Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds

September 22, 1998
The Office of Compliance, Inspections and Examinations
U.S. Securities & Exchange Commission

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I. Executive Summary

Research is the foundation of the money management industry. Providing research is one important, long-standing service of the brokerage business. Soft dollar arrangements have developed as a link between the brokerage industry's supply of research and the money management industry's demand for research.

Broker-dealers typically provide a bundle of services including research and execution of transactions. The research provided can be either proprietary (created and provided by the broker-dealer, including tangible research products as well as access to analysts and traders) or third-party (created by a third party but provided by the broker-dealer). Because commission dollars pay for the entire bundle of services, the practice of allocating certain of these dollars to pay for the research component has come to be called "softing" or "soft dollars".

Under traditional fiduciary principles, a fiduciary cannot use assets entrusted by clients to benefit itself. As the Commission has recognized, when an adviser uses client commissions to buy research from a broker-dealer, it receives a benefit because it is relieved from the need to produce or pay for the research itself. In addition, when transactions involving soft dollars involve the adviser "paying up" or receiving executions at inferior prices, advisers using soft dollars face a conflict of interest between their need to obtain research and their clients' interest in paying the lowest commission rate available and obtaining the best possible execution.

Soon after "May Day" 1975, when the Commission abolished fixed commission rates, Congress created a safe harbor under Section 28(e) of the Securities Exchange Act of 1934 ("Exchange Act") to protect advisers from claims that they had breached their fiduciary duties by causing clients to pay more than the lowest available commission rates in exchange for research and execution. Due to the conflict of interest that exists when an investment adviser receives research, products or other services as a result of allocating brokerage on behalf of clients, the Commission requires advisers to disclose soft dollar arrangements to their clients. Since 1975, the use of soft dollars has grown, as have the number of firms that provide research and other products and services in exchange for soft dollars. The total value of third-party research purchased annually with soft dollars is estimated to exceed $1 billion.1

Because of the widespread use of soft dollars by advisers, the diverse perceptions by observers that the use of soft dollars is either inherently abusive or beneficial to clients (or somewhere in-between), and a number of recent enforcement cases involving soft dollar practices, we conducted an inspection sweep to gather information about the current uses of soft dollars. Specifically, we conducted limited scope on-site inspections of the soft dollar activities of 75 broker-dealers and 280 investment advisers and investment companies from November 1996 through April 1997.2 Our review covered $274 million in soft dollar payments for third-party research, which is estimated to represent between 32% and 41% of all soft dollar commissions paid for third-party research by advisers from January through October 1996.3 The findings from these inspections are set forth below.4

Soft dollar practices of advisers observed during our sweep inspections are generally consistent with those found during our routine inspections of advisers and broker-dealers. We found that almost all advisers obtain products and services (both proprietary and third-party) other than pure execution from broker-dealers and use client commissions to pay for those products and services. The broker-dealers, investment advisers and investment companies participating in soft dollar arrangements were of all types and sizes. Most products and services obtained by advisers with soft dollars fall within the definition of research -- they provide lawful and appropriate assistance to the adviser in the performance of its investment decision-making responsibilities. Thus, the vast majority of products and services received by advisers are within the safe harbor established by Section 28(e) of the Exchange Act.

While most of the products acquired with soft dollars are research, we found that a significant number of broker-dealers (35%) and advisers (28%) provided and received non-research products and services in soft dollar arrangements. Although receipt of non-research (or non-brokerage) products for soft dollars can be lawful if adequate disclosure has been made, our sweep inspections revealed that virtually all of the advisers that obtained non-research products and services had failed to provide meaningful disclosure of such practices to their clients. Examples of products acquired included: advisers using soft dollars to pay for office rent and equipment, cellular phone services and personal expenses; advisers using soft dollars to pay an employee's salary; an adviser using soft dollars to pay for advisory client referrals and marketing expenses; an adviser using soft dollars to pay legal expenses, hotel and rental car costs and to install a phone system; and an unregistered hedge fund adviser using soft dollars to pay for personal travel, entertainment, limousine, interior design and construction expenses.5

We also found that, even with respect to research and brokerage products and services within the safe harbor, many advisers' disclosure of their soft dollar practices was inadequate, in that it did not appear to provide sufficient information to enable a client or potential client to understand the adviser's soft dollar policies and practices, as required under the law. Nearly all of the advisers that we examined made some form of disclosure to clients regarding their brokerage and soft dollar practices. Most advisers, however, used boilerplate language to disclose that their receipt of research products and services was a factor that they considered when selecting brokers. In our assessment, only half of the advisers that we examined described in sufficient detail the products, research and services that they received for soft dollars such that clients or potential clients could understand the advisers' practices.

The Commission last provided extensive guidance on the products and services that could be obtained within the safe harbor in a release issued in 1986. Among other things, the release reiterated that those products and services that provide administrative benefits or other non-research assistance to the adviser are outside of the safe harbor. The release acknowledged that research was being provided electronically and stated that a computer dedicated exclusively to software that is used for research for clients' benefit is covered by the safe harbor. Since 1986, the use of electronically provided research has increased. We found inconsistency in the way in which broker-dealers and advisers classified various items used to send, receive, and process research electronically. Industry participants are grappling with decisions involving whether the devices

needed to obtain access to research and to analyze data constitute research or non-research (e.g., personal computers, fiber optic cables, Internet access, leased high-speed telephone lines).

We also found shortcomings by advisers seeking the protection of the safe harbor with respect to "mixed-use" items. When advisers obtain products that have both research and non-research uses, so-called "mixed-use" items, and desire to purchase these items within the safe harbor, they must make a good faith effort to allocate the cost of the products between hard and soft dollars, according to their anticipated uses. Many advisers that we examined were either not allocating the purchase price of mixed-use items between hard and soft dollars or could not justify how the hard dollar/soft dollar allocation was reached. Several advisers appeared to believe that any allocation, even if not realistic, would be acceptable in complying with the Commission's mixed-use criteria. In addition, few advisers disclosed the bases for their allocation decisions.

We noted that the average commission rate on third-party soft dollar trades was six cents per share, the same average rate being paid to firms providing proprietary research. This suggests that, while there is no separately itemized charge for proprietary soft dollar benefits, advisers have placed an equivalent value on these services. Examiners also were told however, that many firms providing proprietary research are used by advisers to execute larger or more difficult trades. Thus, the average commission rate paid to these firms also may reflect payment for the care used in obtaining best execution for these transactions.

Despite existing guidance that research credits generated with principal transactions fall outside of the Section 28(e) safe harbor, we found that broker-dealers and advisers used principal transactions to earn soft dollar credits without adequate disclosure. We also found instances of a lack of adequate disclosure when research served accounts other than those accounts used to purchase the research.

Finally, we found that most broker-dealers and advisers lacked comprehensive soft dollar controls. We believe that this lack of comprehensive controls may have led to instances of incomplete disclosures to clients, using soft dollars for non-research purposes without disclosure, and inappropriate mixed-use allocations. As appropriate, certain of our examinations were referred to the Commission's Division of Enforcement for further investigation.

Overall, based on these findings which are discussed further in the body of the report, we have several recommendations:6

I.

