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Pangaea: Converging Global Approaches to Bundled Brokerage and Soft Dollar Practices

Andrew R. Mannarino*

I. Introduction: The History of Soft Dollars in the United States

“Bundled Brokerage” refers to the bundle of services an investment adviser¹ receives in exchange for stock orders sent to broker-dealers for execution.² By placing stock orders with a broker-dealer, the investment adviser uses commission dollars associated with the execution of trades to pay for the so-called bundle of services.³ For many trades that brokers execute on

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1. Disclosure by Investment Advisers Regarding Soft Dollar Practices, Exchange Act Release No. 34-35375, 60 Fed. Reg. 9750 (proposed Feb. 14, 1995), available at <http://www.sec.gov/rules/proposed/soft.txt> [hereinafter SEC February 1995 Release].

Investment adviser means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities, or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation as part of a regular business, issues or promulgates analyses or reports concerning securities.

Investment Adviser's Act of 1940, 15 U.S.C. § 80b-2(11) (2006).

2. See U.S. SEC. & EXCH. COMM'N.: INSPECTION REPORT ON THE SOFT DOLLAR PRACTICES OF BROKER-DEALERS, INVESTMENT ADVISORS, AND MUTUAL FUNDS 3 (1998), available at <http://www.sec.gov/news/studies/softdolr.htm> [hereinafter INSPECTION REPORT].

3. The “Bundle of Services” is broken into two categories: research services and brokerage services. Research services include “‘analyses’, ‘advice’, and ‘reports.’” Brokerage services are “those products and services that relate to the execution of the trade.” Commission Guidance Regarding Client Commission

behalf of investment advisers, there will often be components of the brokerage commission which reflect research and brokerage services the investment adviser has obtained from the broker-dealer.⁴

Investment advisers could pay broker-dealers directly for their services with hard dollar checks drawn from fees associated with managing the accounts and counted as operating expenditures. Instead, research and brokerage services typically are paid with trade commissions generated from the pool of investment funds. Therefore, payment for services is considered to have been made with "soft dollars."⁵ The simplest explanation of "soft dollars" in brokerage terms is that a portion of a brokerage commission is used to pay a broker-dealer for services other than the execution of the trade.⁶ Section 28(e) of the Securities and Exchange Act of 1934 provides a "safe harbor" for commission dollars spent in excess of the mere execution of the trade for qualifying brokerage and research services.⁷ The subject of this commentary is the Security and Exchange Commission's (SEC) recent interpretive guidance as to which brokerage and research services qualify for Section 28(e)'s safe harbor protection.

The use of soft dollars in the United States derives from the SEC's decision in 1975 to abolish fixed commission rates among the nation's stock exchanges.⁸ The era of fixed commission rates was rooted in the original Buttonwood Agreement.⁹ Among the reasons for the abolition of fixed commission rates was concern that broker-dealers were competing on services rather than price, "result[ing] in complex, irrational distinctions

Practices Under Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-52635 6, 17 C.F.R. 241 (Oct. 19, 2005), *available at* <http://www.sec.gov/rules/interp/34-52635.pdf> [hereinafter SEC October 2005 Release].

4. THOMAS P. LEMKE & GERALD T. LINS, *SOFT DOLLARS AND OTHER BROKERAGE ARRANGEMENTS* 1, 3 (1996); *see also* INSPECTION REPORT, *supra* note 2, at 3.

5. LEMKE & LINS, *supra* note 4, at 3.

6. INSPECTION REPORT, *supra* note 2, at 3.

7. 15 U.S.C. § 78bb(e) (2006).

8. SEC October 2005 Release, *supra* note 3, at 5; D. Bruce Johnsen, *Property Rights to Investment Research: The Agency Costs of Soft Dollar Brokerage*, 11 YALE J. ON REG. 75, 76 (1994) (hereinafter *Property Rights to Investment Research*); INSPECTION REPORT, *supra* note 2, at 3.

9. Adoption of Securities Exchange Act Rule 19b-3, Exchange Act Release No. 11203, 40 Fed. Reg. 7394, 7395 (Jan. 23, 1975).

between permissible ancillary services and prohibited rebates of the minimum commission.”¹⁰ Another reason to abrogate fixed commissions was the concern over the percentage of assets used to pay a commission for a low priced stock versus a higher priced stock.¹¹ The concern over commission rebates was that large institutions held an opportunity to negotiate lower rates of commissions through rebates, but the individual investor enjoyed no such opportunity.¹²

As a result of the SEC’s decision to abolish fixed commission rates, securities industry practitioners feared that investment advisers would no longer be capable of availing themselves of the various services associated with trade commissions because of their fiduciary duty to seek out the lowest possible cost for trade execution.¹³ The SEC decided to recommend a provision that would permit investment advisers to pay a higher rate for trade execution to broker-dealers in order to continue to receive the broker’s bundle of services, including proprietary research.¹⁴ The provision, codified in Section 28(e) of the Securities and Exchange Act of 1934 (Section 28(e)), provides a “safe harbor” for investment advisers to pay a higher rate of commission to purchase research and brokerage services with brokerage commissions.¹⁵

Section 28(e) specifically provides:

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 member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of the exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services pro-

10. *Id.* at 7396.

11. *Id.*

12. *Id.* at 7397.

13. SEC October 2005 Release, *supra* note 2, at 7; Johnsen, *supra* note 8, at 82.

14. SEC October 2005 Release, *supra* note 2, at 8; Johnsen, *supra* note 8, at 83.

15. SEC October 2005 Release, *supra* note 2, at 8.

vided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion.¹⁶

The scope of Section 28(e)'s protection to investment advisers, who engage in many of the commission practices to be discussed, has long been a subject of debate. This debate has focused on defining "brokerage and research services" that qualify for the Section 28(e) safe harbor. Since Section 28(e) was codified in 1976, the Commission has issued three major interpretive releases, the most recent of which is a subject of this commentary.¹⁷ In recent years, the debate over the practices of investment advisers appears to have accelerated.

The "market-timing" scandals, which impacted a number of popular mutual fund companies, drew significant attention to mutual funds' practices.¹⁸ The use of market-timing to transact in mutual fund shares was uncovered in 2003 by then-New York Attorney General Eliot Spitzer.¹⁹ Mr. Spitzer discovered that Canary Investments traded mutual fund shares after hours.²⁰ The problem arose when after hours trades were priced to that day's Net Asset Value (NAV)—the price measurement for mutual funds.²¹ Positive after-hours news would have made the shares more expensive if purchased at the following day's NAV.²² The result was that those who were owners of record when the day began had their gains diluted by those who

16. 15 U.S.C. §§ 78bb(e) (2006); Due to the use of the term "soft dollars" in unrelated contexts, the Commission prefers to use the term "client commission practices." See SEC October 2005 Release, *supra* note 3, at n.2. The Securities Industry since has adopted the term "Client Commission Arrangements" to replace "Soft Dollars."

17. Use of Commission Payments by Fiduciaries, Exchange Act Release No. 12251, 41 Fed. Reg. 13678 (Mar. 24, 1975) (hereinafter 1975 Release); Interpretive Release Concerning Scope of Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-23170, 51 Fed. Reg. 16004 (Apr. 30, 1986); SEC October 2005 Release, *supra* note 3.

18. See, e.g., Floyd Norris, *Pile of Pennies is Adding Up To a Scandal In Mutual Funds*, N.Y. TIMES, Nov. 1, 2003, at C1.

19. *Id.*

20. *Id.*; see also Thomas R. Hurst, *The Unfinished Business of Mutual Fund Reform*, 26 PACE L. REV. 133 (2005).

21. Norris, *supra* note 18.

22. See generally Stephen Labaton, *House Backs Bill to Overhaul Mutual Funds*, N.Y. TIMES, Nov. 20, 2003, at C1.

were permitted to purchase shares once the positive news was released after the markets closed at that day's price.²³ This resulted in direct injury to mutual fund shareholders. The market timing scandal inculcated some of the biggest names in the mutual fund industry.

Subsequent to the market timing scandals and the investigations that followed, several stories came to light regarding client commission practices and the manner in which several investment advisers used client commissions generated from adviser clients' funds for their own benefit. For example, an August 2005 story in the *Wall Street Journal* exposed an extravagant bachelor party that several brokers had hosted for a Fidelity Mutual Fund trader. The brokers expected to be compensated in commission dollars from stock trades the Fidelity traders would pay them in return for the event and for the lavish lifestyle the brokers provided.²⁴ The bachelor party included the use of a private jet for \$65,000 to transport the Fidelity traders to the South Beach, Florida event.²⁵ S.G. Cowen, Lazard Capital Markets, and Jeffries, Inc. all contributed funds to pay for the affair.²⁶ The Jeffries sales trader (broker) enjoyed a seven-figure expense account to use for such client entertainment.²⁷

Suddenly, client commission practices were very much in the spotlight, and several of the large mutual funds acted unilaterally to alter their commission practices. Last year, Massachusetts Financial (MFS) decided to separate "research and distribution costs" from trading commissions paid from assets.²⁸ MFS asked brokers to provide it with an "execution only" commission price and stated that they "are valuing their [broker-

23. See Hurst, *supra* note 20, at 136.

24. See Susanne Craig & John Hechinger, *Entertaining Excess: Fishing for Fidelity Business, One Firm Employed Lavish Bait*, WALL ST. J., Aug. 11, 2005, at A1. See also Andrew Parker, *SEC Might Charge Fidelity After GiftsProbe Mutual Funds*, FIN. TIMES, Jul. 26, 2005.

