.” These issues are particularly acute if the product or service obtained benefits only the adviser, or only other clients of the adviser, and not the client whose trades generated the soft dollars used to obtain the benefit. This is at odds with the fundamental notion that commissions generated by trading in a client’s account belong to the client, not the adviser, therefore should not be used by the adviser as a fiduciary to benefit itself.⁶

Fraud/Disclosure: Because of the conflicts of interest inherent in an arrangement where a fiduciary (the adviser) uses a client’s asset (commissions generated in the client’s account) in such a way as to benefit the adviser (to obtain products or services that the adviser would otherwise have to obtain with its own “hard dollars”), issues are raised as to whether the adviser is defrauding the client if that conflict is not fully disclosed to and consented to by the client.⁷ Full and fair disclosure of the adviser’s conflicts of interest is fundamental to the adviser’s fiduciary duty and typically deemed necessary in order to avoid violating the anti-fraud provisions of the Investment Advisers Act of 1940, most notably Sections 206(1), (2) and (4). Accordingly, it is not surprising that many of the SEC enforcement actions involving soft dollars are centered on allegations of fraud.⁸

Breach of Contract: Advisory contracts often address placement of the client’s brokerage and it is not uncommon for contracts to provide that any “soft dollars” practices utilized with regard to the client’s account will be undertaken within the parameters of the Section 28(e) safe harbor (more on Section 28(e) under Questions 3 through 6 below). In that case, any use of a client’s commissions inconsistent with 28(e) or other applicable contractual provisions would raise breach of contract issues.

Form ADV: Item 8E of Part I of Form ADV asks advisers: “Do you or any related person receive research or other products or services other than execution from a broker-dealer or a third party in connection with client securities transactions?” With little doubt, this would call for disclosure of a traditional “soft dollar” arrangement. However, it would also appear to call for disclosure of many other non-traditional arrangements or practices – formal or informal, documented or undocumented, one-off

or on-going, intentional or not – in which the adviser receives something (other than execution) from anyone (a broker or third party) in connection with client transactions. At least for purposes of disclosure under this Item, those other arrangements or practices could be viewed as “doing soft dollars.” For example, this might cover the adviser who is getting client referrals from a broker and rewarding the broker with client commissions. It might also cover the adviser who is being sent research by a broker with whom the adviser places trades, even though the adviser did not ask for the research and, indeed, does not even use the research. These advisers – and others engaged in non-traditional arrangements or practices -- might be caught unaware of how broad Item 8E is and inadvertently fail to disclose an arrangement or practice involving use of client commissions that the adviser does not view as “doing soft dollars.”⁹

Items 12 and 13 of Part II of Form ADV also call for disclosure of arrangements relating to the adviser’s discretion over client brokerage and soft dollars. On Schedule F of Part II, advisers are required to describe in more detail their brokerage placement practices, which would include a description of most typical “soft dollar” arrangements, as well as many of the non-traditional arrangements or practices that were referenced in the preceding paragraph. Although Schedule F gives advisers the opportunity to explain arrangements that Part 1 of the Form discloses only by checking a box, it nonetheless makes it incumbent on advisers to describe the arrangements fully and make any additional soft dollar disclosure to the client that is warranted under the circumstances.¹⁰

Failure to make required disclosures on Form ADV can result not only in regulatory action by the SEC, but in cases where the client relies on a deficient Form ADV as its vehicle to make disclosure to clients, it could also ground a fraud claim by clients.

Section 17(e) of the Investment Company Act: For advisers to funds, soft dollars also implicate Section 17(e) of the Investment Company Act of 1940. In substance, Section 17(e) makes it unlawful for an adviser to accept compensation for fund portfolio transactions (except in the course of business as an underwriter or broker).¹¹ This embodies the legal concepts that prohibit fiduciaries from receiving benefits from their position, either at the expense of the beneficiaries or even without injuring them when the benefits might subvert the fiduciaries’ loyalty and unjustly enrich them. Accordingly, an adviser’s soft dollar arrangements involving a fund client may well violate Section 17(e), unless otherwise protected, for example, by the Section 28(e) safe harbor (more on Section 28(e) under Questions 3 through 6 below). Due to Section 17(e), fund soft dollar arrangements outside of Section 28(e) may constitute violations, even if fully disclosed.¹²

Rule 12b-1(h) under the Investment Company Act: Historically, fund advisers were permitted to take a broker’s sales of fund shares into consideration when choosing brokers to execute fund trades. However, the SEC eventually concluded that the conflicts of interest inherent in that practice were so great that it should be banned. Accordingly, the SEC adopted Rule 12b-1(h) in 2005, which prohibits a fund (and therefore indirectly its adviser) from compensating a broker for promotion or sales of fund shares by directing the fund’s portfolio securities transactions to the broker. Although funds may still use brokers who sell their shares to execute portfolio transactions, they may do so only under the parameters of the rule, which call for the adoption of policies and procedures designed to avoid the broker being selected because of its assistance with distribution.

ERISA/Other laws: Soft dollar practices may also implicate ERISA¹³ for advisers who manage pension or other accounts governed by that statute. Other non-securities laws (such as foreign laws or state Blue Sky laws) may also be implicated by soft dollars, depending on an adviser’s business and clients. A discussion of ERISA and such other laws is beyond the scope of this outline, but it is often the case that the fiduciary, disclosure and related matters discussed in this outline under the federal securities laws will have analogies under those other laws as well.

Aiding/Abetting: The SEC’s 2006 Interpretive Release on soft dollars specifically states that broker-dealers who participate in improper soft dollar arrangements that result in an adviser violating legal or fiduciary obligations may themselves have liability as aiders and abettors of the adviser’s violation.¹⁴ This places the burden on brokers to do their part in avoiding violations.

3. What Is Section 28(e) and How Does it Apply to Soft Dollars?

Section 28(e) is part of the Securities Exchange Act of 1934, added to the statute following the elimination of fixed brokerage commissions in 1975. It applies to soft dollars by providing a “safe harbor” from liability for certain soft dollar practices that fall within the parameters of that section.

During years past when commission rates were fixed, brokers could not compete with one another on the basis of lower commissions, so they competed on the basis of research provided. Once fixed commissions were eliminated in May of 1975, the industry wanted to continue the practice of having brokers provide research in addition to execution, without the risk of a breach of fiduciary duty claim or claim of other legal violation arising from the money manager “paying up” for the research, meaning paying a higher commission rate to a broker providing research than might be available if the transaction were executed through a different broker.¹⁵ Section 28(e) was therefore enacted to protect against those potential claims.