We noted many examples of advisers claiming the protection of the safe harbor without meeting its requirements. We also found that industry participants were not uniformly following prior Commission guidance with respect to soft dollars. As a result, we recommend that the Commission publish this report to reiterate guidance with respect to the scope of the safe harbor and to emphasize the obligations of broker-dealers, investment advisers and investment companies that participate in soft dollar arrangements. We also recommend that the Commission reiterate and provide further guidance with respect to the scope of the safe harbor, particularly concerning (a) the uses of electronically provided research and the various items used to send, receive and process research electronically, and (b) the uses of items that may facilitate trade execution;

II.

Many broker-dealers and advisers did not keep adequate records documenting their soft dollar activities. We believe that the lack of adequate recordkeeping contributed to incomplete disclosure, using soft dollars for non-research purposes without disclosure, and inadequate mixed-use analysis. We recommend that the Commission adopt recordkeeping requirements that would provide greater accountability for soft dollar transactions and allocations. Better recordkeeping would enable advisers to more easily assure compliance and Commission examiners to more

readily ascertain the existence and nature of soft dollar arrangements when conducting inspections;

III.

We noted many instances where advisers' soft dollar disclosures were inadequate or wholly lacking -- especially with respect to non-research items. We recommend that the Commission modify Form ADV to require more meaningful disclosure by advisers and more detailed disclosure about the products received that are not used in the investment decision-making process. In addition, the Commission should require advisers to provide more detailed information to clients upon request; and

IV.

In light of the weak controls and compliance failures that we found, we recommend that the Commission publish this report in order to encourage advisers and broker-dealers to strengthen their internal control procedures regarding soft dollar activities. We suggest that advisers and broker-dealers review and consider the controls described in this report, many of which were observed as effective during examinations.

We believe that taken together, these recommendations should improve compliance by industry participants using soft dollars, within the framework of existing law. Following the implementation of these recommendations, we will continue to monitor compliance with the law in this area, and we urge the Commission to consider other remedies if the recommendations described above are found not to be fully effective in improving compliance.

II. Background

A. Soft Dollars Defined

The Commission has defined soft dollar practices as arrangements under which products or services other than execution of securities transactions are obtained by an adviser from or through a broker-dealer in exchange for the direction by the adviser of client brokerage transactions to the broker-dealer.7 An individual or firm must exercise "investment discretion" over an account, as defined in Section 3(a)(35) of the Exchange Act, in order to use client commissions to obtain research under Section 28(e) of the Exchange Act ("Section 28(e)").

B. Pre-1975 Practices

Soft dollar arrangements developed as a means by which brokers discounted commission rates that were fixed at artificially high levels by exchange rules. Prior to 1975, institutional advisers took advantage of competition among brokers and their willingness to accept compensation lower than the fixed rates in order to recapture portions of the commissions paid on institutional orders. Fixed commission rates that far exceeded the costs of executing trades provided the fuel to support an increasingly complex pattern of practices to recapture portions of these commissions by advisers, including "give-ups" and other "reciprocal practices".8 Investment company managers directed give-ups to brokers that sold fund shares in order to motivate or reward such sales efforts. Fund managers also used give-ups as a reward for research ideas furnished by brokers to them in their capacity as investment advisers to funds.9

C. Section 28(e)

In order to make the markets more competitive, the Commission abolished the system of fixed commissions and implemented the present system of negotiated rates, effective May 1, 1975.10 Soon thereafter, Congress enacted Section 28(e) as part of the Securities Acts Amendments of 1975. Congress acted in response to concerns expressed by money managers and brokers that,

under the new system of negotiated rates, if managers caused a client account to pay anything but the lowest commission rate available to obtain research ("paying up"), they would be held in breach of their fiduciary duty to their clients.11 Section 28(e) provides that a person who exercises investment discretion with respect to an account shall not be deemed to have acted unlawfully or to have breached a fiduciary duty solely by reason of his having caused the account to pay more than the lowest available commission if such person determines in good faith that the amount of the commission is reasonable in relation to the value of the brokerage and research services provided. According to the Commission:

Congress concluded that general fiduciary principles did not contemplate that the lowest commission rate would necessarily be in the beneficiary's best interest, and it adopted Section 28(e) in order to assure money managers that, under a system of competitive commission rates, they might use reasonable business judgment in selecting brokers and causing accounts under management to pay commissions.12

In adopting Section 28(e), Congress acknowledged the important service broker-dealers provide by producing and distributing investment research to money managers.13 Section 28(e) defines when a person is deemed to be providing brokerage and research services, and states that a person provides brokerage and research services insofar as he/she:

(A) furnishes advice directly or through publications or writing as to the value of securities, the advisability of investing in, purchasing or selling securities, or the availability of purchasers or sellers of securities;(B) furnishes analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy and performance of accounts; or(C) effects securities transactions and performs functions incidental thereto (such as clearance, settlement, and custody) or required 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.

Finally, Section 28(e)(2) grants the Commission rulemaking authority to require that investment advisers disclose their soft dollar policies and procedures, as "necessary or appropriate in the public interest or for the protection of investors."14

D. Activities Outside of the Section 28(e) Safe Harbor

Because Section 28(e) is a safe harbor, it cannot be violated. An investment adviser that proposes to use client commissions outside of the safe harbor, for example to acquire products or services other than brokerage or research, would need to carefully consider its obligations pursuant to its fiduciary duties to its clients, and under the antifraud provisions of the federal securities laws. Indeed, the Commission has stated that "[c]onduct outside of the safe harbor of Section 28(e) may constitute a breach of fiduciary duty as well as a violation of specific provisions of the federal securities laws."15

An adviser is obligated under both the Investment Advisers Act of 1940 ("Advisers Act") and state law to act in the best interests of its client.16 This duty 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.17 In such a situation, the antifraud provisions of the federal securities laws also would require full and fair disclosure to the client of all material facts concerning the arrangement. Indeed, as the Commission 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."18 Consent may be expressly provided by the client; consent also may be inferred from all of the facts and circumstances, including the adviser's disclosure in its Form ADV.

It also should be noted that Section 28(e) only excuses paying more than the lowest available commission. It does not shield a person who exercises investment discretion from charges of violations of the antifraud provisions of the federal securities laws arising from churning an account, failing to obtain the best price or best execution, or failing to make required disclosure.19

An adviser that has disclosed its conflicts of interest related to receiving products or services outside of the safe harbor may still have violated legal or regulatory provisions administered by the

Department of Labor, banking regulators, or state authorities. For example, the Employee Retirement Income Security Act of 1974 ("ERISA"), generally prohibits fiduciaries from profiting from the use of plan assets outside of the Section 28(e) safe harbor.20

In addition, advisers' receipt of soft dollars also may raise concerns under state law. Compliance with federal law may not independently relieve advisers of their state law obligations. For example, fiduciaries managing state funds (i.e., state employee pensions funds) often are subject to "anti-kickback" laws that may prohibit the receipt of soft dollars by fiduciaries.

E. 1976 Release

The Commission provided guidance concerning the scope of Section 28(e) in the 1976 Release. In the 1976 Release, the Commission stated that the safe harbor did not protect advisers that received "products and services which are readily and customarily available and offered to the general public on a commercial basis."21 The Commission also stated that, under appropriate circumstances, the safe harbor would be available where a broker-dealer provides an adviser with research produced by a third party, provided that the adviser could make a good faith determination that the research was not readily and customarily available and offered to the public on a commercial basis.22

F. 1986 Release

Industry difficulty in applying the restrictive standards of the 1976 Release caused the Commission to review soft dollar practices again in the mid-1980s. This review led to the 1986 Release.