25. See Craig & Hechinger, *supra* note 24.

26. *Id.*

27. *Id.* The Fidelity story was the most prominent story of such abuses, but there were many others. See, e.g., Press Release, Fidelity Boss Investigates over Olympic tickets gift, THE EVENING STANDARD, June, 28, 2005; Bloomberg News, *MFS Is Facing Another SEC Inquiry*, N.Y. TIMES, Feb. 19, 2004, at C8.

28. Landon Thomas Jr., *Mutual Fund Tells Wall Street It Wants a la Carte Commissions*, N.Y. TIMES, Mar. 16, 2004, at C1.

dealer] research at zero.”²⁹ On October 20, 2005, one day after the SEC’s October 2005 Release, Fidelity Mutual Funds announced an agreement with Lehman Brothers Holdings, Inc. under which Fidelity will pay separately for Lehman Brothers’ trading and proprietary research.³⁰ Fidelity intends to strike similar deals with other brokers.³¹ Other mutual fund companies have settled directly with regulators. MFS announced in 2004 that it would pay \$351 million to settle complaints related to trading, “directed brokerage and revenue sharing arrangements with distributors of its products.”³² Alliance Capital also agreed in 2003 to pay a \$250 million fine to settle complaints regarding its trading practices,³³ and Janus Mutual Funds agreed to pay \$31.5 million in a settlement with then-New York Attorney General Elliot Spitzer for its role in the market timing scandals.³⁴ Janus also decided to cease its “soft dollar” practices.³⁵

Many in the industry have pressed the SEC to respond by narrowing the services that would receive safe harbor under Section 28(e).³⁶ In the meantime, Congress has attempted to pass legislation in response to some of the scandals surrounding investment advisers.³⁷ Criticism has abounded, however, and

29. *Id.*

30. *Fidelity Presses Brokers to Split Trading Costs From Research*, BLOOMBERG NEWS, Oct. 20, 2005.

31. *Id.*

32. Bloomberg News, *MFS is Facing Another SEC Inquiry*, N.Y. TIMES, Feb. 19, 2004, at C5.

33. Kenneth Gilpin, *Market Insight; Predicting the Future of Funds, Post-Scandal*, N.Y. TIMES, Dec. 21, 2003, at C7.

34. Riva D. Atlas, *Janus Capital to Refund \$31.5 Million to Investors*, N.Y. TIMES, Dec. 20, 2003, at C2.

35. *Id.*

36. See, e.g., Letter from Matthew P. Fink, President of the Investment Company Institute, to William H. Donaldson, Chairman, Securities and Exchange Commission (Dec. 16, 2003), available at <http://www.sec.gov/rules/petitions/petn4-492.htm> [hereinafter Fink Letter] (requesting certain services to be excluded from Section 28(e)’s protection and asking for an outright ban on “brokerage for sales” practices, where a mutual fund advisor takes fund sales into account when allocating brokerage); NASD MUTUAL FUND TASK FORCE, REPORT OF THE MUTUAL FUND TASK FORCE: SOFT DOLLARS AND PORTFOLIO TRANSACTION COSTS 5-8 (2004), available at http://www.nasd.com/web/groups/rules_regs/documents/rules_regs/nasdw_012356.pdf [hereinafter TASK FORCE REPORT].

37. See Labaton, *supra* note 22. Labaton’s article mentions specifically that the proposed legislation would require close monitoring with respect to timing of mutual fund trades, preparing reports to directors regarding client commission

the SEC has been slow to respond.³⁸ It appears that further pressure was placed on the SEC when the United Kingdom's Financial Services Authority (FSA) announced that they would be adopting specific rules regarding bundled brokerage and soft dollar use.³⁹ The FSA's final rules were announced in July of 2005 in Policy Statement 05/09.⁴⁰ The SEC announced in September 2005 that it would seek public comment on limiting soft dollar arrangements.⁴¹ The SEC recognized the need for clear guidance on client commission practices, and SEC Chairman Christopher Cox said that "going after these abuses one at a time is not enough."⁴² The SEC issued interpretive guidance in October 2005, accepted comments from the industry, and promulgated final guidelines in July 2006.⁴³

The purpose of this article is to comment on the Commission's October 2005 and July 2006 Interpretive Releases concerning client commission practices, particularly to address the differences in the two releases and provide an overview of the United States' soft dollar framework. This comment will also examine rules promulgated by the FSA in July, 2005 and compare the United Kingdom's approach to soft dollars with the approach adopted in the United States. Certainly, many in the industry looked to the FSA's rules while awaiting comment from the Commission, and the Commission took the FSA's

practices (use of soft dollars), drafting a code of ethics and hiring a compliance officer, and increasing the number of independent directors on a fund company's board. *Id.*

38. See, e.g., Jonathan Fuerbinger, *Portfolios Etc., The Mysterious World of Mutual Fund Costs*, N.Y. TIMES, Nov. 9, 2003, at C6 ("Not only has the S.E.C. been slow, but it also appears undecided about what an investor needs to know and can understand.").

39. Press Release, Financial Services Authority, FSA Announces Soft Commissions Policy Update (Nov. 10, 2004) (on file with author). The FSA is a regulatory body similar to the SEC.

40. BUNDLED BROKERAGE AND SOFT COMMISSION ARRANGEMENTS: FEEDBACK ON CP 05/05 AND FINAL RULES (July 2005), http://www.fsa.gov.uk/pubs/policy/ps05_09.pdf [hereinafter CP 05/05/FINAL RULES].

41. Reuters, *Move by S.E.C. On 'Soft Dollars'*, N.Y. TIMES, Sept. 22, 2005, at C3.

42. *Id.* (quoting SEC Chairman Christopher Cox).

43. SEC October 2005 Release, *supra* note 3; Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934: Final Rule, Exchange Act Release No. 34-54165, 17 C.F.R. 241 (Jul. 24, 2006), available at <http://www.sec.gov/rules/interp/2006/34-54165fr.pdf> [hereinafter SEC July 2006 Release].

guidelines into consideration in both releases, particularly the July 2006 release.⁴⁴ This commentary will also make recommendations for a workable framework that will allow the securities industry to flourish and investors to be well informed.

The subject of soft dollars within the context of investor protection has not received its due within academia. The concerns that soft dollars present to individual investors stem from the potential for investment advisors to misappropriate their clients' funds for their own benefit, breaching their fiduciary duties to fund shareholders.⁴⁵ Academics have instead focused on protection of the individual stock investor, yet the investor most in need of protection might be the mutual fund investor, the smallest and least protected.⁴⁶ This group comprises a great number of Americans who invest for retirement through 401(k) plans and IRAs.⁴⁷

It is critical that the regulators recognize that superfluous expenditures come directly out of the portfolios of small investors and deprive them of significant amounts of money over the course of their lives while they save for retirement. For this reason, the "good faith" provision of Section 28(e) can only be assured through an appropriate regulatory framework.⁴⁸ The winds of change have already begun to transform the security industry's soft dollar area, but until the SEC ensures that all investors have a legitimate opportunity to understand the costs incurred in a mutual fund investment, both explicit and hidden, ambiguity will abound, abuses will persist, and the SEC will need to provide more guidance.

44. See, e.g., TASK FORCE REPORT, *supra* note 36, at 10; SEC July 2006 Release, *supra* note 43, at 19.

45. SEC October 2005 Release, *supra* note 3, at 3.

46. Cf. Bevis Longstreth, *Pension Benefit and Legal Investment Law: The Profile Designer Disclosure for Mutual Funds*, 64 BROOKLYN L. REV. 1019, 1028 (1998) (stating that "those investors least sophisticated are the ones who most need protection.").

47. See, e.g., Craig & Hechinger, *supra* note 24 ("Fidelity manages more than \$1 trillion in retirement and other savings for 20 million customers.").

48. 15 U.S.C. § 78bb(e) (2006).