At its core, Section 28(e) says¹⁶ that an adviser does not breach its fiduciary duty or violate other law simply because the adviser causes an account to pay up for brokerage or research services provided by a broker, if the adviser determines that the commission was reasonable relative to the value of the brokerage and research provided. In this way, Section 28(e) creates a “safe harbor,” meaning that so long as the adviser operates inside the parameters of that section, the adviser will be protected against legal claims even if it causes an account to pay up.

4. What are the Basic Elements of the Section 28(e) Safe Harbor?

There are many nuances to Section 28(e) stemming from its wording and the various interpretations of it that have been issued by the SEC over the years.¹⁷ Summarized below are the basic elements:

- A “pass” for paying up:
Section 28(e) protects an adviser against violations arising solely for having caused an account to “pay up.” It does not protect an adviser for failing in its duty to a client or account in any other respect, perhaps most notably in failing in its fiduciary obligation to seek best execution on behalf of the account. As a result, it is often said that soft dollar practices under Section 28(e) are “subject to best execution,” meaning that the adviser cannot expect protection under 28(e) for placing transactions with a soft dollar broker if using that broker compromises the quality of the execution (for example, speed, confidentiality, or any other qualitative aspect of the execution), no matter whether the commission charged is reasonable relative to the value of the products or services received or not. Moreover, the adviser cannot expect protection under 28(e) even for having caused the account to “pay up” unless all the parameters of the safe harbor are met.
- A “pass” on exclusive benefit:
Read narrowly, Section 28(e) provides an adviser protection from claims solely for having caused an account to pay up. However, 28(e) also impliedly protects an adviser from violations that may result from the adviser using a client’s asset (the commissions generated in the client’s account) for the adviser’s own benefit or the benefit of the adviser’s other clients, including in cases where it results in no benefit at all to the client whose commissions generated the benefit.¹⁸ As mentioned previously, using a client’s commissions to obtain services that benefit the adviser – or the adviser’s other clients – is at odds with the fundamental principle that fiduciaries should use a beneficiary’s assets for the exclusive benefit of the beneficiary (at least without full disclosure and client consent). However, 28(e) allows an adviser to cause an account to pay up so long as the value of the services provided are reasonable, viewed in terms of either that particular transaction or the adviser’s overall responsibilities with respect to the accounts as to which the adviser exercises investment

discretion. In this way, then, 28(e) is interpreted to give advisers a “pass” on exclusive benefit as well.

- Agency trades only:

The SEC has interpreted Section 28(e) as potentially available to protect client commissions on agency transactions and in addition on fees on certain riskless principal transactions that are reported with similar transparency under NASD trade reporting rules.¹⁹ The 28(e) safe harbor is not available to protect products or services obtained in connection with fixed-income trades that are not executed on an agency basis, principal trades (except those riskless principal transactions covered by the NASD trade reporting rules) or trades in other instruments that are traded net with no explicit commissions. In these types of trades, there is insufficient information available to the adviser to make the necessary determinations under 28(e) of reasonableness of the commissions (spreads or transaction fees) in relation to the value of the products and services received.

- Discretionary accounts only:

Section 28(e) is interpreted as governing the conduct of all persons who exercise investment discretion with respect to an account.²⁰ Section 28(e) will therefore not protect any benefits obtained by an adviser with commissions on non-discretionary client accounts and will not protect persons, like pension plan sponsors or trustees in directing brokerage on a pension account, if the sponsors or trustees are not exercising investment discretion.

- 3-part framework for analysis:

The SEC’s 2006 Interpretive Release on soft dollars sets out a 3-part analysis for defining the parameters of the 28(e) safe harbor. Each one of these questions must be answered favorably in order for the safe harbor to be available:

1) Does the product or service provided meet the eligibility criteria of Section 28(e)(3),²¹ meaning is it “research” or “brokerage” within the safe harbor?

- What is “research”?

For “research” to meet the eligibility criteria under Section 28(e)(3), it must reflect substantive content, meaning the expression of reasoning or knowledge. Therefore, eligible research includes:

- Advice, which may be provided either directly or through publications or writings, as to the value of securities, the advisability of investing in, purchasing or selling securities, or the availability of securities or purchasers or sellers of securities.
- Analyses or reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy or the performance of accounts.

The safe harbor encompasses third-party research and proprietary research on equal terms.²²

Unlike brokerage, research services include services provided before the communication of an order.

- What is “brokerage”?

For “brokerage” to meet the eligibility criteria under Section 28(e)(3), it must be included within a temporal timeframe that begins when the adviser communicates with the broker-dealer for the purpose of transmitting an order for execution and ends when funds or securities are delivered or credited to the advised account or the account holder’s agent. Therefore, eligible brokerage includes:

- Effecting securities transactions;

- Performing functions incidental to such transactions such as clearance, settlement and short-term custody;
- Performing functions required by rule or regulation in connection with such transactions.

Unlike research, brokerage services can include connectivity services and trading software where they are used to transmit orders to the broker because this transmission of orders has traditionally been considered a core part of the brokerage service. The SEC believes that mechanisms to deliver research, on the other hand, are separable from the research and the decision-making process.

Various examples of items of “research” and “brokerage” that fall inside and outside these latest interpretations of the definitions are shown in the table appearing in Appendix A to this outline.

2) Does the eligible product or service provide lawful and appropriate assistance in the performance of relevant responsibilities?

- What is “lawful and appropriate assistance”?

In order to be within the 28(e) safe harbor, an item must not only be eligible research or brokerage, but must provide the adviser with lawful and appropriate assistance in making investment decisions. This focuses on how the adviser uses eligible items. Therefore, even otherwise eligible items will not be considered within the safe harbor if they are used, for example, for marketing purposes since that does not provide assistance to the adviser in making investment decisions. As a result of this element of the safe harbor, items used for more than one purpose must also be allocated appropriately in order to document which portion may be paid for with soft dollars within the safe harbor and which portion must be paid for with hard dollars. (More on mixed-use allocations under Question 6 below.)

3) May the adviser conclude, in good faith, that the commissions paid are reasonable in relation to the value of the research and brokerage products and services provided by the broker, either in relation to the particular transaction or the adviser’s overall responsibilities with respect to discretionary accounts?

- How are “reasonableness” and “value” determined?

Unfortunately, there is still scant guidance on how an adviser can determine under the safe harbor whether commissions paid are reasonable in relation to the value of the products and services provided. However, the adviser is expected to make the determination in order to stay within the safe harbor and would therefore be wise to document the effort whenever applicable. The burden of proof in demonstrating this determination rests with the adviser.²³

Recently, some brokers have begun “unbundling” their commission rates for execution only and execution plus research. This unbundling should help to inform advisers about the market value of the research provided and aide them in the determination of reasonableness. In addition, advisers might look to the soft dollar “ratios” established for bundled rates as indicative of “value” of the research provided, although it may still be difficult to know how much of the total commission rate paid is for execution versus products or services provided.