In the 1986 Release, the Commission revised the standard that it had articulated in the 1976 Release and adopted a broader definition of "brokerage and research services" that is more closely based on Section 28(e). In the 1986 Release, the Commission stated that the fact that a product or service is commercially available does not preclude a finding that the product or service is research.23 The Commission emphasized that "the controlling principle to be used to determine whether something is research is whether it provides lawful and appropriate assistance to the money manager in the carrying out of his investment decision-making responsibilities," and that "[w]hat constitutes lawful and appropriate assistance in any particular case will depend on the nature of the relationship between the various parties involved and is not susceptible to hard and fast rules."24

1. Mixed-Use Products and Services

In many cases, a product or service may serve dual purposes, providing both research and administrative uses. For example, many computer systems provide "mixed-use" functions including accounting, recordkeeping, and client reporting as well as research. Where a product obtained with soft dollars has research and non-research uses, the 1986 Release provides that an adviser should make a reasonable allocation of the cost of the product according to its anticipated uses if it wishes to have all products received for soft dollars fall within the safe harbor. That component of the product or service that assists the adviser in making investment decisions may be paid by the adviser with commission dollars under the safe harbor, while the non-research portions are considered outside of the safe harbor and generally must be paid for by the adviser using its own hard dollars unless the adviser has obtained its clients' consent based on full and fair disclosure of its practices. The Commission stated that the standard would be satisfied when a fiduciary can demonstrate a good faith attempt, under all of the circumstances, to allocate the anticipated uses of a product. The Commission also stated that advisers are responsible for keeping adequate books and records concerning mixed-use allocations so as to be able to make the required showing of good faith. The Commission stated further that the allocation decision by the adviser itself poses a conflict of interest that should be disclosed to clients.25

2. Third-Party Research

Since the early days of the brokerage industry, full-service broker-dealers have provided research and other services to customers in addition to executing trades as part of an overall package of services provided to customers. Customers have always paid for this in-house (or proprietary) research, as well as the other services, with commissions; normally no separate price tag was attached to such research or other services. Customers' commissions are used to pay, not only for execution services, but also for proprietary research, access to information and analysts' opinions on an as-needed basis, the brokerage firm's commitment to work difficult trades, and for the firm's willingness to commit capital and other resources for the customer's benefit. These practices continue today. The costs of these services are not separately itemized or billed to customers of brokerage firms but instead are considered part of the overall service provided to customers.

With the abolition of fixed commissions and continued popularity of soft dollar arrangements, industry participants created an alternative way to use advisory client commissions to obtain research. Under this alternative, broker-dealers provide advisers with research and other products/services produced by third parties. The cost of third-party research is more easily quantifiable than the cost of proprietary research, and in fact is quantified by the third-party providers to the brokers that provide the research to advisers.

In the 1986 Release, the Commission reiterated that advisers are not limited to receiving proprietary research in order to benefit from the safe harbor.26 Rather, research may be produced by a third party and still fall within the safe harbor. The Commission has emphasized, however, that to be within the safe harbor the research must be "provided by" the broker. The research may be delivered directly to the adviser by the third party, but the broker must be obligated to pay for the research services.27 The Commission stated further that while a broker may under appropriate circumstances arrange to have research materials or services produced by a third party, it is not "providing" such research services within the safe harbor when it pays obligations incurred by the adviser to the third party.28 The 1986 Release also states that the safe harbor applies to a commission paid in good faith to an introducing broker for executing and clearing services performed by the introducing broker's normal and legitimate correspondent.29 In all cases, the determination of whether the third-party research falls within the safe harbor depends upon the nature of the product or service, how the investment adviser uses the product or service, and the investment adviser's good faith determination that the commissions paid are reasonable in relation to the research and brokerage received.

3. Disclosure

a. Advisers

Section 28(e) does not relieve investment advisers of their disclosure obligations under the federal securities laws. Disclosure is required whether the product or service acquired by the adviser using soft dollars is inside or outside of the safe harbor.30 Advisers are required to disclose, among other things, the products and services received through soft dollar arrangements, regardless of whether the safe harbor applies.

Investment advisers also are required to disclose all soft dollar conflicts of interest that may cause them to render advice that is not disinterested.31 Accordingly, the Commission has directed that advisers must fully disclose to their clients all products and services obtained under soft dollar arrangements, stating:

An adviser need not list individually each product, item of research, or service received, but rather can state the types of products, research, or services obtained with enough specificity so that clients can understand what is being obtained. Disclosure to the effect that various research reports and products are obtained would not provide the specificity required.32

Registered investment advisers must disclose certain information about their brokerage allocation policies to clients in Items 12 and 13 of Part II of Form ADV.33 Specifically, if the value of products, research and services provided to an investment adviser is a factor in selecting brokers to execute client trades, the investment adviser must describe in its Form ADV:

- the products, research and services;
- whether clients may pay commissions higher than those obtainable from other brokers in return for the research, products and services;
- whether research is used to service all accounts or just those accounts paying for it; and
- any procedures that the adviser used during the last fiscal year to direct client transactions to a particular broker in return for products, research and services received.

The purpose of this disclosure is to provide clients with material information about the adviser's brokerage selection practices which may be important to clients in deciding to hire or continue a contract with an adviser and which will permit them to evaluate any conflicts of interest inherent in the adviser's policies and practices.34 In this respect, the Commission and courts have stated that disclosure is required, even when there is only a potential conflict of interest.35

It is important to note, however, that disclosure in the Form ADV may not satisfy an adviser's obligation under Section 206 to disclose soft dollar arrangements. For example, Part II of Form ADV must be delivered only at the commencement of the advisory relationship, and offered to be delivered only annually thereafter. Thus, an adviser may have to update Part II and provide existing clients with additional disclosure whenever material changes occur in its soft dollar practices.36

b. Investment Companies

The Investment Company Act of 1940 ("Investment Company Act") imposes various disclosure and other obligations on advisers and funds in connection with soft dollar transactions. These provisions were summarized in the 1986 Release.37 In general, registered investment companies are required to disclose certain information about their brokerage and soft dollar practices in their prospectuses and statements of additional information.38 Funds must make the same brokerage allocation disclosure in their registration statements that is required of advisers in Form ADV, although they also must disclose the amount of soft dollar transactions and commissions paid because of research provided.39 In addition, in evaluating the fund's contract with its adviser, the fund's board of directors has a duty to request and evaluate (and the adviser has an obligation to provide) all information necessary to consider the terms of the contract.40 As the Commission stated in 1986, this responsibility may include monitoring the adviser's soft dollar arrangements.