II. Disclosure of Soft Dollar Practices: Do Investors Really Need to be Informed?

A. *The Investment Adviser's Good Faith Determination of the Value of Research and Brokerage Services*

There is an appropriate place in the securities industry for bundled brokerage, and the arguments set forth below will in no way attempt to undermine that conclusion. There are significant benefits to soft dollar brokerage, and when the benefits are weighed against the detriments, the role of bundled brokerage within the securities industry prevails. Even among calls from industry experts to narrow the scope of services that qualify for Section 28(e)'s protection, certain practices should remain intact.⁴⁹ For example, the value of independent research creates compelling reasons for such research boutiques to be compensated in third party trading agreements, one type of soft dollar arrangement.⁵⁰ The proliferation of independent, unbiased research provides significant benefits to investment advisers and their fiduciaries.⁵¹ There are concerns that the use of trades to pay for research potentially undermines "best execution."⁵² There is also concern that too narrow an interpretation of Section 28(e)'s safe harbor protection would pose an undue burden on small investment advisers who cannot absorb costs as easily as large mutual funds.⁵³

The problem, however, is that there are inherent conflicts of interest within commission practices, and several investment advisers have used client commissions for their own benefit.⁵⁴

49. See Fink Letter, *supra* note 36 (writing the Chairman of the SEC to propose narrowing the scope of Section 28(e) protection).

50. See, e.g., Gretchen Morgenson, *How to Succeed on Wall Street Conflict-Free*, N.Y. TIMES, Dec. 19, 2004, at C5. In third party trading arrangements, trades can be executed at one broker-dealer while the research component of the commission is paid away to another broker-dealer. Such arrangements are discussed in detail *infra*. See LEMKE & LINS, *supra* note 4, at 10-11.

51. See, e.g., TASK FORCE REPORT, *supra* note 36, at n.10.

52. SEC February 1995 Release, *supra* note 1, at 3. D. Bruce Johnsen notes that a investment adviser might overuse research because it can be paid for with commissions rather than hard dollars. Mr. Johnsen also notes that managers might be compelled to overtrade to pay for research bills and direct trades for inferior execution to satisfy research bills. See Johnsen, *supra* note 8, at 88.

53. See TASK FORCE REPORT, *supra* note 36, at 4.

54. See, e.g., Craig & Hechinger *supra* note 24. See also SEC October 2005 Release, *supra* note 3, at 3; S.E.C. v. Sweeney, Litig. Release No. 15664 (Mar. 10,

Section 28(e) provides the safe harbor protection for paying more than the lowest available rate of commission on a brokerage transaction so long as the investment adviser “determines in *good faith* that such amount of commission was reasonable in relation to the value of the brokerage and research services provided.”⁵⁵ The question then arises as to what constitutes an investment adviser’s good faith determination, and how can an investment adviser be held to such a standard? The Commission’s original guidance appears to have admonished investment advisers “to be prepared to demonstrate the required good faith determination in connection with the transaction”⁵⁶ Over the years, the Commission has punished a number of investment advisers who did not use client commissions in good faith, but as Chairman Cox has admitted, punishing offenses one at a time is not sufficient, particularly for investors who suffer the misdeeds that never get punished.⁵⁷

In its 1986 interpretive release, the SEC altered its view on the products and services that qualify for Section 28(e)’s safe harbor. It extended the scope of the safe harbor to brokerage and research services that provide “lawful and appropriate assistance to the [investment adviser] in the performance of his investment decision-making responsibilities.”⁵⁸ In making the abstract determination as to what constitutes “lawful and appropriate assistance” it is critical that sufficient and appropriate disclosure to fiduciaries be required. Only then can a satisfactorily objective determination be made as to whether services have lawfully and appropriately assisted the investment adviser and whether he has acted in good faith. If complete transparency into all of an investment adviser’s

1998), available at <http://www.sec.gov/litigation/litreleases/lr15664.txt> (last visited Apr. 26, 2007).

55. 15 U.S.C. § 78bb(e)(1) (2006) (emphasis added).

56. SEC October 2005 Release, *supra* note 3, at 12 (internal quotation omitted).

57. See Reuters, *supra* note 41. See also *In re Founders Asset Mgmt.*, 54 SEC Docket 762, 764 (June 15, 2000) (directing trades to brokers in exchange for client referrals); *In re Dawson-Samberg Capital Mgmt.*, 54 SEC Docket 786, 788-89 (Aug. 3, 2000) (using soft dollars to pay for non-research business related and personal expenses).

58. See SEC October 2005 Release, *supra* note 3, at 14 (quoting Securities, Brokerage, and Research Services, Exchange Act Release No. 23170, 51 Fed. Reg. 16004-01 (Apr. 30, 1986) [hereinafter SEC April 1986 Release]).

commission practices existed, the investment adviser would be less likely to submit to the potential conflicts that can arise within the context of commission practices.

B. *The Current State of Disclosure*

The current state of disclosure of client commission practices does not provide adequate transparency to the investor. In its October 2005 Release, the Commission provided broad interpretive guidance concerning client commission practices, but remained silent on the issue of disclosure of such practices.⁵⁹ The Commission responded in large part to many of the suggestions made by industry experts, but declined to address the disclosure issue. For example, in its discussion of the recommendations of the NASD Mutual Fund Task Force, the SEC mentioned that the Task Force had recommended improved disclosure, but declined to address the issue directly.⁶⁰ The SEC then listed the specific recommendations of the Task Force including mandating enhanced disclosure in fund prospectuses to improve investor awareness and enhancing investor awareness as to portfolio transaction costs.⁶¹ In his article *The Unfinished Business of Mutual Fund Reform*, Thomas J. Hurst said,

Current SEC regulations do not require the disclosure of trading costs either as part of the mutual fund expense ratio or separately. Thus, these figures cannot be easily obtained from publicly available documents. When the modest level of disclosure required of mutual funds is compared with the detailed information to be given to consumers obtaining a mortgage or auto loan, the difference is striking and seems to be without justification.⁶²

The Commission again addressed the need for adequate disclosure in its July 2006 Release, where it stated that, “further guidance in this area may be particularly important.”⁶³

Although Congress authorized the SEC within Section 28(e) to adopt rules for disclosure to clients of an investment adviser’s commission practices, the SEC never created rules

59. SEC October 2005 Release, *supra* note 3; July 2006 Release, *supra* note 43.

60. TASK FORCE REPORT, *supra* note 36, at 18.

61. *Id.* at n.54.

62. Hurst, *supra* note 20, at 147.

63. SEC July 2006 Release, *supra* note 43, at 24.

under Section 28(e) regarding disclosure of client commission practices.⁶⁴ Instead, the SEC adopted rules under the Investment Adviser's Act of 1940 and the Investment Company Act of 1940.⁶⁵ The absence of the disclosure discussion in either the SEC's October 2005 or July 2006 Releases might indicate that the SEC is preparing separate guidance on the disclosure issue.⁶⁶ Disclosure has traditionally been considered the province of either the Investment Adviser's Act of 1940 or the Investment Company Act of 1940, not the Securities Exchange Act of 1934, and this is probably due to an investment adviser's role as fiduciary and its obligation to disclose any material information.⁶⁷ It would make sense, however, for the SEC to create a single set of disclosure rules specifically for investment advisers and investment companies intending to avail themselves of the safe harbor protection of Section 28(e). One criticism of the Commission is that it is not sure what information investors really need.⁶⁸

Currently, Rule 204-3 sets out the requirements for disclosure by investment advisers of client commission practices.⁶⁹ These rules, however, apply only to investment advisers and not necessarily to investment companies.⁷⁰ Investment Advisers must disclose their commission practices in Form ADV, specifically in Part II.⁷¹ Investment advisers are required to provide Part II of Form ADV or a document with all of Part II's information to prospective clients at least forty-eight hours prior to establishing an advisory relationship and to current clients at

64. See, e.g., SEC February 1995 Release, *supra* note 1.

65. 15 U.S.C. §§ 80a-1, b-1 (2006).

66. The Commission proposed disclosure rules in 1995, which would have required disclosure of commission practices in an annual report and new form ADV. See SEC October 2005 Release, *supra* note 3. The proposed rule would have been Rule 204-4, but was never adopted. *Id.* Congress also proposed a law that would require the SEC to develop enhanced rules for disclosure in 2003. *Id.*

67. See SEC April 1986 Release, *supra* note 58, at 16007-08.

68. Jonathan Fuerbringer, *Portfolios Etc.: The Mysterious World of Mutual Fund Costs*, N.Y. TIMES, Nov. 9, 2003, at C6 (citing a memorandum by Paul Royce, the director of the SEC's division of investment management).

69. Rules and Regulations of the Investment Advisor's Act of 1940, 17 C.F.R. §. 275 (2007).

70. INSPECTION REPORT, *supra* note 2 (discussing the disclosure requirements for both investment advisors and investment companies). See also SEC April 1986 Release, *supra* note 58, at 16007-08.

71. SEC April 1986 Release, *supra* note 58, at 16008.

least annually.⁷² The disclosure requirements may be effective in informing clients of investment advisers, but such clients typically are savvier than the mutual fund investor.