Other factors that an adviser might take into consideration in determining the value of the products and services provided are:

- the adviser’s own view of the value received;
- the relative benefits that the product or service provides to the adviser and its clients;

- the utility of the product or service; and
 - whether there may be alternate means of obtaining the product or service or the equivalent at a different cost.
- The “effecting” transactions element:
Section 28(e) protects advisers who have paid up to a broker for “effecting” a securities transaction. SEC interpretations require that a broker, in order to be considered “effecting” a transaction, must execute, clear or settle the trade or perform at least one of four minimum functions and see that the other functions have been reasonably allocated to other brokers in a manner fully consistent with SEC and any other applicable SRO rules (such as NASD or exchange rules).²⁴ The four functions are:
 - (1) taking financial responsibility for all customer trades until the clearing broker has received payment (or securities), meaning one of the brokers in the transaction must be at financial risk for the customer’s failure to pay;
 - (2) making and/or maintaining records relating to customer trades required by SEC or SRO rules, including blotters and memoranda of orders;
 - (3) monitoring and responding to customer comments concerning the trading process; and
 - (4) generally monitoring trades and settlements.

Recognizing that a broker may have a role other than executing, clearing or settling a trade but still be “effecting” a transaction for 28(e) purposes allows trade execution to be functionally separated from the provision of research without permitting abusive “give-ups.” “Give-ups” are arrangements where an adviser requires an executing broker to pay over a portion of its commission to another broker that may have had no role in effecting the transaction and may have provided no benefit to the advised accounts, for example, as a concealed method for compensating the broker for referring clients to the adviser. In the past, the SEC has found “give-ups” to be violations of the federal securities laws.²⁵

- The “provided by” element:
Section 28(e) requires that the broker receiving commission for “effecting” securities transactions must “provide” the brokerage or research services. Although brokers are not required to actually produce the products or services in-house in order to satisfy the “provided by” element, the products or services must nonetheless be “provided by” the broker within the meaning of SEC guidance. Under that guidance, the “provided by” element will be satisfied if the broker is obligated to pay for a product or service delivered by a third-party to the adviser but will not be satisfied if the broker simply pays obligations that the adviser has to a third-party.

However, the SEC’s current position allows the safe harbor to be available in situations where the broker uses an adviser’s client commissions to pay for eligible research and brokerage for which the broker is not directly obligated to pay if the broker pays the third-party provider directly and takes steps to assure itself that the client commissions that the adviser directs the broker to use to pay for those items are used only for eligible research and brokerage. Accordingly, the safe harbor will be available if (i) the broker pays the provider directly; (ii) the broker reviews the description of the services to be provided for red flags that indicate it might not be within 28(e) and agrees with the adviser to use client commissions only to pay for those items that reasonably fall within the safe harbor; and (iii) the broker develops and maintains procedures so that research payments are documented and paid for promptly.²⁶

- Disclosure:
Section 28(e)(2) specifically requires advisers relying on the safe harbor to make disclosure of their commissions policies and practices as the SEC may prescribe. At a minimum, this would include disclosure on the portions of Form ADV calling for information about an adviser’s commissions practices, along with the conflicts of interest posed by those practices. For fund

advisers, this might also include more detailed disclosure about soft dollar practices made to the fund board in connection with the 15(c) contract approval or renewal meeting.²⁷ Note also that the SEC is currently considering issuing additional guidance on soft dollar disclosures to supplement the 2006 Interpretive Release, as well as working on an initiative to help fund boards better discharge their oversight function as it relates to soft dollars.²⁸

5. What Happens if an Adviser Uses Soft Dollars Outside the Section 28(e) Safe Harbor?

The safe harbor created by Section 28(e) is “non-exclusive,” meaning that uses of soft dollars outside the parameters of that section are not automatically considered legal violations. Rather, outside the safe harbor, normal legal principles apply and only through analysis of those principles can it be determined if any particular use of soft dollars violates the law. Therefore, while there may be permissible uses of client commissions outside of the safe harbor, operating outside the safe harbor will, at a minimum, require adequate disclosure to clients, including a discussion of any relevant conflicts of interest that arise.

Unfortunately, some of the many soft dollar enforcement actions have involved advisers acting outside the safe harbor. One such case involved an adviser using client commissions to compensate a broker for client referrals in an arrangement that was not disclosed in its Form ADV or to clients otherwise.²⁹ Because that action was essentially based on the adviser’s failure to disclose, it implies that the adviser might have been able to use client commissions outside the safe harbor in this way, if full disclosure had been made. However, some advisers today might well avoid using soft dollars to reward for client referrals altogether, concerned that the heavy disclosure and fiduciary burden that presents may be insurmountable as a practical matter.

Advisers should also be mindful of the fact that even though the 28(e) safe harbor may be non-exclusive, the adviser’s client disclosures or advisory agreement may place limits on the adviser’s permissible use of client commissions regardless of whether the practice would be permissible under 28(e). For example, an advisory agreement or disclosure may specify that any brokerage placed in exchange for products or services will be undertaken in accordance with 28(e). In that case, an adviser operating outside the safe harbor will risk a breach of contract or fraud claim regardless of whether the practice would pass muster under legal principles applicable outside the safe harbor.

6. What If a Use of Soft Dollars in Partially Inside and Partially Outside of the Safe Harbor?

As mentioned above, in order for an eligible item to be within the safe harbor, it must be used in such a way as to provide lawful and appropriate assistance in the performance of an adviser’s investment decision making responsibilities. If an eligible item has a mixed use, with some portion qualifying under the safe harbor, another not, the adviser must make a reasonable allocation of the costs of the item according to its use. The adviser must also keep adequate documentation of the allocation and the bases for the allocations. Lack of adequate documentation might prevent an adviser from making its required good faith showing of the reasonableness of the commissions paid in relation to the value of the item allocated as eligible research or brokerage under 28(e).

Factors an adviser might consider in making a reasonable allocation of mixed-use items include:

- How the adviser and its employees use the product or services;
- The relative benefits provided to the adviser or its clients;
- The amount of time the product or service is used for eligible vs. non-eligible purposes;
- The relative utility to the firm of the eligible vs. non-eligible uses; and
- The extent to which the product is redundant with other products used by the firm for the same purpose.

Generally speaking, the procedure for making mixed-use allocations does not require laser-like mathematical precision, but rather a good faith effort to make a reasonable allocation, consistently applied.