Finally, the Investment Company Act generally restricts the types of products that can be acquired with fund commissions to research and brokerage within the safe harbor of Section 28(e). Section 17(e)(1) of the Investment Company Act makes it unlawful for any affiliated person of a registered investment company (such as its adviser) to receive any compensation for the purchase or sale of property to or for the investment company when acting as an agent (except when acting as a broker or an underwriter). This provision is designed to prevent conflicts of interest. Receipt by an adviser of compensation outside of the safe harbor generally would violate this provision, regardless of the disclosure provided.41

4. Directed Brokerage Arrangements

In soft dollar arrangements, an investment adviser selects the brokers that will execute trades and provide research and other services to the adviser. In contrast, in a "directed brokerage" arrangement, a client asks its adviser, subject to the adviser's satisfaction that the client is receiving best execution, to direct commission business to a particular broker that has agreed to provide services, pay obligations or make cash rebates to the client.42

Directed brokerage does not involve the same conflicts posed by soft dollars and does not implicate the provisions of the safe harbor. Regarding these differences, the Commission has stated: Brokerage/service arrangements are structurally similar to the more common research soft dollar arrangements under which an investment adviser uses client commission dollars to obtain research services. In a research soft dollar arrangement, however, the receipt of a benefit by an adviser through the use of its clients' commission dollars raises conflicts of interest concerns addressed by the safe harbor provisions of Section 28(e) . . . These concerns generally are not raised by brokerage/service arrangements, which typically involve use of a fund's commission dollars to obtain services that directly and exclusively benefit the fund (emphasis added).43
Under a directed brokerage arrangement, while the adviser makes investment decisions for the client, the client (often a qualified plan sponsor on behalf of the plan) selects the broker that will execute the client's trades in return for services from the broker. In such cases, advisers are following the direction of their clients. Advisers do not receive products, cash rebates, or services under these arrangements. Instead, the advisers' clients receive the products, services or cash rebates generated by their commissions.44

Broker-dealers are required to accurately confirm transactions with customers under Exchange Act Rule 10b-10. Specifically, Rule 10b-10(a)(2)(i)(B) requires disclosure by a broker to customers of amounts of remuneration received from the customer in connection with an agency transaction. In a directed brokerage arrangement, the broker has agreed to charge a specified commission but at the same time has agreed to rebate part of that commission or otherwise use part of the commission to benefit the customer directly. Rule 10b-10 requires, at a minimum, that if cash is rebated, the confirmation must state that part of the commission was rebated.45

G. Subsequent Developments

Since the issuance of the 1986 Release, the Commission and the staff have provided additional interpretive and other guidance relating to soft dollar arrangements. Specific areas of interpretation include: principal transactions,46 syndicate soft dollars,47 agency transactions involving OTC securities,48 futures transactions,49 trading errors,50 and consulting services, recruitment and training.51

H. Investment Adviser and Broker-Dealer Obligations

All advisers have an obligation to act in the best interests of their clients and to place client interests before their own. They also have an affirmative duty of full and fair disclosure of all material facts to their clients.52 These fiduciary duties are enforceable under the antifraud provisions of Sections 206 and 207 of the Advisers Act and Section 10(b) and Rule 10b-5 under the Exchange Act. The Commission has instituted numerous enforcement actions against advisers based, at least in part, on the failure to adequately disclose soft dollar arrangements, or misrepresentations regarding soft dollar practices.53

Both advisers and broker-dealers have an obligation to obtain the best execution of securities transactions when they arrange for or execute trades on behalf of clients and customers. 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.54 Advisers and broker-dealers are not obligated to obtain the lowest possible commission cost, but rather should seek to obtain the most favorable terms for a customer transaction reasonably available under the circumstances. In the context of soft dollars, the Commission has stated:

> A money manager should consider the full range and quality of a broker's services in placing brokerage including, among other things, the value of research provided as well as execution capability, commission rate, financial responsibility, and responsiveness to the money manager. The Commission wishes to remind money managers that the determinative factor is not the lowest possible commission cost but whether the transaction

represents the best qualitative execution for the managed account. In this connection, money managers should periodically and systematically evaluate the execution performance of broker-dealers executing their transactions.55

The Commission and the courts have stressed the duty to obtain best execution with respect to customer and client trades.56 The Commission and the courts also have held that the failure to seek the most favorable terms reasonably available under the circumstances may violate the antifraud provisions of the federal securities laws.57 The Commission's examination staff will continue to scrutinize the quality of execution of customer securities transactions during regular examinations of broker-dealers and advisers.

Clients of an adviser are also customers of the broker-dealers through which their adviser trades.58 The Commission has specifically addressed the duties of broker-dealers when they provide products and services in soft dollar transactions. In the III Report, the Commission stated: "[brokers] should recognize that compliance with any direction or suggestion by a fiduciary which would appear to involve a violation of the fiduciary's duty to its beneficiaries could implicate them in a course of conduct violating the antifraud provisions of the federal securities laws.59 The Commission further stated: "[a] broker which causes or assists an institution to violate a duty to the investor may be aiding and abetting a fraudulent or deceptive act or practice. Furthermore, a broker would have a duty to inquire with respect to his participation in a course of conduct which, to a reasonable person, would raise a question of fraudulent or deceptive acts or practices."60

In the III Report, the Commission found that the participating brokers were aware that money managers were receiving benefits from III in return for directing brokerage transactions. The brokers were also aware of the limited extent of their own participation in the provision of those benefits. Accordingly, it was the Commission's view that "the brokers should have been alerted to the possibility of conduct which contravened applicable fiduciary principles and the federal securities laws and that, under [those] circumstances, they should have ascertained whether there were provisions to insure that adequate disclosure was being made to clients of the money managers."61

In light of this Commission guidance, the staff believes that broker-dealers may be found liable for aiding and abetting investment advisers' violations of their fiduciary duties to advisory clients, where the broker-dealer continues participation in a course of conduct that the broker-dealer either knows, or should reasonably be aware, is fraudulent.62

Section 206 of the Advisers Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder encompass broad antifraud provisions which, depending upon relevant facts and circumstances, may apply to advisers' and broker-dealers' participation in fraudulent soft dollar activity. Section 15(b)(4)(E) of the Exchange Act authorizes the Commission to impose sanctions on any broker-dealer that has willfully violated, or aided or abetted the violation by any other person of any provision of the federal securities laws. Similarly, Section 203(e) of the Advisers Act authorizes the Commission to impose sanctions on advisers. Section 21(C) of the Exchange Act and Section 203(k) of the Advisers Act also authorize the Commission to order persons who violate or cause violations of the federal securities laws to cease and desist from committing or causing such violations. In addition, the Commission is authorized to sanction both advisers and broker-dealers that have failed reasonably to supervise their employees who have committed violations of the federal securities laws.63 Broker-dealers and advisers should adopt reasonable procedures and controls in order to fulfill their supervisory duties and ensure compliance with the law.

III. Examination Sweep: Objectives, Methodology and Universe

Our primary objective in conducting the inspection sweep was to obtain a comprehensive understanding of current soft dollar practices. To obtain this understanding, we conducted limited on-site inspections of the soft dollar practices of 75 broker-dealers and 280 investment advisers

and investment companies between November 1996 and April 1997. The on-site inspections covered soft dollar arrangements during the period of January 1 through October 31, 1996.64

We commenced the sweep with examinations of 75 broker-dealers believed to be actively involved in third-party soft dollar arrangements. At each broker-dealer, we reviewed the products and services provided to advisers or purchased on their behalf, the types of transactions used to generate soft dollar credits, and procedures employed to monitor soft dollar arrangements. We also studied commission rates, conversion ratios and the criteria used by broker-dealers to ascertain if a product could qualify for protection under the safe harbor.