Mutual Funds are controlled by the Investment Company Act of 1940. Investment Companies must submit Form N-1A, which is their registration form.⁷³ Within Form N-1A, the investment company must make similar disclosure as that required by Form ADV Part II.⁷⁴ The investment company's disclosures are available to investors upon request in an Investment Company's Statement of Additional Information (SAI).⁷⁵ Where, on the one hand, the investment advisory client is required to receive written documentation prior to establishing a relationship and annually after commencement, the mutual fund investor must request disclosure information; it is not automatically given or readily available.

C. *The FSA's Disclosure Requirements: Comparative Disclosure*

The FSA requires that investment advisers make disclosure to investment clients prior to the establishment of a relationship and periodically thereafter.⁷⁶ The rule states, "if an investment manager enters into arrangements for the receipt of goods or services that relate to the *execution* of trades or the provision of research," it must disclose those arrangements.⁷⁷ The required disclosure includes "details of the goods or services that relate to the *execution* of the trades, and wherever appropriate, [separate identification of] the details of the goods or services that are attributable to the provision of research."⁷⁸ A satisfactory prior disclosure should include the details of the manager's policy regarding "goods or services that relate to the *execution* of trades or the provision of research."⁷⁹ Prior disclosure should also explain the reasons why the manager finds it necessary to tie payment for research, goods, and services to

72. INSPECTION REPORT, *supra* note 2, at 11-13.

73. SEC April 1986 Release, *supra* note 58, at 16009.

74. *Id.*

75. *Id.*

76. CP 0505/FINAL RULES, *supra* note 40, at Appendix 1, 10.

77. *Id.*

78. *Id.* (emphasis added).

79. *Id.* at 11.

trade execution commissions.⁸⁰ The FSA, within the context of the disclosure rule, states that an investment manager or his firm should have discretion to decide the appropriate method of disclosure, but the FSA will consider in its judgment of the adequacy of disclosure the extent to which the manager “adopt[s] disclosure standards developed by industry associations such as the Investment Management Association, the National Association of Pension Funds, and the London Investment Banking Association.”⁸¹

The FSA stated in Policy Statement 05/09 that it expects the Investment Management Association’s (IMA) Disclosure Code to become the industry standard.⁸² The IMA is a non-regulatory industry association. The FSA acknowledged that certain situations might not call for the extensive degree of disclosure as the IMA’s code but stressed that an investment adviser would bear the burden of showing that their methodology is sufficient.⁸³ The FSA appears to consider the IMA’s Disclosure Code to be presumptively adequate.

The IMA’s Disclosure Code is an extensive document that details a disclosure regime that is potentially overbroad. It is especially interesting that the FSA has endorsed the IMA’s Disclosure Code, particularly since the Code is geared specifically toward pension funds.⁸⁴ This signals an endorsement by the FSA of a code that protects smaller and less sophisticated investors. According to the IMA, the Code is a minimum set of standards, and managers cannot claim compliance by partial adherence to the code’s guidelines.⁸⁵ The Code’s goal is to arrive at a quantitative conclusion as to the investment management costs to a fund.⁸⁶ The Code does not dictate, however, the methodology to be used in ascertaining the costs of investment management.⁸⁷ Instead, the Code requires managers to develop

80. *Id.*

81. *Id.*

82. *Id.* at 8.

83. *Id.*

84. See INVESTMENT MANAGEMENT ASSOCIATION, PENSION FUND DISCLOSURE CODE 2 (2d. ed. 2005), available at <http://www.investmentuk.org/news/standards/pfdoc2.pdf> [hereinafter PENSION FUND CODE].

85. *Id.* at 4.

86. See *id.* at 6.

87. See *id.*

their own measurement methods and requires that investment managers provide a thorough explanation of the methods used.⁸⁸ This allows readers to make their own determinations about the information provided.⁸⁹

Under the Code, there are two levels of disclosure. Level One disclosure deals with “house policies and procedures in relation to the management of costs incurred on behalf of clients.”⁹⁰ Such policies and procedures include disclosure of the dealing venues and methods,⁹¹ broker selection,⁹² broker review,⁹³ variations in the rate of commissions,⁹⁴ commission recapture and directed commission programs,⁹⁵ and dealing efficiency and monitoring.⁹⁶ Other Level One policies include conflicts of interest,⁹⁷ purchase of research,⁹⁸ use of derivatives

88. *Id.*

89. *Id.* at 7.

90. *Id.*

91. Dealing methods and venues includes the use of brokers or full service brokerage, crossing networks (electronic systems designed to match orders electronically), direct market access (where the investment manager executes trades in the marketplace without the order being touched by a broker), descriptions of trading strategies (whether the dealer charges a markup or a commission is paid), factors that relate to the decisions, and descriptions of how the manager procures best execution. *Id.* at 9 (Appendix 1).

92. The process by which the manager selects brokers must be disclosed, including frequency of review and relevant factors in determining the use of brokers as well as commission targets for each broker and how those are determined. *Id.*

93. This includes the methods of negotiating the bundled commission and the proportion of the commission that pays for execution and the portion that pays for research services as well as monitoring commission targets and disclosing changes to the targets. *Id.*

94. Disclosure of the range or all commission rates (in basis points) across all the various asset classes is required as well as the impact of various trading strategies on commission rates. *Id.* at 10.

95. Directed brokerage arrangements occur when a plan sponsor directs the investment adviser to send trades to a particular broker where the commissions from those transactions are either used to pay for services incurred by the plan sponsor or to rebate part of the commission to the plan sponsor. See, e.g., LEMKE & LINS, *supra* note 4, at 135-40.

96. This includes monitoring transaction costs and the use of any transaction cost analytical software. PENSION FUND CODE, *supra* note 84, at 10.

97. This includes a description of the policies and procedures, identification, monitoring, and resolution of conflicts of interest. *Id.*

98. This includes policies on proprietary as well as third party research, the assessment of the value of research, and how research is actually purchased. *Id.* at 11.

products for fund management, initial public offering policies,⁹⁹ custody selection, placing of deposits, and foreign exchange transactions.¹⁰⁰ Level Two disclosure provides a greater degree of granularity and includes disclosure of the percent of a portfolio at the end of a period (quarter/year) that is not compliant with the Code, management fees for the fund, including compensation of the manager and associates,¹⁰¹ the custodial costs borne by the fund and to whom they were paid, trading volumes, commissions generated and how they were spent,¹⁰² stock lending activities, and taxation. The IMA also provides a template for a comparative disclosure table to assist investment advisers in meeting some of these requirements.¹⁰³

D. *Forging a Better Disclosure Regime in the U.S.*

Admittedly, the IMA's Disclosure Code might be too broad and detailed to be helpful to less sophisticated investors, and the differences in approach between the United States and the United Kingdom serve to illustrate that there should be separate disclosure regimes for the investor or advisory client and the regulatory authorities. The IMA's Code is useful because much of the information required can easily be distilled, once procured, into a useful and understandable construct for investors. Indeed, much of the same information that the IMA requires must also be disclosed in either an investment adviser's Form ADV or a mutual fund's statement of additional information.¹⁰⁴

99. This requires procedures for complying with regulatory requirements in this area as well as the influence on trading by the prospect of procuring allocations in initial public offerings. *Id.*

100. This requires disclosure on how the investment adviser distributes foreign exchange transactions including credit rating of counterparties and the risk of dealing with particular counterparties. *Id.*

101. This requires a determination of the cost to the particular client when funds are pooled. *Id.*

102. This includes the top ten trading partners, analysis of the commission generated at various commission rates, analysis of how those commissions were spent including a breakdown of the costs attributed to execution and the costs attributed to research (including proprietary and third party research), total commissions generated, and the firm wide generation of commissions with the average commission rate paid. *Id.* at 12.

103. *Id.* at 13 (appendix 3).

104. SEC April 1986 Release, *supra* note 58 at 16008. See also TASK FORCE REPORT *supra* note 36, at 13.

In addition to the information it receives from Forms ADV or N-1A, the SEC should require that broker-dealers prepare statements by client for the SEC of all the soft dollar credits granted on behalf of a particular investment adviser for a given year. The SEC could then cross reference the broker information with the information contained in the required forms in order to ensure the veracity of the information provided by investment advisers to the SEC.

In order to satisfy an investment adviser's disclosure obligations to clients, however, the SEC can mandate protocols outlining the manner in which Investment Advisers and Investment Companies deliver information regarding client commission practices.¹⁰⁵ Furthermore, the Commission could require investment advisers and investment companies to "unbundle" commissions for the purposes of soft dollars. For example, an investment adviser or company should be able to arrive at a determination as to what amount of the commissions paid were specifically for execution and what amount of the commissions paid were credited for soft dollar purposes.