Examples of mixed-use items might include the cost of:

- Portfolio evaluation services (which might be used for the investment decision-making process as well as marketing).
- OMS (order management systems) (which might be used in investment decision-making as well as compliance).
- Proxy voting services (which might be used in investment decision-making as well as in making decisions about how to vote proxies or in administrative tasks such as casting, counting, recording and reporting votes).
- Trade analytical software (which might be used in investment decision-making as well as compliance and/or administrative uses).

Advisers making mixed-use allocation should include in their disclosures information concerning the conflict of interest that arises from the allocation, to the extent the adviser has an incentive to make those allocations in such a way as to minimize the amount of out-of-pocket expenses it incurs.

7. What Other Sources are Available for Guidance on Soft Dollars?

In addition to the SEC guidance referenced elsewhere, other sources with available guidance on soft dollars include:

- The CFA Institute (formerly AIMR) established Soft Dollar Standards to provide investment professionals guidance on how to use client brokerage ethically and in a manner that benefits clients, based upon the following concepts:
 - i. Soft dollars belong to the client;
 - ii. Investment managers may only purchase research with client brokerage if the primary use of the research, whether a product or a service, directly assists managers in their investment decision-making process and not in the management of the investment firm;
 - iii. Investment managers are fiduciaries and, therefore, must disclose all relevant benefits they receive through client brokerage.³⁰
- The Department of Labor (DOL) issued a report on soft dollars in 1997, including testimony from many industry-related participants.³¹
- The Securities Industry Association (now merged with The Bond Market Association to form the Securities Industry and Financial Markets Association, SIFMA) issued Best Practices relating to soft dollars in 1998.³²
- The U.K. Financial Services Authority adopted final client commission rules in conjunction with issuing policy statement PS 05/9. Although the U.K. rules are a bit different from interpretations adopted by the SEC, the SEC watched the U.K. process closely.³³

Part 2: Best Practices for Soft Dollars

Following are a number of tips advisers should consider in managing their soft dollar practices. Many of these tips are aimed at addressing compliance failures that the SEC has cited in various soft dollar enforcement actions and reports over the years.

TIP #1. Consider soft dollars in the risk assessment process.

- Every adviser should conduct a periodic assessment of the risks of its business to help define the appropriate scope and parameters of its compliance program. Soft dollars

should be taken into consideration in this process, even if the adviser concludes after analysis that it “doesn’t do soft dollars.”

- For advisers that say they “don’t do soft dollars,” specifically consider the breadth of Item 8E on Form ADV to determine if they should respond “yes” to that item even if they don’t have traditional or formal soft dollar arrangements. As discussed in Part 1 of this outline, many non-traditional practices or arrangements could conceivably require Item 8E disclosure even though they might not be thought of as “doing soft dollars.”
- Create risk assessment documentation reflecting that soft dollars were at least considered in the assessment, even if the conclusion is drawn that the adviser really is not “doing soft dollars.” This will comfort the SEC Staff that the adviser is thinking broadly and “outside the box” in order to protect the adviser from previously unconsidered or hidden risks.
- Consider all broker arrangements and relationships for their soft dollar and Item 8E of Form ADV implications, including not only traditional brokerage relationships, but trading platforms and other items or services provided by brokers as well.

TIP #2. Check and update as necessary all relevant soft dollar disclosures.

- As mentioned previously, many of the SEC enforcement actions relating to soft dollars are based on fraud or non-disclosure. Advisers should consider their soft dollar and brokerage practices disclosures in a comprehensive, coordinated fashion to ensure that all appropriate disclosures are made and that all disclosures made are accurate and consistent.
- Consideration should be given to disclosures on:
 - Form ADV (in particular, Item 8E of Part 1, Items 12 and 13 of Part II and related parts of Schedule F).³⁴
 - For fund advisers, disclosure about the fund’s or adviser’s soft dollar and brokerage practices appearing in the fund’s Statement of Additional Information.
 - Also for fund advisers, disclosures about soft dollars and brokerage practices made to the fund Board, in particular at the so-called 15(c) meeting where the Board considers approval or renewal of the advisory agreement and must take into consideration soft dollar benefits that flow to the adviser in setting fees.
 - For funds and fund advisers, disclosures made in the fund’s Annual Report to Shareholders and/or Proxy Statement as to the factors considered by the Board when approving or renewing the advisory contract.
- Advisers who use mixed-use items should disclose the basis for their allocations and relevant conflicts of interest associated with making those allocations.
- Consider soft dollar disclosure implications of all arrangements with brokers, not just those executing trades but also those providing trading platforms or otherwise involved in the adviser’s business or its clients’ accounts.

TIP #3. Work soft dollars into the adviser’s Trade Management and Best Execution policies and procedures.

- As far back as the 1998 Soft Dollar Sweep Report, the SEC encouraged advisers to create reasonable controls and systems of supervision over soft dollars to ensure compliance.

- Establish procedures aimed at meeting the 3-part analysis of the 28(e) safe harbor for all soft dollar practices intended to fall within 28(e).
 - Consider the 1998 Soft Dollars Sweep Report recommendation that a person or committee be appointed to oversee all the firm's soft dollar and directed brokerage arrangements.
 - Consider keeping a firm "master list" of all soft dollar arrangements, the name of the product or service provided, the name of the providing broker, name of any third-party provider involved, amount of the annual soft dollar "commitment" and any soft-to-hard dollar ratio agreed to.
 - Reconcile periodic statements from the providing brokers against the firm's own internal master list.
 - Consider asking firm traders to document the bases on which a particular broker was selected for a trade and specifically to identify if available research or brokerage was a consideration.
 - Consider asking relevant firm personnel to rate or help value the research and brokerage services received from soft dollar brokers.
 - Ask brokers who send unsolicited and unhelpful research to quit doing so.
 - Require all relevant personnel to keep track of mixed-uses and to properly document allocations.
- Monitor and test the procedures regularly, probably not less than once a quarter, with a more full review at least once a year.
- Historically, advisers have been permitted to take into consideration the value of research provided as a factor when selecting brokers.³⁵ But recent remarks by the SEC Staff have muddied the waters in certain respects. The Director of the Division of Investment Management has stated in public remarks that, in his view, personal benefits or considerations should not be a "motivating factor" in an adviser's determination regarding how, where, when and with whom to place a client trade. If such factors are being considered, he encourages advisers strongly to re-think their practices, disclosure and control structures.³⁶ Advisers should take this viewpoint into consideration when establishing and reviewing their soft dollar controls.

TIP #4. Work soft dollars into the adviser's Books and Records procedures.