During broker-dealer inspections, we identified investment advisers that may have received products or services that appeared to be outside of the safe harbor. Each broker-dealer was asked to provide a list of registered investment advisers with which they had third-party soft dollar arrangements, including detailed information on total commissions paid to the broker-dealer, total dollars spent for each adviser's soft dollar arrangements, products and services provided to each adviser, soft dollar ratios for each arrangement, and the commercial value of each product or service provided to advisers. We then used commission reports, trade blotters, canceled checks and invoices to test the accuracy of each list.

Using information obtained from the broker-dealers and internal knowledge gained from prior examinations, we selected 280 investment advisers and fund complexes for examination. The selection criteria included, for example, the purchase of mixed-use items and the purchase of non-research items (see Appendix A for a complete list of examination selection criteria). At each adviser, we reviewed the products and services acquired with soft dollars, the types of transactions and commissions paid, the use of the products and services, the adviser's compliance procedures and its disclosures. The advisers that we examined ranged from small boutiques catering to a few retail clients to multi-billion dollar institutional account managers, and they represent a diverse group of advisers that actively use client commissions to generate soft dollar credits. In the aggregate, these advisers managed over $2.6 trillion in 450,000 private accounts. The median asset size of the advisers was $15.8 million under management in 39 private accounts. Our review covered $274 million in soft dollar payments over a ten-month period and is estimated to represent between 32% and 41% of all soft dollar commissions for third-party products paid by advisers from January to October 1996.

IV. Broker-Dealer Examination Findings

A. Soft Dollar Arrangements

The broker-dealers that we examined varied in size, type and extent to which they participated in soft dollar arrangements. Most of the firms visited offered traditional order execution services for a variety of transactions and customer types. Frequently, soft dollar arrangements made up a relatively small portion of these broker-dealers' businesses. Several of the broker-dealers did not actively promote their soft dollar practices. They engaged in soft dollar arrangements merely as an accommodation to established customers that had requested the arrangements. Other broker-dealers that we examined were established solely for the purpose of engaging in soft dollar arrangements.

Of the 75 broker-dealers that we examined, 71 were engaged in soft dollar or directed brokerage arrangements during the examination period, and two others had soft dollar arrangements until 1996. These broker-dealers provide soft dollar credits or commission rebates to a variety of customers, including: advisers, investment companies, pension funds, banks, trust companies, other large institutional investors, hedge funds and private limited partnerships. The details of most arrangements, such as conversion ratios, commission rates and types of products and services provided, are generally negotiated on a customer-by-customer basis.

Seventy of the 75 broker-dealers employ soft dollar/hard dollar ratios ranging from 1.2:1 to 5.1:1. The average ratio was 1.7:1. The ratio reflects the amount of commission dollars that a customer needs to generate in order to receive one dollar's worth of products/services. For example, a ratio of 1.7:1 means that for every $1.70 in commissions received by the broker-dealer, the adviser will receive $1.00 worth of products/services. Of the 70 broker-dealers, 47 employed an average ratio per soft dollar arrangement below 2:1, while 23 employed an average ratio above 2:1.

The majority of broker-dealers have entered into oral soft dollar arrangements with advisers, with 61.8% of the broker-dealers that we examined specifically stating that they do not have written soft dollar agreements. In place of written agreements, some broker-dealers had "client letters", "letters of intent", or "product confirmation letters". While over 34% of the broker-dealers that we examined indicated that they utilized written agreements, we found that the agreements were most often between the broker-dealer and an independent contractor or third-party vendor, not between the broker-dealer and the adviser. Some broker-dealers and advisers have rejected written soft dollar agreements based on the belief that formal, binding commitments to generate a minimum amount of commissions during a period of time would place a heavy burden on them to demonstrate that customers consistently receive best execution on their trades.65

B. Products/Services Provided

While most broker-dealers provided only products and services which were clearly research, fully 35% of the broker-dealers that we examined paid for at least one product or service which appeared to be unrelated to research or execution.66 These products/services included, among other things: rent, computer hardware used for administrative or personal use, CFA exam review courses, AIMR membership dues, travel expenses, cable and satellite television for non-research areas, telephone service, employees' salaries, messenger services, consulting services, postage, parking fees, office equipment, word processing software, tuition and tax preparation services.

Using criteria set forth in Section 28(e)(3) and the 1986 Release, we analyzed all of the products and services provided by the broker-dealers that we examined. We determined that the majority of broker-dealers (65%) provided only products and services that were clearly research or brokerage, and that approximately 35% of the broker-dealers that we examined provided at least one product or service unrelated to research or brokerage. We categorized the products/services of several hundred vendors into 26 classifications. Those classifications and examples of the products/services in each classification are outlined in the following table and in more detail in Appendix B.

Products/Services Provided by Broker-Dealers

Product/Service Classification	Examples
Accounting fees	year-end financial audit of investment partnership
Association fees	AIMR dues, ICI annual dues, American Society of CLU & ChFC
Cable television	DirecTV, local cable TV, Pay TV
Commission rebates	cash returned to or expenses paid for a qualified plan or fund
Computer hardware	monitors, printers
Computer software	proxy voter software, maintenance and support, Eagle Software Group
Conferences/seminars	AIMR conference fees, Internet conferences
Consulting services	advisory services, Callan Associates, Yanni Bilkey Investment
Courier/postage/ express mail	messenger service, Federal Express, Airborne Express
Custodial fees	payment of custodial fees to lower expenses of a retail or institutional account
Electronic databases	Ibbotson Associates, Value Line, Interactive Data Corp, Moody's
Employee salary/benefits	salary, insurance policy
Execution Assistance	on-line quote systems
Industry publications	Business Week, Fortune, Forbes, Wall Street Journal,
Legal fees	retainer, research bills
Management fees	investment adviser fees, pension consultant fees
Miscellaneous expenses	dinner, parking fees, limousine service, concert tickets, radio station
Office equipment/supplies	fax machines, office furniture, staples, spring water, VCR, copy machines
On-line quotation/news	Bloomberg, Reuters, Dow Jones, PC Quote, Dial Data,
Portfolio management software	Advent, Ibbotson Associates
Rent	physical office space of adviser
Research/Analysis Reports	Barra, Zack's Investment Research, Baseline, Value Line, Global Trend Alert
Telephone expenses	Nynex, AT&T, mobile phone bills, pager expenses, connections to on-line services
Travel expenses	hotel accommodations, airfare
Tuition/training	CFA courses, study books for courses, computer training, psychology training
Utilities expense	electricity bills

1. Non-Research Items

As stated, 35% of the broker-dealers that we examined entered into at least one non-research arrangement. Specific examples of our findings are listed below (other examples of non-research items acquired by advisers in soft dollar arrangements are listed in the advisers' findings section, infra). It should be noted that inadequate disclosure by the adviser was common to each finding:

- A broker-dealer allowed soft dollar credits to be used to pay the salary of an adviser's research employee. (Following the examination, the adviser reimbursed clients approximately $85,000).
- A broker-dealer allowed soft dollar credits to be used to pay for most of an adviser's non-research information technology purchases.
- A broker-dealer allowed soft dollar credits to be used to pay travel, airfare, hotels, meals, and other expenses of a research consultant.
- A broker-dealer and an adviser entered into a soft dollar arrangement to pay for research services provided by a "consultant" operating out of the adviser's office.
- A research employee, who desired to relocate, quit his job at a mutual fund adviser. Rather than lose his services, the adviser retained him as an independent consultant (working from his new home) and convinced a broker-dealer to pay his fees via soft dollars.
- A broker-dealer permitted soft dollars to be used to pay for an adviser's office rent and equipment, cellular phone services and personal expenses of one of the adviser's principals including computers and office equipment for home use, round-trip airfare to Hong Kong for the principal's son, postage and bottled water.