The NASD Mutual Fund Task Force had considered recommending that any manager that relies on the safe harbor protection of Section 28(e) make a good faith estimate of the "percentage of Commissions and/or the fund's NAV [Net Asset Value] that was used to obtain soft dollar benefits."¹⁰⁶ The Task Force was concerned that the lack of a "uniform methodology" in assessing what percentage of commissions were used to pay for soft dollars would result in a lack of "comparability across fund groups."¹⁰⁷ The Task Force noted that there may not be sufficient transparency in the payment for proprietary research as a component of execution.¹⁰⁸ Other soft dollar arrangements

105. The goal of the 1940 Act was to "substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry." SEC v. Cap. Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963); *but see* Longstreth, *supra* note 46, at 1031 (responding to an SEC declaration that an investor could always request more information if he wanted, Longstreth stated, "[t]hese statements imply that the SEC considers even average fund investors capable of 'fending for themselves', a standard heretofore reserved for institutional and other sophisticated investors who did not need the protections of the Securities Act.").

106. TASK FORCE REPORT, *supra* note 36, at 11.

107. *Id.*

108. *Id.*

including third party research provide an easier framework for an analysis of soft dollar payments due to ratios provided to investment advisers that explicitly state what portion of a commission will be credited to soft dollars.¹⁰⁹

This problem in evaluating the portion of brokerage commissions used to pay for proprietary research is easily remedied by requiring that broker-dealers separate the execution component from commissions for investment advisers on any invoices or confirmations. Requiring the broker to provide an execution only rate to every broker-dealer client would achieve several benefits. It would allow investment advisers to still avail themselves of all services a broker provides by paying a bundled commission, while providing transparency to their investors as to how much the investment adviser is paying for research. Such an approach would also preserve the flexibility of the investment adviser's subjective determination as to the value of a broker's proprietary research, but it would also allow an investment adviser a transparent methodology to pay solely for execution on some trades and for execution and research on other trades. In this scenario, the investment adviser could direct order flow to trading partners strictly for best execution reasons.

Another concern of the mutual fund task force was that the detriment to the investor from inaccurate information would outweigh the benefits of disclosure.¹¹⁰ This concern is driven by the idea that the numbers would be the result of "good faith" estimates, but if the investment adviser is required to ascertain the costs of the various components of the trade cycle and how payments are credited, a hard dollar number for disclosure purposes can be determined. Adequate disclosure, at a minimum, would provide the average investor with an opportunity to consider the impact of soft dollars on returns at the time of making an investment decision and periodically to judge such impact. Disclosure need not be complex. A fund could disclose quarterly on a statement to the investor the Net Asset Value at the end of the Quarter and the Net Value Minus Soft Dollars (NVSD). An investor could compare the investment to other funds that do

109. *Id.*

110. *Id.* at 11-12.

not use soft dollars and analyze whether the costs justify the returns achieved.

The Commission should consider making all of this data readily available to industry organizations such as Morningstar, the Investment Company Institute (ICI), and the Investment Counsel Association of America (ICAA), as well as giving incentives to such organizations to distill the data into easily understandable and useful pieces that will aid the small investor in ascertaining the value of his investment. Such organizations in the United States are in the best position to play the role of the IMA in the United Kingdom. For investors that seek a greater level of detail, the Commission should require that Form ADV or the SAI be readily available on an Investment Adviser or Investment Company's website. Such documents should not be available only upon request but should be open and transparent to the public. Although it would have been appropriate for the Commission to propose new rules regarding disclosure in its October 2005 Release, the Commission acknowledges that improvements might be needed in disclosure of commission practices and will likely look at the adequacy of disclosure.¹¹¹

III. Research and Brokerage Services

A. Introduction

The SEC did a commendable job in both its October 2005 and July 2006 Interpretive Releases, providing guidance to the securities industry as to what specifically constitutes "research and brokerage" services under Section 28(e) of the Securities and Exchange Act of 1934.¹¹² The SEC acknowledged that it took the FSA's rules regarding the use of client commissions to purchase research and execution related services into consideration and that there is little meaningful difference in the SEC's approach compared to the FSA's approach.¹¹³ Studies since the SEC's previous guidance on the scope of Section 28(e) have

111. See SEC October 2005 Release, *supra* note 3, at n.72.

112. 15 U.S.C. § 78 bb(e) (2006).

113. SEC October 2005 Release, *supra* note 3, at 20. The FSA refers to execution services and research, whereas the Securities and Exchange Commission refers to research and brokerage services, the language of Section 28(e). See PS 05/09, *supra* note 76.

shown that a large percentage of investment advisers and broker-dealers were using client commissions to pay for services that the Commission deems outside the safe harbor protection of Section 28(e).¹¹⁴ Examples of non-research related services include certified financial analyst (CFA) review courses, membership dues and professional licensing fees, office rent, utilities, phone, carpeting, marketing, entertainment, meals, copiers, office supplies, fax machines, couriers, backup generators, electronic proxy voting services, salaries, and legal and travel expenses.¹¹⁵

In light of Congress's intent in enacting Section 28(e)'s safe harbor protection that the term "brokerage and research services" be understood in broad terms, the SEC reiterated its belief "that the section should be construed in light of its limited purposes."¹¹⁶ Under the Commission's current guidance, in order to determine whether a product or service qualifies for the safe harbor protection of Section 28(e), the investment adviser must satisfy three elements: (1) the investment adviser must determine whether the services furnish advice, analyses or reports, or effect securities transactions and perform functions incidental to execution;¹¹⁷ (2) the investment adviser must make the determination that the product or service provides "lawful and appropriate assistance in the performance of his investment decision-making responsibilities;"¹¹⁸ and (3) the investment adviser must make a "good faith determination that the amount of client commissions paid is reasonable in light of the value of the products or services provided by the broker-dealer."¹¹⁹ Of the three elements, the "lawful and appropriate assistance" standard is the sole element not explicitly mentioned in Section 28(e); it derives from the SEC's 1986 interpretive release.¹²⁰

114. SEC October 2005 Release, *supra* note 3, at 21-22.

115. *Id.*

116. *Id.* at 25.

117. *Id.* at 26; SEC July 2006 Release, *supra* note 43, at 26; 15 U.S.C. § 78bb(e)(3)(A)-(C) (2006).

118. SEC October 2005 Release, *supra* note 3, at 26; SEC July 2006 Release, *supra* note 43, at 26.

119. SEC October 2005 Release, *supra* note 3, at 26.

120. *Id.* at 21; *see generally* SEC April 1986 Release, *supra* note 58.

B. *Research*

The threshold issue is what constitutes “brokerage and research” services within the confines of this construct. Generally speaking, advice, analyses, and reports all may constitute research.¹²¹ Such advice, analyses, and reports must fall within the provisions of Section 28(e).¹²² The Commission has said that the provisions of Section 28(e)(3)(A)-(B) might incorporate a much broader list than that enumerated in the statute, making the list an inclusive versus an exclusive list.¹²³ Political commentary could therefore qualify as research.¹²⁴

The benchmark that will ultimately determine whether advice, analyses, or reports qualify as research is that “each must reflect substantive content – that is, the expression of reasoning or knowledge.”¹²⁵ Given this construct, research therefore must reflect “reasoning and knowledge” and be related to the examples provided within Section 28(e)(3)(A)-(B).¹²⁶ The “reasoning and knowledge” standard is consistent with the FSA’s requirement that:

[W]hatever form the output takes, [it] represents original thought, in the critical and careful consideration and assessment of new and existing facts, and does not merely repeat or repack-age what has been presented before; [it] has intellectual rigour and does not merely state what is commonplace or self-evident; and [it] involves analysis or manipulation of data to reach meaningful conclusions.¹²⁷

121. SEC October 2005 Release, *supra* note 3, at 27; SEC July 2006 Release, *supra* note 43, at 27.

122. 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; [or?] (B) furnishes analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts. 15 U.S.C. § 78bb(e)(3)(A)-(B) (2006).

123. October 2005 Release, *supra* note 3, at 27; July 2006 Release, *supra* note 43, at 28.

124. October 2005 Release, *supra* note 3, at 27.

125. *Id.* at 28.

126. *Id.*

127. CONDUCT OF BUSINESS SOURCEBOOK (USE OF DEALING COMMISSION) INSTRUMENT 2005, FSA 8 (as an appendix to PS 05/09, *supra* note 76) [hereinafter CONDUCT SOURCEBOOK].