- Rule 204-2 under the Investment Advisers Act of 1940 requires advisers to create and maintain various books and records. Although the recordkeeping requirements with respect to each individual trade rather are rather perfunctory, the 1998 Soft Dollar Sweep Report criticized advisers for keeping incomplete and inadequate records by which they could monitor their soft dollar practices. The Report recommends that the SEC adopt rules specifically requiring adviser to keep certain written records with respect to soft dollars, including records of their mixed-use allocations and products and services received. Although the Staff has yet to respond to these recommendations with rule changes, books and records rulemaking is on the Staff's current priority list.³⁷
- In contrast to Rule 204-2, Rule 31a-1 under Investment Company Act of 1940 requires funds to maintain and keep current detailed books and records relating to their brokerage placement,³⁸ including among other things, the basis for allocations of orders and commissions, consideration given to any services or benefits supplied by the broker, the nature of the services or benefits made available and the identities of the persons responsible for determining the allocations of commissions.

- Of course, advisers intending to stay within 28(e) should keep sufficient records to demonstrate each element of the safe harbor, including the “reasonableness” determination (see Question 4 above) and records supporting any mixed-use allocations, bearing in mind that the onus will be on the adviser to adequately document compliance.
- Brokers involved with an adviser’s soft dollar practices should also maintain adequate books and records in accordance with SEC and NASD (or other SRO) requirements, including documentation of any soft dollar payments and allocations of trades and commissions among the brokers with a role in effecting a transaction.

TIP #5. Train personnel on all relevant aspects of the firm’s soft dollar practices.

- Make sure marketing and other firm personnel know what they mean when they say “we don’t do soft dollars,” if they intend to make that statement in disclosures or marketing presentations.
- Educate personnel about soft dollars and the firm’s soft dollar practices so that they are adequately apprised of the parameters restricting their activities.
- Inform personnel of the breadth of Item 8E on Form ADV and of the need to disclose any arrangements, traditional or otherwise, that fall within that item.
- Train personnel about the need for mixed-use allocations and on the proper procedures for creating and maintaining related documentation.
- Monitor performance of relevant personnel in following firm procedures and establish appropriate sanctions for procedural failures, which might run the gamut from mere verbal warnings to requiring additional training, imposing financial penalties (e.g., reflected in a reduced bonus), delivering written letters of reprimand or, when warranted, termination of employment.
- Follow up on any sanctions imposed to ensure that they were effective in correcting the conduct and avoiding future failures.

* * *

Despite persistent consternation and confusion, advisers now have more guidance on soft dollars than they ever have at any prior time. This outline provides advisers another tool for getting a better understanding of the current framework and creating a more robust system for controlling their soft dollar practices.

APPENDIX A

EXAMPLES OF ELIGIBLE “RESEARCH” AND “BROKERAGE” UNDER 28(E)

“RESEARCH”	
ELIGIBLE	INELIGIBLE
<p>--“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</p> <p>--“Analyses” or “reports” concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts</p> <p>--Traditional research reports analyzing the performance of a particular company or stock</p> <p>--Report concerning political factors that are interrelated with economic factors if used in the investment decision-making process</p> <p>--Discussions with research analysts when they involve furnishing advice directly as to the advisability of investing in securities</p> <p>--Meetings with corporate executives to obtain oral reports on the performance of a company when reasoning or knowledge imparted at the meeting about the issuer</p> <p>--Seminars or conferences where they relate to research (i.e. provide substantive content relating to issuers, industries and securities)</p> <p>--Software that provides analyses of securities portfolios</p> <p>--Corporate governance research (including corporate governance analytics) and corporate governance rating services when they reflect the expression of reasoning or analysis relating to a subject in the statute (e.g. issuers)</p> <p>--Consultant services if provides advice concerning portfolio strategy</p> <p>--Certain non-mass marketed financial newsletters and other financial and economic publications not targeted to a wide, public audience (if they relate to the subject matters referenced in 28(e))³⁹</p> <p>--Trade magazines and technical journals concerning specific industries (e.g. nano-technology) or product lines (e.g. medical devices) if marketed to and intended to serve the interests of a narrow audience (e.g. physicians) rather than the general public</p>	<p>--Products with inherently tangible or physical attributes (such as telephone lines and office furniture)</p> <p>--Operational overhead expenses</p> <p>--CFA exam review courses</p> <p>--Membership dues (including initial and maintenance fees paid on behalf of the adviser or any of its employees to any organization or representative or lobbying group or firm)</p> <p>--SRO fees</p> <p>--Professional licensing fees</p> <p>--Office rent</p> <p>--Utilities</p> <p>--Phone</p> <p>--Carpeting</p> <p>--Marketing</p> <p>--Entertainment</p> <p>--Meals</p> <p>--Copiers</p> <p>--Office supplies</p> <p>--Fax machines</p> <p>--Couriers</p> <p>--Backup generators</p> <p>--Electronic proxy voting services</p> <p>--Salaries, including research staff</p> <p>--Legal expenses</p> <p>--Travel expenses</p> <p>--Consultant services if provides advice concerning adviser’s internal management or operations</p>

“RESEARCH”	
ELIGIBLE	INELIGIBLE
<p>--Pre- and post-trade analytics, software and other products that depend on market information to generate market research, including research on optimal execution venues and trading strategies, if used in the investment decision-making process</p> <p>--Advice from broker-dealers on order execution, including advice on execution strategies, market color, and the availability of buyers and sellers (and software that includes these types of market research), if used in the investment decision-making process</p> <p>--Data services – such as those providing market data (like stock quotes, last sale prices, trading volumes, etc.) or economic data – provided they satisfy the subject matter criteria and provide lawful assistance in the investment decision-making process</p> <p>--Other data, if they reflect substantive content (meaning the expression of reasoning or knowledge) related to the subject matters identified in 28(e)</p> <p>--Company financial data</p> <p>--Economic data (such as unemployment and inflation rates or gross domestic product figures)</p> <p>--Proxy services, to the extent providing “research” such as reports and analyses on issuers, securities and the advisability of investing in securities</p>	<p>--Travel expenses, entertainment and meals associated with attending seminars</p> <p>--Travel and related expenses associated with arranging trips to meet corporate executives, analysts or others who may provide eligible research orally</p> <p>--Office equipment</p> <p>--Office furniture</p> <p>--Business supplies</p> <p>--Accounting fees and software</p> <p>--Website design</p> <p>--Email software</p> <p>--Internet service</p> <p>--Personnel management</p> <p>--Marketing</p> <p>--Software to assist with administrative functions such as managing back-office functions, operating systems and word processing</p> <p>--Equipment maintenance and repair services</p> <p>--Computer hardware, including terminals</p> <p>--Computer accessories</p> <p>--Peripherals and delivery mechanisms associated with computer hardware</p> <p>--Telecommunications lines</p> <p>--Transatlantic cables</p> <p>--Computer cables</p> <p>--Mass marketed publications (i.e. those intended for and marketed to a broad, public audience)⁴⁰</p> <p>--Proxy services, to the extent providing products or services to handle the mechanical aspects of voting, such as casting, counting, recording and reporting votes</p>