2. Mixed-Use Items

In most of the cases involving items that advisers and/or broker-dealers designated as mixed-use items, the broker-dealers paid the full cost of the item and received reimbursement from the adviser for the portion not related to research. From data collected during the broker-dealer examinations, we found that products/services of a mixed-use nature were identified as being mixed use in one of three ways: by the broker-dealer, by the adviser, or through a joint effort between both parties. Many (53%) of the broker-dealers that we examined left this determination entirely to the advisers. The majority (68%) of the broker-dealers also left the allocation of the cost between soft and hard dollars to the advisers.

C. The "Provided By" Concept

The sweep also uncovered examples of broker-dealers and advisers that (although ostensibly relying on the safe harbor) have disregarded the "provided by" concept - - Section 28(e)'s requirement that the broker be obligated to pay for the product or service received by the adviser. We found that 27% of the broker-dealers that we examined were paying invoices submitted directly by advisers. For example, we found:

- Several advisers directly purchased software and sent the invoices to broker-dealers for payment.
- An adviser directed Broker-Dealer A, with which he had excess soft dollar credits, to send money to Broker-Dealer B in order to satisfy a soft dollar deficit. In neither case was the broker-dealer contractually obligated to pay for the services.
- A third-party researcher issued a bill to an adviser which included travel, air fare, hotels, meals, taxis, parking, telephone and gratuities. The adviser sent the bill to a broker-dealer for payment under its soft dollar arrangement.
- Six broker-dealers paid cash directly to advisers as reimbursements for expenses previously paid by advisers. The reimbursed expenses included business-related travel expenses, stock quotation services, computer software, daily research graphs, a conference, office equipment, a CFA course, First Call, The Wall Street Journal, and Dow Jones News Service.

Each of these practices lies outside of the "provided by a broker-dealer" concept articulated in Section 28(e) and the 1986 Release, and render the protection of the safe harbor inapplicable.

D. Management Approaches

About 22% of broker-dealers that we examined had established separate business units to manage the firms' soft dollar arrangements. These departments varied in size, from two to 17 employees, and many of these employees were identified as account representatives. The employees primarily performed administrative and accounting tasks such as commission tracking, vendor invoice approval and monthly report generation. Other duties included: maintenance of client and vendor contracts, review of client requests for products/services, and assessment of profitability. Of the remaining broker-dealers, 23% had as their only business activity the provision of products and services under soft dollar arrangements and 55% utilized senior management personnel, such as CEOs, CFOs, and Comptrollers, to oversee soft dollar arrangements.

Most of the broker-dealers that we examined charged their customers the same prices for products/services as they were charged by vendors. Only one broker-dealer was found to employ the practice of "bumping". The broker-dealer purchased bulk research services at a discounted price but used the full service price in computing the amount of commission dollars that advisers needed to pay for the service. In addition, we found at least two vendors that were charging higher prices to broker-dealers for their products/services than prices charged for their products if an adviser were to purchase the products directly from the vendor. The vendors' reasons for the premiums were the extra processing required for the tri-party contract with the broker-dealer and adviser, and the added risk associated with having the broker-dealer pay the bill when it was invoiced.

E. Monitoring Compliance with Section 28(e)

As described herein, broker-dealers should have supervisory systems and compliance procedures to assure that all aspects of their activities are in compliance with the law. While most of the broker-dealers that we examined had implemented some type of internal controls over their soft dollar activities, many broker-dealers expressed the view that nearly all compliance responsibility in this area rests with advisers. The staff believes that broker-dealers should have adequate control procedures in place for their soft dollar activities. Only five of the broker-dealers examined (6.7%) had extensive internal controls in place, which included computerized tracking of soft dollar sales and written procedural guidance. Only 13% of the broker-dealers that we examined had adopted (or were in the process of adopting) written compliance policies and procedures for soft dollar activities. The level of detail in these written policies and procedures varied among firms. In one case, the "policies" merely consisted of a folder containing articles and papers discussing Section 28(e) matters. Key controls that we noted at a handful of broker-dealers included: ensuring that the broker-dealer is contractually liable for each third-party arrangement; refusing to pay any invoices submitted by advisers; maintaining a written record of the products/services provided to the adviser in exchange for soft dollars; and a deliberative process for determining whether products and services fall within the safe harbor. Based on data collected from examinations, a list of some observed controls used by broker-dealers and advisers is located in Appendix F.

Although we found several instances in which broker-dealers rejected proposed soft dollar arrangements for non-research products/services, only 26 of the broker-dealers (or one-third of those that we examined) had a process in place to review and approve arrangements prior to their implementation.67 The reviews usually were conducted by a member of the legal or compliance department or by an officer of the firm. If the reviewer was uncertain about how the adviser intended to use the product/service, he might request, from the vendor, either a sample of the product or a demonstration of the service being requested. If the vendor was not contacted, then the adviser may be asked to provide a "letter of intent" describing its planned use of the product/service.

Of the broker-dealers that we examined, 32.8% indicated that one senior management individual was responsible for ongoing compliance monitoring. Responsibilities of those persons included review of any new arrangements, ratio negotiation and review/approval of invoice payments. We found that one of the 75 broker-dealers that we examined reviewed and evaluated advisers' soft dollar disclosure as part of its compliance monitoring procedures.68

F. Obtaining New Customers

We found that the majority of broker-dealers that we examined (76%) did not employ dedicated sales forces to obtain new soft dollar customers and did not actively promote soft dollar arrangements. Some broker-dealers informed us that they participated in soft dollar arrangements only because their competition offered similar arrangements. Others provided the arrangements as an accommodation to existing customers. Some broker-dealers also indicated that the arrangements were not always profitable to their firms.

Approximately 24% of the broker-dealers that we examined had sales forces dedicated to soliciting soft dollar customers. While these sales departments ranged in size from one to 13 employees, most were small, consisting of one to three employees. At one broker-dealer, a consultant was hired, at the rate of $500/month, to solicit new soft dollar customers. All of the broker-dealers' sales staff were paid in part or entirely through a percentage of commissions received under soft dollar arrangements.

Some broker-dealers without dedicated sales forces actively marketed their soft dollar services in other ways. Promotion methods included: use of an affiliated sales force; customer, trader and vendor referrals; encouraging existing customers to use soft dollars to purchase specific products such as Bridge terminals and Lipper data; limited use of Internet Web sites and cold calls to introduce advisers to the broker-dealer's soft dollar business. Additional customer solicitation techniques included: sales literature mailings to potential customers, attendance at soft dollar compliance seminars, and accompanying potential customers on "theme trips" to product vendors.

About 38% of broker-dealers that we examined used either a catalog or a list containing products/services available for soft dollars. Catalogs provided full listings of all products/services offered by the broker-dealer, including descriptions of the products. Lists were typically not all-inclusive, lacking product descriptions.