Among the products and services that could be considered research under the “reasoning and knowledge standard” are “financial newsletters and trade journals . . . [q]uantitative analytical software and software that provides analyses of securities portfolios, . . . and [s]eminars or conferences.”¹²⁸ The Commission was careful to point out that trade journals and financial newsletters qualify only if they serve a very narrow audience and are not mass marketed.¹²⁹ Mass marketed publications are specifically excluded because they do not comprise the type of “research” Congress intended to fall within the scope of the safe harbor.¹³⁰

The SEC also included market data within the definition of what would constitute research.¹³¹ According to the SEC, market data consolidates information on a real time basis and provides a “legitimate research function of pricing securities for investment and keeping a manager informed of market developments.”¹³² “[M]arket data contains aggregations of information on a current basis related to the subject matter identified in the statute.”¹³³ While the SEC’s views of the value of market data are accurate, the SEC should be vigilant of the redundant nature of market data and warn investment advisers that they should pay only once for the market data with soft dollars, or at a minimum, be required to make a good faith showing as to why the manager has decided to pay for redundant market data across several services/venues. In addition, the Commission should recognize that market data is a commodity product that can be purchased cheaply, and using commissions to pay for market data could result in grossly overpaying for it. In the case of market data, the investment adviser should have a higher burden of making a good faith showing as to the reasonableness of the price paid for market data as research. Market data might also qualify as mixed use product, being an indis-

128. SEC October 2005 Release, *supra* note 3, at 28. While seminars could be considered “research”, airfare and travel expenses to attend a conference, meals, and entertainment do not qualify. *Id.* at 29.

129. SEC July 2006 Release, *supra* note 43, at 31.

130. *Id.* at 30.

131. SEC October 2005 Release, *supra* note 3, at 30.

132. *Id.*

133. SEC July 2006 Release, *supra* note 43, at 35.

pensable part of the trade execution process, and the SEC should consider this as well.

Items precluded from being considered research include telephone lines, salaries of research personnel, professional licensing fees, computer hardware and accessories, telecommunications lines, transatlantic cables, computer cables, and back office systems, and travel.¹³⁴ All of these items lack “substantive content.”¹³⁵ Areas of divergence between the FSA and the SEC on what could qualify as research include seminar fees and subscriptions to publications, but it is important to note that these items might not always fall within the safe harbor protection of Section 28(e).¹³⁶ In order to use eligible research services within the safe harbor protection of Section 28(e), the Commission reminded investment advisers that the research must still provide the investment adviser with “lawful and appropriate assistance” in making investment decisions.

C. *Brokerage Services*

“Brokerage Services” means effecting transactions and providing services incidental to effecting the transactions such as clearance and settlement of trades.¹³⁷ Given concerns expressed within the industry and acknowledged by the SEC that the advent of technology and sophisticated trading systems would lead to many of the same issues regarding computer hardware and research, the SEC provided the following guidance:

In our view, brokerage under Section 28(e) should reflect historical and current industry practices that execution of transactions is a process, and that services related to execution of securities transactions begin when an order is transmitted to a broker-dealer and end at the conclusion of clearance and settlement of the transaction Specifically, for the purposes of the safe harbor, we believe that brokerage begins when the [investment advisor] communicates with the broker-dealer for the purpose of transmitting an order for execution and ends when funds or se-

134. *Id.* at 28-29.

135. *Id.* at 27.

136. CONDUCT SOURCEBOOK, *supra* note 127, at 9.

137. SEC October 2005 Release, *supra* note 3, at 32.

curities are delivered or credited to the advised account or the account holder's agent.¹³⁸

The Commission adopted a temporal standard to prevent services that do not qualify as eligible "research" under Section 28(e) to be inappropriately treated as "brokerage" eligible for the safe harbor.¹³⁹ This temporal standard can be problematic. The Commission uses the temporal standard to extend the safe harbor protection to such physical and tangible items as connectivity between the client and the broker, including dedicated lines between the investment adviser and the broker-dealer, dedicated dial up telephone lines between the investment adviser and the trading desk at the broker-dealer and message services like FIX used to transmit orders and executions back and forth between the broker-dealer and the investment adviser.¹⁴⁰ Brokerage services also include "trading software operated by a broker-dealer to route orders to market centers and algorithmic trading software."¹⁴¹

The problem arose when, in the context of the investment adviser's order management system (OMS), the SEC decided in its October 2005 Release not to extend the safe harbor to include an investment adviser's order management system (OMS) as a brokerage service eligible for the protection under Section 28(e).¹⁴² The exclusion of the OMS from eligible "brokerage" is not explicitly articulated in the July 2006 release, and based on the temporal standard, the exclusion applies. However, several OMS' have become registered broker-dealers and as such are trying to participate in the brokerage commissions of many of the orders transmitted for execution.¹⁴³ For example, most order management systems offer access to broker-dealer algorithms and connect via lines that the Commission stated can be considered for the safe harbor protection of Section 28(e). The OMS vendor routes a stock order for execution through a tele-

138. *Id.* at 33-34; see also SEC July 2006 Release, *supra* note 43, at 40.

139. SEC July 2006 Release, *supra* note 43, at 37-38.

140. SEC October 2005 Release, *supra* note 3, at 34-35. FIX is a standard messaging protocol for the transmission of messages, orders, executions, and indications of interest between broker-dealers and investment advisers.

141. *Id.* at 34-5.

142. *Id.* at 35.

143. See, e.g., Charles River Brokerage, http://www.crd.com/ser_bro.html (last visited Mar. 28, 2007).

communications line to a destination such as a broker's trading desk or an electronic destination. The line used to transmit the stock order qualifies for Section 28(e)'s safe harbor and payment can be made with commission dollars.¹⁴⁴

OMS vendors charge for connectivity lines either through monthly charges or per share charges. An investment advisor might pay a standard monthly charge or a per share amount as part of the commission associated with the stock order, but the function of the line is the same, regardless of the destination where the order is sent. The line performs an order delivery function. The Commission should bear in mind that it is difficult to consider a per share charge to one destination (which might greatly exceed a flat fee) to be reasonable in light of a significantly lower monthly charge to another destination, when in each scenario the service being performed is order transmission. The broker-dealer bundles connectivity costs into the commission charged for the trade execution, and the investment adviser pays different amounts for transmission, depending on the type of destination.

Moreover, in excluding the OMS from consideration as a brokerage service, the Commission should acknowledge that OMSs will begin to offer services that do qualify as trade execution, such as develop their own proprietary Algorithmic trading strategies as well as direct connections to market centers for trade execution. This could lead to the Commission revisiting OMSs in short order. In its comment letter to the Commission regarding the October 2005 Release, the Investment Company Institute (ICI) admonished the Commission to reconsider its position on OMSs.¹⁴⁵ The ICI said that the release does not actually define what qualifies as an OMS or recognize the various ways in which OMSs can be used. The ICI predicted that technology would continue to advance and OMSs would change over time.¹⁴⁶ Furthermore, the ICI supported the Commission's

144. SEC October 2005 Release, *supra* note 3, at 34.

145. Letter From Paul S. Stevens, President of the Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Nov. 22, 2005), *available at* http://www.ici.org/statements/cmltr/05_sec_soft_dol_com.html#P33_10498 [hereinafter Katz Letter].

146. *Id.* The ICI noted that OMSs were not given safe harbor protection by the SEC because the Commission found that OMSs were not sufficiently related to the execution. The ICI, in its letter, disagreed. *Id.*

“temporal standard” but noted that the execution process should begin sooner in 28(e) terms.¹⁴⁷ The ICI criticized the Commission’s standard for being too rigid in its definition of trade commencement.¹⁴⁸ The ICI also recommended that the Commission consider extending “mixed use” status to OMSs.¹⁴⁹

In its July 2006 Release, the Commission acknowledged that commenters had recommended including the OMS as an eligible mixed use item.¹⁵⁰ This appears to be the appropriate approach, particularly with OMSs providing more brokerage type activities, such as trade allocation and order routing. A mixed use item is one that may be considered to provide a “research service” or a “brokerage service” but also provides services that are not used either in the investment decision making process or the trade execution process.¹⁵¹

The FSA’s temporal standard for trade execution is consistent with the ICI’s recommendation of broadening the Commission’s Standard.¹⁵² The FSA considers the lifecycle of an order to be the period of time between the investment decision and the conclusion of the trade.¹⁵³ Specifically, the FSA’s rules provide that in order for goods or services to be considered execution, they should be “linked to the arranging and conclusion of a specific investment transaction (or series of related transactions) . . . and provided between the point at which the investment manager makes an investment or trading decision and the point at which the investment transaction (or series of related transactions) is concluded.”¹⁵⁴ Under the FSA’s standard, the OMS should qualify as an execution service. Certainly, the OMS does not appear on the FSA’s list of services that do not qualify either as execution or research.¹⁵⁵

Therefore, the SEC might consider the many facets of the OMS, its evolution and the role the OMS will eventually play in

147. *Id.*

148. *Id.*

149. *Id.*

150. SEC July 2006 Release, *supra* note 43, at 47.

151. LEMKE & LINS, *supra* note 4, at 88; *see also* INSPECTION REPORT, *supra* note 2, at 9.

152. *See* Katz Letter, *supra* note 145.