“BROKERAGE”	
ELIGIBLE	INELIGIBLE
<p>--Activities required to effect securities transactions</p> <p>--Functions performed incidental to effecting securities transactions</p> <p>--Functions in connection with effecting securities transactions required by the SEC or SROs</p> <p>--Clearance, settlement and custody services in connection with trades effected by the broker</p> <p>--Post-trade matching of trade information</p> <p>--Post-trade exchange of messages among broker-dealers, institutions and custodians related to the trade</p> <p>--Post-trade electronic communication of allocation instructions between institutions and broker-dealers</p> <p>--Post-trade routing settlement instructions to custodian banks and broker-dealers' clearing agents</p> <p>--Post-trade short-term custody related to effecting particular transactions in relation to clearance and settlement of the trade</p> <p>--Comparison services required by SEC or SRO rules, for example, in certain circumstances, the use of electronic confirmation and affirmation of institutional trades is required in connection with settlement processing</p> <p>--Communications services related to the execution, clearing and settlement of securities transactions and other incidental functions</p> <p>--Connectivity service between the money manager and the broker-dealer and other relevant parties such as custodians</p> <p>--Dedicated lines between the broker-dealer and the money manager's order management system</p> <p>--Lines between the broker-dealer and order management systems operated by a third-party vendor</p> <p>--Dedicated lines providing direct dial-up service between the money manager and the trading desk at the broker-dealer</p> <p>--Message services used to transmit orders to broker-dealers for execution</p>	<p>--Hardware such as telephones and computer terminals, including those used in connection with OMS and trading software</p> <p>--Software functionality used for recordkeeping or administrative purposes, such as managing portfolios</p> <p>--Quantitative analytical software used to test “what-if” scenarios relating to adjusting portfolios, asset allocations, or for portfolio modeling (whether or not provided through OMS)</p> <p>--Compliance mechanisms, such as (i) performing tests which analyze information over time in order to identify unusual patterns, including for example, an analysis of the quality of brokerage execution (for the purpose of evaluating best execution), an analysis of portfolio turnover rate (to determine whether portfolio managers are overtrading securities), or an analysis of the comparative performance of similarly managed accounts (to detect favoritism, misallocation of investment opportunities or other breaches of fiduciary responsibility); (ii) creating trading parameters for compliance with regulatory requirements, prospectus disclosure or investment objectives; or (iii) stress-testing a portfolio under a variety of market conditions or to monitor style drift</p> <p>--Trade financing, such as stock lending fees, capital introduction and margin services</p> <p>--Error correction trades or related services in connection with errors committed by advisers</p> <p>--Long-term custody and custodial recordkeeping</p>

“BROKERAGE”	
ELIGIBLE	INELIGIBLE
<p>--Trading software used to route orders to market centers</p> <p>--Software that provides algorithmic trading strategies</p> <p>--Software used to transmit orders to direct market access (DMA) systems</p> <p>--OMS aspects that include trading software used to route orders, provide algorithmic trading strategies, or transmit orders to DMA systems or provide connectivity to this software</p>	

¹ Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934 (Release No. 34-54165) (July 18, 2006) (“2006 Interpretive Release”).

² To illustrate the variability in terminology, consider that the term “soft commissions” in the U.K. typically refers to commissions used to obtain research services provided by third parties, which advisers in the U.S. might think of as third-party, independent research. On the other hand, the term “bundled commissions” is used in the U.K. to refer to research services provided by a broker along with execution, which we might think of as proprietary research. Although the issues of bundling and third-party providers are well-known in the U.S., we typically do not draw this distinction in the basic terminology and most often use “soft dollars” to refer to arrangements to obtain either kind of research, third-party or proprietary.

³ A binding contract to place a specified amount of brokerage with a particular broker might be considered fundamentally at odds with an adviser’s duty to seek best execution on behalf of its clients, which would presumably require the adviser to be free to execute through a different broker in cases where the other broker offered best execution and the soft dollar broker did not.

⁴ The duty to seek best execution is not expressly stated in the federal securities laws. Rather, it is implied or inferred from various sources. Under the Investment Advisers Act, courts have imposed on advisers a fiduciary duty that includes an affirmative duty of "utmost good faith, and full and fair disclosure of all material facts" and an affirmative obligation "to employ reasonable care to avoid misleading" clients. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 at 194, 84 S.Ct. 275 (1963). This fiduciary obligation has long been interpreted to include the duty to seek best execution under Section 206 of the Advisers Act, which generally prohibits adviser fraud. See In the Matter of Fleet Investment Advisors, Advisers Act Rel. No. 1879 (June 15, 2000), citing Kidder Peabody & Co., Inc., Edward B. Goodnow, Advisers Act Rel. No. 232, 1968 SEC LEXIS 251 (October 16, 1968) and other cases. See also Rule 206(3)-2(c) under the Investment Advisers Act, which refers to the adviser’s duty to act in the best interests of its clients, including the duty “with respect to best price and execution” for client transactions. Best execution is discussed in more detail in the CLEonline.com seminar entitled “Best Execution: Considerations for Advisers and Funds.”

⁵ An adviser’s duty to seek best execution has also been implied from basic common law fiduciary principles governing principals and agents. See “Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds,” The Office of Compliance, Inspections and Examinations, U.S. Securities & Exchange Commission (September 22, 1998) (the “1998 Soft Dollar Sweep Report”) at Section II.H.: “The origins of the best execution duty predate the federal securities laws and may be traced to the common law agency obligations of undivided loyalty and reasonable care that an agent owes to his or her principal.” Among other things, this means that advisers must act in a client’s best interest when placing brokerage and adequately disclose any conflicts.

⁶ The most common way that advisers address these fiduciary issues is by operating within the “safe harbor” of Section 28(e) of the Securities Exchange Act of 1934, which is discussed in more detail in later sections of this outline.

⁷ As just discussed, the adviser’s fiduciary duty to its client generally precludes the adviser from using client assets for its own benefit or the benefit of other clients, without obtaining the client's consent based on full and fair disclosure. See the 1998 Soft Dollar Sweep Report, *supra* note 5, at Section II.D, citing Restatement (Second) Trusts § 170 comment a, § 216 (1959), and Advisers Act Release No. 1469 (February 14, 1995), at fn. 8 and accompanying text. Indeed, the SEC has stated, "the adviser may not use its client's assets for its own benefit without prior consent, even if it costs the client nothing extra." *Id.*, citing various SEC enforcement actions. Consent may be expressly provided by the client or consent

also may be inferred from all of the facts and circumstances, including the adviser's disclosure in its Form ADV. Id.