G. Types of Transactions

The broker-dealers that we examined participated in a wide variety of transactions with advisers. We found that broker-dealers allowed transactions in the following types of securities to generate soft dollar credits: fixed-income, listed equities, OTC equities, foreign equities, options, syndicate, futures contracts, ADRs, and new issues/secondary offerings. We noted that the majority of the broker-dealers that accepted fixed-income and OTC equity transactions for soft dollar credits did so only on an agency basis, although two broker-dealers provided soft dollar credits on principal trades. These results are discussed in more detail in the section on investment adviser findings, infra.

H. Commissions

Commissions charged by broker-dealers on transactions that included a soft dollar component ranged from two to 45 cents per share. Most of the commissions charged were between three and nine cents per share. Approximately 70% of the broker-dealers that we examined charged an average commission rate of six cents per share for their soft dollar executions.

Using a sample of the broker-dealer examination data collected, we noted that only 20% of the advisers involved in soft dollar arrangements paid higher commission rates for third-party soft dollar trades as compared with "execution only" trades and trades involving proprietary research.

The remaining 80% of advisers involved in third-party soft dollar arrangements paid commissions comparable to the commissions charged by full service firms. We observed transactions in which advisers were able to pay lower commissions than average (e.g., through electronic crossing networks or in connection with client-directed brokerage to discount broker-dealers). In these instances, advisers probably paid lower commissions than if they had conducted the same transaction through other broker-dealers. As noted herein, "paying up" is the payment of more than the lowest available commission rate in exchange for services other than execution. Paying average commission rates could still constitute "paying up," if lower commission rates are available. As noted, in fulfilling their duty of best execution, advisers should periodically evaluate the execution performance of broker-dealers executing their transactions.

V. Investment Adviser Examination Findings

A. Broker-Dealers Used

The advisers that we examined had formal or informal third-party soft dollar arrangements with 269 different broker-dealers. On average, each adviser received third-party soft dollar products and services from seven different broker-dealers. The top five broker-dealers used by the advisers for third-party soft dollar trades, as measured by the number of separate arrangements, were Standard & Poor's, Interstate Securities, Autranet, Paine Webber and Westminster Research.

B. Commitments

The inspections showed a median annual commitment of $11,880 per third-party soft dollar arrangement. The commitments ranged from $25 for a subscription to Popular Science magazine to a $1,546,875 commitment for 62 Bloomberg terminals. We noticed that several advisers had either positive or negative balances affecting current year soft dollar commitments due to amounts carried forward from previous years -- meaning that during the previous year the adviser either directed excess or insufficient commission dollars to a particular broker-dealer in order to meet a soft dollar commitment. As noted above, the majority of these soft dollar arrangements were oral. Although many advisers stated that there was no express or implied commitment made to the broker-dealers to direct a minimum amount of commissions for each arrangement, the fact that soft dollar account balances were carried over from year to year suggests that there usually was a reasonable expectation that the adviser would pay the broker-dealer a specific amount of commissions in exchange for the items provided by the broker-dealer. Examiners were told that the practice of carrying over soft dollar balances benefits both broker-dealers and advisers: broker-dealers receive normal margins on commission business rather than the hard dollar price of the item provided, and advisers can pay the amounts owed over time and are not compelled to churn accounts or otherwise engage in trading simply to meet soft dollar commitments to brokers.

C. Products/Services Acquired

1. Analysis of Products/Services

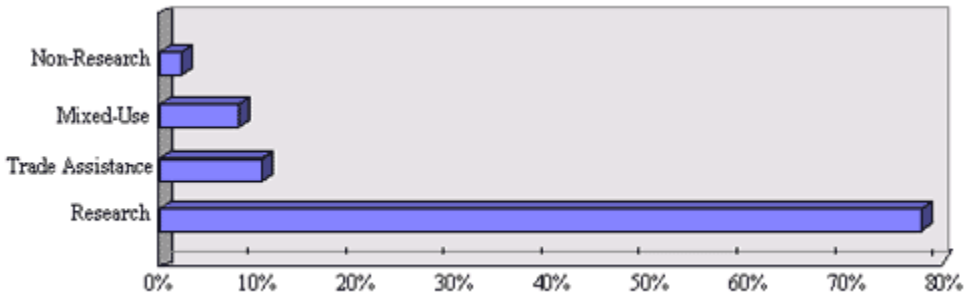
Advisers were asked to provide examiners with a list of all products and services obtained through soft dollar arrangements. A primary purpose of the soft dollar sweep was to determine if advisers were obtaining or using products in ways that were outside of the safe harbor. Of the advisers sampled, 72% acquired only research with their soft dollar credits; 28% had entered into at least one arrangement to purchase a product or service outside of the safe harbor. No advisers obtained only non-research products or services.

We summarized data from a sample of 180 advisory firms, which included a total of 4,731 third-party soft dollar arrangements. The total amount of commission dollars paid in these soft dollar arrangements was $274 million. Each arrangement was categorized based on the adviser's use of the product or service into one of the following categories:

- Research
- Non-Research
- Mixed Use
- Trade Execution Assistance

We found that 80% of the total arrangements analyzed were for research; 10% were for execution-related assistance; 8% were for mixed-use items; and 2% were for non-research products and services. (Appendices C and D provide detail with respect to the types of products acquired in these arrangements.) The average number of different products purchased with soft dollars was 29 per adviser over the course of ten months, with a range of 1 to 421.

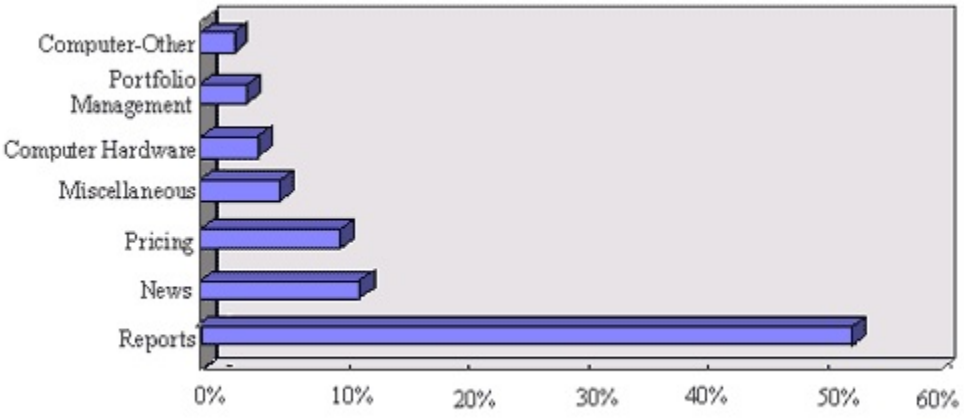
Use of Products Purchased With Soft Dollars
(as a Percentage of Arrangements Reviewed)



We further analyzed the types of products purchased as a percentage of the total arrangements. Approximately 55% of the sampled products were reports, with general company and general economic reports comprising about 22% of the sample. News services constituted another 14%, with on-line news services contributing 5% to that figure. The use of pricing services accounted for 12%, and the remaining 19% was distributed between portfolio management data, computer related products, and miscellaneous products.