153. CONDUCT SOURCEBOOK, *supra* note 127, at 8.

154. *Id.*

155. *Id.* at 9.

the trade process, as well as the possibility of overlap among the services provided by the OMS and other products which might cause investment advisers to overpay for services that separately would qualify for the protection under Section 28(e). However, the July 2006 Release, while not explicitly including the OMS among eligible mixed use items, reaffirmed the concept of mixed use. Including the OMS as a mixed use item is certainly a permissible conclusion practitioners could draw from the final release.¹⁵⁶

IV. Third Party Research and Commission Sharing Agreements

A. *Overview and Debate Over Third Party Research*

Using trade commissions to pay for so called “third party” research continued to be a contentious aspect to the debate concerning client commission practices until the environment shifted due the Commission’s July 2006 Release. For example, in a 1995 SEC rule proposal, Goldman Sachs and Morgan Stanley recommended that the Commission adopt rules of disclosure that would require periodic disclosure as to the specific soft dollar benefits an investment adviser received as well as the specific value of those benefits.¹⁵⁷ Industry proponents of independent research urged that the Goldman/Morgan proposal was “anti-competitive and discriminatory.”¹⁵⁸ The Goldman/Morgan proposal would have alleviated disclosure of proprietary research because such research does not carry a specific dollar price.¹⁵⁹ On the other hand, the cost of third party research is explicit because it is paid away by the executing broker.¹⁶⁰ In spite of views to the contrary, the SEC has always seen the value in third party research and has extended the

156. SEC July 2006 Release, *supra* note 42, at 47.

157. See SEC February 1995 Release, *supra* note 1.

158. *Id.* at 5.

159. *Id.* at 7. This is the exact reason for the earlier proposal that the execution component of a trade must be explicit in every trading scenario. An investment adviser should always know the amount of the execution component of the commission, while still retaining the subjective flexibility to pay the value over time he deems necessary for the research services. See also INSPECTION REPORT, *supra* note 2, at 10 (discussing the history of bundled brokerage and why a value has never been attached to proprietary research).

160. SEC February 1995 Release, *supra* note 1, at 7.

safe harbor protection of Section 28(e) to the use of commissions to purchase third party research.¹⁶¹

The SEC's earlier guidance on the methods used to pay for third party research was a major area in which the SEC's and FSA's views diverged on commission sharing arrangements. The most striking difference between the October 2005 and the July 2006 releases is the dramatic shift in guidance with respect to Commission Sharing Arrangements, or, as the Commission now calls them, Client Commission Arrangements.¹⁶²

B. *Third Party Research Arrangements*

Traditionally, third party research arrangements involved procurement of non proprietary (third party) research by a broker-dealer.¹⁶³ The research was provided by the broker-dealer to the investment adviser. In such situations, an "explicit" cost could be attached to the research, and the investment adviser could compensate the "soft dollar" broker for the research with commissions generated from trades. This differed from services provided by a full service broker, where the commission charged covers a bundle of services with little transparency into the specific costs of the services provided.¹⁶⁴ Several different methodologies to help investment advisers procure and deliver third party research exist within the securities industry, but the Commission has stated that the "provided by" provision of Section 28(e) must be satisfied.¹⁶⁵ Section 28(e) states that the investment adviser will not have breached his fiduciary duty by

161. INSPECTION REPORT, *supra* note 2, at 10.

162. SEC July 2006 Release, *supra* note 43, at 50.

163. LEMKE & LINS, *supra* note 4, at 70.

164. *Id.* at 71.

165. SEC October 2005 Release, *supra*, note 3, at 40. The author knows of three prevailing methodologies for providing research to third parties. In the first arrangement, a soft dollar broker will purchase research on behalf of investment advisers and provide the research to them with the hope that the investment adviser pays for the research through one of the soft dollar broker's trading partners. In such a situation, the soft dollar broker has paid in advance for the research and is at risk that it might never be compensated by the investment adviser. *See generally* Westminster Research, <https://www.westminsterresearch.com/Default.aspx> (last visited Mar. 28, 2007) (providing a brief overview of the services provided by the *soft dollar* broker). In another type of arrangement called a commission sharing arrangement, a broker-dealerbroker-dealer uses client commissions to pay for research services the investment adviser has obtained unilaterally. *See* SEC October 2005 Release, *supra* note 3, at 41.

paying up for research so long as he “determines in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer”¹⁶⁶ According to the Commission’s guidance in October 2005, “The essential feature of the ‘provided by’ element is that the broker-dealer has the direct legal obligation to pay for the research.”¹⁶⁷ This does not mean that the research must be sent to the investment adviser directly by the soft dollar broker or by the executing broker-dealer; the third party can send the research directly to the investment adviser.¹⁶⁸

The core requirement was the broker’s obligation to pay for the research services. The third party could send the research directly to the investment adviser, so long as the broker-dealer incurred the payment obligation.¹⁶⁹ “[A] money manager may not rely upon Section 28(e) if he uses the broker-dealer merely to pay an obligation that has [been] incurred with a third party.”¹⁷⁰ If the investment adviser incurs an obligation with a research provider and directs a broker-dealer to use portions of the brokerage commission to remit payment to the research provider for the obligation previously incurred, the investment adviser will be operating outside of the scope of Section 28(e)’s safe harbor protection. The standard that a broker-dealer must incur a direct legal obligation for the third party services was not new.¹⁷¹

C. *Eligible Arrangements*

In October 2005, the SEC articulated specific necessary elements of a legitimate correspondent clearing relationship that would qualify commission arrangements between legitimate correspondents within the safe harbor protection of Section

166. 15 U.S.C. § 78bb(e) (2006).

167. SEC October 2005 Release, *supra* note 3, at 40.

168. *Id.* See also LEMKE & LINS, *supra* note 4, at n.152 (internal citations omitted) (the method of delivery of the research does not matter so long as the arrangement is wholly compliant with applicable securities laws).

169. SEC October 2005 Release, *supra* note 3, at 41.

170. *Id.* at 40-41.

171. See SEC April 1986 Release, *supra* note 58, at 16006 (explaining that the “provided by provision” has always contemplated an obligation on the part of the broker to pay for the research services provided by the third party).

28(e).¹⁷² The SEC might have articulated such elements due to concerns that investment advisers had participated in programs in which the research provider had no knowledge or role in the execution of trades and simply received checks from the executing broker-dealer at the investment adviser's direction.¹⁷³ The Commission has said that where more than one broker is a party to the commission sharing arrangement, "the introducing broker [must be] engaged in securities activities of a more extensive nature than merely receipt of commissions paid to it by other broker-dealers."¹⁷⁴

The Commission identified three prevalent types of commission sharing arrangements: first, where the introducing broker both executes and provides the research but clears and settles the trades through another broker-dealer; second, where the research provider receives a portion of the commission and might have no role in the execution, clearance or settlement of the trade but relies on the services of a clearing broker;¹⁷⁵ and third, where the research provider shares in commissions with its legitimate correspondent while providing substantive functions related to the effectuation of the trade.¹⁷⁶

The Commission had considered the type of functions that each broker performs to serve as the touchstone of whether a commission sharing agreement enjoys the safe harbor protection of Section 28(e).¹⁷⁷ Specifically, under the October 2005 Release, the SEC would have considered commission sharing arrangements eligible for the safe harbor protection under Section 28(e), if they were part of a legitimate and "normal" corre-

172. See SEC October 2005 Release, *supra* note 3, at 46.

173. *Id.* at 43.

174. *Id.* at 43-44 (internal quotation omitted).

175. This commission sharing arrangement encompasses two scenarios: one where a broker-dealer purchases the research from a third party and provides it to the investment adviser with no guarantee that the broker will ever receive payment (satisfying the "provided by" provision of Section 28(e)), and one where the executing and clearing broker are the same and direct portions of the commission wherever the investment adviser directs in order to satisfy the investment adviser's prior obligation. The first scenario is probably eligible for the safe harbor protection of Section 28(e) and the second scenario does not. In the second scenario, the research provider has no role in the trade and therefore conducts not substantive trading services such as clearing and settlement. See source cited *supra* note 145.

176. See SEC October 2005 Release, *supra* note 3, at 43.

177. *Id.*

spondent relationship and fulfilled other criteria as well.¹⁷⁸ The minimum standard would have required an introducing broker to:

- be at risk to the clearing broker in the event that the investment adviser does not pay the commission on the trade;
- maintain accurate records “relating to its customer’s trades required by SEC and SRO rules;”
- provide customer service regarding the transactions including “monitoring” the trades and answering client commentary on the trade process; and
- “generally monitor trades and settlements.”¹⁷⁹

In addition to the requirements imposed on the introducing broker, the executing broker “must [have been] legally obligated to the third party producer of research or brokerage services to pay for the service ultimately provided to a[n investment advisor] (i.e. ‘provided by’ requirement).”¹⁸⁰

After this guidance was issued, the SEC had imposed a much more stringent standard than the FSA with respect to third party research. The SEC’s approach, however, had been guided by the “provided by” provision.¹⁸¹ The FSA’s rules were based on the anticipation of an enhanced disclosure regime.¹⁸² According to the FSA, commission sharing agreements are beneficial to clients, as long as the appropriate levels of disclosure are met.¹⁸³ Under the FSA’s standard, commission sharing agreements that would not qualify for the safe harbor protection of Section 28(e) in the United States would have been legitimate in the United Kingdom, provided that the adequate disclosure is made.