⁸ A particularly instructive soft dollars enforcement action involved allegations of fraud, along with allegations of failure to supervise, and lists a litany of the various compliance failures attributed to the adviser and its supervising personnel, including among them: (1) failure to adopt written procedures governing soft dollar activities; (2) failure to conduct continuing education on the standards for soft dollar practices; (3) failure to assign clear responsibilities for supervision of soft dollar arrangements; and (4) failure to investigate warnings or “red flags” that certain of its soft dollar arrangements were improper. In the Matter of Dawson-Samberg Capital Management, Inc. now known as Dawson-Giammalva Capital Management, Inc. and Judith A. Mack, Advisers Act Rel. 1889 (Aug. 3, 2000).

⁹ In fact, those advisers may be holding themselves out as “not doing soft dollars” without understanding that their statement may need to be reconciled with their practices and with their disclosure under Item 8E of Form ADV. Confusion over Item 8E is discussed in “Advisers Misreport Use of Soft Dollars,” Investment News (July 24, 2006), p.1, in which Lori Richards, Director of the SEC’s Office of Compliance Inspections and Examinations, is quoted as saying: “One very common misperception among investment advisers is that when they obtain research from a proprietary broker-dealer, they don’t consider that to be a soft dollar transaction.” The 2006 Interpretive Release, however, clarifies that the source of the research does not make a difference to whether the adviser is doing soft dollars that need to be disclosed. The same Investment News article quotes the executive director of the Investment Adviser Association as saying, with regard to unsolicited research and apparently to support the point that advisers are misreporting on Item 8E of Form ADV: “What a lot of investment advisers have thought, and probably still think, is, if I’m not asking for it or if I’m not using it, I don’t have to mark yes here.” He is further quoted as saying SEC officials have made it “clear” that if an adviser uses a full-service broker and pays full commissions for trades, they are “undoubtedly getting something other than execution,” implying that whatever it is that advisers are getting for those full commissions should be disclosed in response to Item 8E. This may be an overstatement of the issue but presumably, if the adviser is not getting something other than execution for full commissions, the adviser should be carefully documenting why using the full-service broker and paying full commissions for that trade represents best execution.

¹⁰ For example, an adviser to a mutual fund should disclose details of its soft dollar arrangements, including names, dates and amounts, to the fund board and not solely rely on its general ADV disclosure to discharge its duty to the fund. See the 1998 Soft Dollar Sweep Report, supra note 5, at Section VI: “The Form ADV disclosure requirement, however, w[as] not designed to fulfill the obligations that fund directors have under Section 15(c).”

¹¹ Section 17(e)(1) makes it unlawful for "any affiliated person of a registered investment company, or any affiliated person of such person . . . acting as agent, to accept from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property to or for such registered company or any controlled company thereof, except in the course of such person's business as an underwriter or broker."

¹² See In the Matter of Fleet Investment Advisors Inc., Advisers Act Rel. 1821 (Sept. 9, 1999) at n. 16: “Even if [the adviser] had adequately disclosed its receipt of client referrals in exchange for brokerage commissions, the disclosure would not have cured the 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.”

¹³ The Employee Retirement Income Security Act of 1974, as amended (29 U.S.C. 1001 et seq.), perhaps most notably Sections 403, 404, and 406.

¹⁴ 2006 Interpretive Release, *supra* note 1, at n. 183.

¹⁵ Question 2 above discusses an adviser's duty to seek best execution in more detail, explaining why paying up might result in a claim that the adviser breached its fiduciary duty.

¹⁶ Section 28(e)(1) provides that: "No person..., 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...solely by reason of his having caused the account to pay a...broker or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another...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...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."

¹⁷ The major SEC interpretations of Section 28(e) appear in Release No. 34-12251 (March 24, 1976); Release No. 34-23170 (April 30, 1986); Charles Lerner, U.S. Department of Labor No-Action Letter (October 25, 1988) (adviser may not use soft dollar credits with a broker to cover trade errors); a 1989 SEC roundtable discussion referenced in the SEC's Market 2000 report (January 1994) (the "SEC Market 2000 Report"); Charles Lerner, U.S. Department of Labor No-Action Letter (July 25, 1990) (safe harbor does not include trades executed on a principal basis); Hoenig & Co., Inc. No-Action Letter (Oct. 15, 1990) (transaction fee paid to a broker-dealer for a principal trade, such as a block trade, is not within the safe harbor, regardless of the label placed on the fee); Instinet Corp. No-Action Letter (Jan. 15, 1992) (safe harbor applies to agency transactions in equity securities on a computer-based, market information and trading system and after-hours order matching system); In the Matter of Patterson Capital Corp., et al., Advisers Act Release No. 1235 (June 25, 1995) (marketing consulting services are not "research"); the 1998 Soft Dollars Sweep Report, *supra* note 5; Release No. 34-45194 (December 27, 2001); and the 2006 Interpretive Release, *supra* note 1. Although there was a phase-in period to rely on old soft dollar guidance, advisers were required to come into compliance with the 2006 Interpretive Release by January 24, 2007.

¹⁸ See the SEC Market 2000 Report, *supra* note 17, at V-14: "In addition, because Section 28(e) permits managers to use one client's commissions to obtain research exclusively benefiting another client's account, particular clients may not benefit from the manager's use of their commissions for research services." Contrast this, however, with the cautionary remarks of the SEC Staff in 2006: "Thus, while using soft dollars to benefit accounts that did not pay for the research is certainly permitted under the law, there are some questions of fairness and equity that advisers would be wise to consider when faced with certain situations." October 2006 Donohue Speech, *infra* note 28, at VI, which questions whether advisers have adequately met their responsibility to analyze and disclose the conflicts that are presented when commissions of one client or group of clients benefits another.

¹⁹ 2006 Interpretive Release, *supra* note 1, at n. 27.

²⁰ This would include investment advisers, mutual fund portfolio managers, fiduciaries of bank trust funds and money managers of pension plans and hedge funds. 2006 Interpretive Release, *supra* note 1, at n. 25. See also, *Id.* at n. 151 and surrounding text.

²¹ Section 28(e)(3) in its entirety provides: "For purposes of this subsection 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.”

²² 2006 Interpretive Release, *supra* note 1, at III.H.

²³ *Id.* at n. 150 and surrounding text.

²⁴ *Id.* at n. 175 and surrounding text.

²⁵ *Id.* at n. 165 and surrounding text.

²⁶ *Id.* at Section III.I.3. The Staff recently provided no-action relief to a commission pooling arrangement operated by Goldman Sachs where third-party research providers were compensated for their research products and services from commissions set apart in a commissions pool under 28(e). See Goldman, Sachs & Co. No-Action Letter (January 17, 2007). Although the purpose of that letter was to confirm that the research service provider did not fall within applicable definitions of “broker-dealer” and therefore have to register as a broker-dealer because it was paid from pooled commissions, the arrangement as described was nonetheless evidently acceptable to the Staff as a viable 28(e) arrangement.

²⁷ See *supra* note 10.

²⁸ *Id.* at n. 13. See also Speech by SEC Staff: Keynote Luncheon Address Before the SIA Institutional Brokerage Conference by Andrew J. Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission (October 30, 2006) (the “October 2006 Donohue Speech”) at II, available at <http://www.sec.gov/news/speech/2006/spch103006ajd.htm>.

²⁹ See In the Matter of Founders Asset Management LLC and Bjorn K. Borgen, Investment Advisers Act Release No. 1879 (June 15, 2000). More recent actions include In the Matter of William J. Lennon, Investment Advisers Act Release 2433 (September 21, 2005) (allegations included adviser traded excessively in various accounts in order to generate soft dollar credits that were used, among other things, to pay for personal living expenses); In the Matter of Rudney Associates, Inc. and Eric A. Rudney, Investment Advisers Act Release 2300 (September 21, 2004) (adviser failed to disclose on its Form ADV the existence of a soft dollar arrangement with broker or that the soft dollar arrangement was one of the factors it used when considering whether to select the broker and in determining the reasonableness of the broker’s commissions); SEC v. Gordon J. Rollert, United States District Court for the District of Massachusetts, No. 01-Civ.-10237-JLT (April 29, 2004) and In the Matter of Gordon J. Rollert, Investment Advisers Act Release 2095 (December 23, 2002) (criminal and civil administrative actions taken against adviser and principal for alleged violations including fraudulent soft dollar scheme); and In the Matter of Chris Woessner, Administrative Proceeding File No. 3-10607 (March 19, 2003) (failure to disclose use of client commissions to compensate broker for referral of large union pension client).

³⁰ Available at <http://www.cfainstitute.org/centre/ethics/softdollar/index.html>.

³¹ Available at <http://www.dol.gov/ebsa/adccoun/softdollar.htm>.

³² Available at http://www.sia.com/best_practices/pdf/SoftDollars.pdf.

³³ The U.K. Financial Services Authority Policy Statement 05/9 (July 2005), Bundled Brokerage and Soft

Commission Arrangements: Feedback on CP 05/5 and Final Rules, available at http://www.fsa.gov.uk/pubs/policy/ps05_09.pdf. The FSA rules apply only to equity trades and not to fixed-income trades.

³⁴ “Boilerplate” language is likely to be considered insufficient. In the 1998 Soft Dollar Sweep Report, supra note 5, the SEC found that existing adviser disclosure was inadequate because about half the advisers did not include enough detail to allow clients to understand the adviser’s soft dollar policies and practices. In addition, in the amendments to Part II of Form ADV proposed in 2000, the SEC included specific proposed soft dollar disclosure requirements. Although proposed amendments to Part II of Form ADV have yet to be adopted, the proposed disclosure requirements are informative. They include, for example: (i) a description of the benefits obtained by the adviser from not having to produce or pay for products obtained with soft dollars, revealing the self-interested incentive advisers have to select soft dollar brokers; (ii) whether the adviser uses soft dollars to benefit all accounts or just those accounts that generate the soft dollars and whether the adviser allocates the soft dollar benefits among the generating accounts; (iii) an explanation of any practice of directing brokerage to brokers who refer clients to the adviser and the conflict that creates; (iv) disclosure about whether the adviser batches orders and the benefit the adviser may be able to obtain from volume discounts, or an explanation that the adviser does not batch orders, or does not negotiate commissions, and that as a result, the client may pay higher commissions; (v) an explanation of whether the adviser permits or requires clients to direct brokerage and how that may impact the commission rates paid by the client; (vi) an explanation of the benefits of, and how to participate in, a commission recapture program. Proposed Rule: Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV, Release No. IA-1862 (April 5, 2000).

³⁵ Speech by SEC Commissioner: "Lifting The Veil - Investment Industry Trading Practices And Best Execution Workshop," Mutual Fund Directors Forum by Commissioner Annette L. Nazareth, U.S. Securities and Exchange Commission (June 7, 2006) at II, available at <http://www.sec.gov/news/speech/2006/spch060706aln.htm>: “[A] money manager may consider the full range and quality of a broker's services in placing brokerage including, among other things, the security's trading characteristics and the relative difficulty of execution, the broker's access to markets or expertise, price, confidentiality, speed of execution, the value of research provided, commission rate, financial responsibility, and responsiveness to the money manager.”

³⁶ October 2006 Donohue Speech, supra note 28, at III.

³⁷ Speech by SEC Staff: Keynote Address Before IA Week's 6th Annual Fall Compliance Conference by Andrew J. Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission (September 25, 2006) (the “September 2006 Donohue Speech”) at IV, available at <http://www.sec.gov/news/speech/2006/spch092506ajd.htm>.

³⁸ Specifically, Rule 31a-1(b)(9) requires: “A record for each fiscal quarter, which shall be completed within ten days after the end of such quarter, showing specifically the basis or bases upon which the allocation of orders for the purchase and sale of portfolio securities to named brokers or dealers and the division of brokerage commissions or other compensation on such purchase and sale orders among named persons were made during such quarter. The record shall indicate the consideration given to (i) sales of shares of the investment company by brokers or dealers, (ii) the supplying of services or benefits by brokers or dealers to the investment company, its investment adviser or principal underwriter or any persons affiliated therewith, and (iii) any other considerations other than the technical qualifications of the brokers and dealers as such. The record shall show the nature of the services or benefits made available, and shall describe in detail the application of any general or specific formula or other determinant used in arriving at such allocation of purchase and sale orders and such division of brokerage commissions or other compensation. The record shall also include the identities of the persons responsible for the determination of such allocation and such division of brokerage commissions or other

compensation.”

³⁹ Indicia of publications that are not mass marketed include, among other things, that they are marketed to a narrow audience, directed to readers with specialized interest in particular industries, products or issuers, and have high cost.

⁴⁰ Indicia of a mass marketed publication include, among other things, that they are circulated to a wide audience, intended for and marketed to the public, rather than intended to serve the specialized interests of a small readership, and have low cost.