In stark contrast, the Commission’s final July 2006 release loosened these stringent standards. Given the expansive disclosure regime in the United Kingdom, the regulatory disposition in the United States became more lenient than in the United

178. *Id.* at 45-46.

179. *Id.* at 46.

180. *Id.*

181. *Id.* at 40.

182. CP 05/05/FINAL RULES, *supra* note 40, at 8. *See also* BUNDLED BROKERAGE AND SOFT COMMISSION ARRANGEMENTS: PROPOSED RULES, 05/5 (March 2005), available at http://www.fsa.gov.uk/pubs/cp/cp05_05.pdf [hereinafter PROPOSED RULES].

183. *See* PROPOSED RULES, *supra* note 182.

Kingdom in just a matter of months, considering that US regulators have not given nearly the amount of consideration to appropriate disclosure to Client Commission Arrangements as the FSA. Whereas the Commission had, a few months earlier, required that the introducing broker perform certain functions that would have included it in effectuating the trade, the new guidelines allowed for a significantly reduced role by introducing brokers.¹⁸⁴ Under the new guidance, the introducing broker must perform one of the four previously mandated functions:

- (1) be financially responsible to the clearing broker-dealer for all customer trades until the clearing broker-dealer has received payment (or securities), i.e., the introducing broker-dealer must be at risk to the clearing broker-dealer for its customers' failure to pay;
- (2) make and/or maintain records relating to its customer trades required by Commission and SRO rules, including blotters and memoranda of orders;
- (3) monitor and respond to customer comments concerning the trading process; and
- (4) generally monitor trades and settlements.¹⁸⁵

The threshold here is quite low. Whereas the introducing broker initially had to perform all of the aforementioned functions,¹⁸⁶ they now are responsible only for "generally monitoring trades and settlements."¹⁸⁷

The Commission attributed its dramatic shift in attitude toward Client Commission Arrangements to several of the comment letters submitted during the comment phase.¹⁸⁸ However, it is hard to believe that without addressing the disclosure issue, the concern over "give up" type abuses can completely subside. Yet, some of the comments centered on the role of independent, third party research and its value in the small cap arena, where information on smaller companies might not be so easy to ascertain.¹⁸⁹

184. See SEC October 2005 Release, *supra* note 3, at 46; SEC July 2006 Release, *supra* note 43, at 56.

185. SEC July 2006 Release, *supra* note 43, at 57.

186. SEC October 2005 Release, *supra* note 3, at 46.

187. SEC July 2006 Release, *supra* note 43, at 57.

188. *Id.* at 57.

189. See generally Letter from John W. Adams, Chairman of Adams Harkness, to Jonathan Katz, Secretary of Securities and Exchange Commission (Nov. 15, 2005), available at <http://www.sec.gov/rules/interp/s70905/jwadams111505.pdf>.

In his comment letter to the SEC in November 2005, John Adams expressed concern that the US had already lost considerable exchange listings of smaller companies to exchanges abroad due to the burdensome compliance obligations of Sarbanes Oxley.¹⁹⁰ Mr. Adams discusses the role of independent research in providing investors with insight into smaller companies.¹⁹¹ He says that research into smaller companies has already declined as the soft dollar landscape has grown more conservative in recent years, and he argues persuasively in favor a soft dollar policies that promote this type of research.¹⁹² It appears that comment letters like Mr. Adams's and others must have influenced the Commission in so substantially reversing its position on third party commission arrangements.

Since July, the impact of these relaxed guidelines has been measurable. In an interview with Kevin Petrello, Head of Commissions Management with Lehman Brothers Inc., Mr. Petrello said that there has been "an increase in client interest in [the soft dollar] area" [stemming from] "enhanced comfort levels firms have with the current regulatory environment."¹⁹³ Mr. Petrello said that current client commission arrangements differ from give ups in that "CSAs make clear that the only services that can be paid for are [Section] 28(e) eligible research."¹⁹⁴ According to Mr. Petrello, CSAs offer money managers significant benefits:

CSAs allow clients to separate research decisions from execution decisions, offer a mechanism to convert broker votes into payments, reduce difficult to track step-out arrangements, and increase information containment and research transparency. They

190. *Id.* at 2. Specifically, Mr. Adams argues that the cost of compliance with Sarbanes Oxley, which he estimates at \$2-\$3 million per year, has caused several smaller companies to either remain private and not go public, to become private after having been public, or to list their shares in an initial public offering abroad. *Id.*

191. *Id.*

192. *Id.*

193. Telephone Interview with Kevin Petrello, Senior Vice President and Head of Commission Mgmt., Lehman Brothers Inc., in N.Y., N.Y. (February 15, 2007).

194. *Id.*

allow two brokers to share commissions generated by a mutual client.¹⁹⁵

Mr. Petrello added that the soft dollar business, now known as Client Commission Arrangements, has matured. "There is enhanced scrutiny and codification, along with 'best practices' recommendations and the SEC seems to have become more comfortable with the perception that systems abuses have dissipated."¹⁹⁶

However, there remains the ongoing issue of disclosure and whether, in the absence of adequate disclosure, former abuses will once again tarnish the industry. Mr. Petrello said that he expects the SEC to address the disclosure issue. "It is my understanding that the SEC will be issuing enhanced disclosure guidelines for the industry in early 2007 and is revisiting the NASD's 2004 Mutual Fund Tasks Force recommendations."¹⁹⁷ Mr. Petrello concluded by commending the SEC in bringing our regulatory framework so close to the FSA regulations in the United Kingdom, especially considering that the FSA has no statute like Section 28(e) of the Securities Exchange Act of 1934 to restrict its rule making in this area.¹⁹⁸

V. Summary

The Commission's October 2005 Interpretive Release provided a very clear framework for how investment advisers should approach the safe harbor protection of Section 28(e). However, the July Release was ground breaking in its approach toward thirty party research arrangements. One has to wonder why the Commission has had to issue four major interpretive releases in the thirty-year history of soft dollars in the United States. The Commission should consider that the need to continually provide guidance on these issues might serve to indicate that the Commission could do better with enforcement. If the rules of Section 28(e) were more strictly enforced, the industry would have less need to interpret these provisions. Also, without an adequate framework for a disclosure regime aimed

195. *Id.*

196. *Id.*

197. *Id.*

198. *Id.*

at educating investors about the costs associated with fund ownership, the threat looms that a more lax soft dollar environment could lead to many of the abuses that appeared prominently in the headlines only a few years ago.

The current mechanisms in place for the disclosure of client commission practices to advisory clients clearly are insufficient, especially for mutual fund clients. The Commission should consider the following:

- The Investment Company client should receive better disclosure than the Investment Advisory client due to the unsophisticated and uninformed status of such investors;
- There should be a comparative mechanism like the one anticipated in the UK that would allow prospective clients as well as existing clients to quickly ascertain the historical impact on returns that commission practices might provide to compare such returns to those of funds not participating in bundled brokerage;
- At a bare minimum, mandate that the SAI (statement of additional information) be sent to investors with the trade confirmation and periodically thereafter as a form of the “brochure” rule for small investors; it should also be incorporated into the fund prospectus;
- Require mutual fund companies and investment advisers whose funds are open to investment by the general public to make all applicable documents regarding commission practices available in .pdf form on company websites;
- Create incentives, perhaps by a soft dollar industry funded pool, for independent companies to manipulate commission data so as to arrive at reasonable values after soft dollars for comparative purposes; also encourage such organizations to conduct ad campaigns that demystify the soft dollar myth or fund such a campaign itself;
- Require broker-dealers to report soft dollar credits on a client by client basis in order to maximize transparency into any wrongdoing; and
- Consider reexamining the role that the OMS plays in the trade cycle and the manner in which OMSs are likely to evolve over the coming years.

The Commission must either act promptly to abuses in the “soft dollar industry” and increase enforcement or risk continually providing this type of guidance on soft dollar issues. SEC Chairman Christopher Cox acknowledged that this guidance was overdue, and he acted to present these ideas to the invest-

ment public quickly. The problem here is Mr. Cox has not given the investment public much that is new, especially considering that many industry practitioners expected the October 2005 release would sound the death knell of the soft dollar industry. Now, one must believe that enforcement will be the sole mechanism to ensure compliance with the applicable provisions and rules stemming from Section 28(e).