Types of Products Purchased With Soft Dollars

(as a Percentage of Arrangements Reviewed)



2. Non-Research Items

In general, many advisers appear to be taking a broader view of research than was intended by the 1986 Release. Although 98% of all soft dollar arrangements in our sample appeared to provide at least some level of research or trading assistance based on the actual use of the products or

services (including arrangements which were considered to be mixed-use), 28% of the advisers that we examined had entered into at least one third-party soft dollar arrangement which, in the staff's view, was outside of the scope of Section 28(e).69

Virtually none of these advisers disclosed their payment for non-research/non-brokerage items with client commissions. Advisers may have considered these items immaterial, as measured by their cost compared with their overall soft dollar expenditures. Examples of non-research items included: CFA exam review courses, AIMR membership dues and other membership and licensing fees, office rent, utilities, electronic proxy voting services, salaries and travel expenses (see Appendices C and D for details).

We observed numerous examples of advisers that failed to separate those expenses which ought to be considered "administrative" or "overhead" expenses (i.e., those that should be funded out of the adviser's fee revenue, absent client consent) from those items which truly provide benefits to clients in the form of research or brokerage services. "Overhead" is defined by most accounting texts as costs of business not directly associated with the production or sale of products and services. In the context of the investment advisory business, costs such as rent, phone, utilities, marketing, salaries, entertainment, travel, meals, copier, office supplies, fax machines, couriers, and backup generators (all real examples of soft dollar expenses observed during the sweep) should be considered overhead, or non-research expenses of the adviser, and outside of the scope of the safe harbor.

We found the following undisclosed practices:

- An adviser directed $93,000 in soft dollars for "verbal regional research" and "strategic planning." Further investigation showed these payments going to family members of the adviser's principal. The adviser could not substantiate these payments as being research-related.
- An adviser used soft dollars to pay for its telephone bill.
- An adviser used soft dollars to pay for financial and tax accounting software, a custom-designed database for administrative purposes, and computer hardware. In addition, the adviser provided another adviser with access to its research products/services that were obtained through soft dollars.
- An adviser used soft dollars to pay for its legal expenses, lodging and rental car costs, and installation of a phone system.
- An adviser used soft dollars to pay a consultant to design an Internet web site.
- An unregistered hedge fund adviser used soft dollars to receive travel, entertainment, theater tickets, limousine services, interior design and construction services, and installation of carpet tile.
- The president of an adviser instructed a broker-dealer to direct soft dollar payments to a related entity which, in turn, rebated the money to another entity controlled by the president. In addition, soft dollars were used for administrative purposes.
- An adviser used soft dollars to pay for advisory client account referrals.
- An adviser used soft dollars to purchase a Bloomberg machine for the exclusive use of the adviser's marketing department.
- An adviser sponsored a college lecture given by a prominent financial speaker. All of the adviser's clients (and many potential new clients) were invited to the lecture. The adviser used soft dollars to pay the speaker's fees.

3. Mixed-Use Items

Many of the advisers that we examined purchased at least one product or service that had both research and non-research benefits. While only 8% of the total products/services that we analyzed were mixed-use items, 68% of advisers that we examined had purchased at least one mixed-use item entirely or partially with soft dollars. When acquiring mixed-use items in reliance on the safe harbor, advisers are required to make a reasonable allocation between hard and soft dollars

according to the anticipated uses of the product, and to pay for non-research uses with hard dollars. In total, advisers allocated approximately $5.05 million in hard dollars and $18.63 million in soft dollars for 290 products. (In the staff's experience, advisers that identify products or services as having mixed uses typically allocate only 10% to 20% of the cost of those items to hard dollars.) Some examples of inaccurate or questionable mixed-use allocations include:

- Many advisers allocated 100% soft dollars for expensive software systems that provided administrative and recordkeeping functions in addition to research.
- An adviser had a soft dollar arrangement to obtain a client portfolio accounting platform. The adviser claimed that 50% of the system's cost should be attributable to research and therefore payable with soft dollars.
- An adviser used soft dollars to pay the total cost of its in-house computer network. Because the network was used for other purposes in addition to research, it should have been considered, at least partially, to be overhead and paid for with hard dollars or the practice should have been disclosed to the adviser's clients.

Advisers that we examined have directed millions of dollars in commissions to purchase third-party performance measurement services that, in most cases, provide a mix of both marketing and research uses. While performance reports accounted for just 3% of the products/services that we reviewed, they accounted for a significant portion of the total commission dollars used in soft dollar transactions. These performance analyses show, for example, how an adviser is performing relative to its peer group and how its asset allocation decisions have affected performance. Section 28(e) expressly includes reports relating to account performance in the definition of research, and advisers use performance measurement services in making investment decisions.70 We also found, however, that these reports often were used to market advisers' services to potential clients. As noted, advisers relying on the safe harbor are required to make an allocation based on the anticipated use of the product. Based on the records available to the staff, we could not determine whether the marketing use was anticipated at the time that the product was purchased. For example:

A large institutional adviser, which claimed that it did not receive any mixed-use items, directed $882,000 in client commissions to pay for 13 separate performance analyses. Much of the information in these performance analyses was included in marketing materials.

We noted that advisers were purchasing performance analyses from firms that also provide consulting services to pension plans. Typically, pension plan consultants assist pension plan fund managers in selecting investment strategies and investment advisers. In exchange for providing these services, the pension plan may direct the adviser to pay commissions to the consultant (in directed brokerage). The staff notes that a conflict of interest exists if an adviser is purchasing performance analyses from consulting firms, not because of the value of the analyses, but in order to curry favor with the consultant in his rankings and recommendations of advisers to pension plans.

Finally, we found that few advisers have memorialized their mixed-use allocation decisions. This made it difficult for these advisers to make the required good-faith showing of the reasonableness of the allocation based on the anticipated use of the product, and difficult for examiners to ascertain the basis for the allocations. For example, we found that one adviser used both soft and hard dollars to pay for a business-related dinner, reception and dance, but had no documentation to support or justify the allocation. As noted, the 1986 Release states that advisers are required to maintain adequate records to justify their allocation of mixed-use items and are required to disclose that allocation method to clients.71

4. Computer Hardware/Software

Many advisers and broker-dealers that we examined failed to follow the Commission's guidance concerning Section 28(e)'s application to computer hardware and peripherals. Regarding computers, the 1986 Release states:
Computer hardware is another example of a product which may have a mixed use. If the hardware is dedicated exclusively to software that is used for research for a client's benefit, it may be paid for in commission dollars. On the other hand, if the computer will be used in assisting the money manager in a non-research capacity (e.g., bookkeeping or other administrative functions), that portion of the cost of the computer would not be within the safe harbor.72

Our examinations found many occasions in which computer hardware was purchased primarily with soft dollars, although the computer hardware was not dedicated primarily to research or brokerage services. We found:

- An adviser used soft dollars to pay a firm to maintain and service its LAN system and to purchase and maintain an emergency generator.
- An adviser used soft dollars to pay for the installation of anti-static carpeting and to "reconnect" the adviser's research-related computers after the installation.
- An adviser used soft dollars to purchase a new computer that was used exclusively by the adviser and his family members for business and personal uses (including computer games and a college thesis) unrelated to research.

Finally, we found that some advisers are not distinguishing between hardware and software used to manipulate and create research and the various peripheral items that support the hardware and software. For example, advisers have rationalized using soft dollars to pay for utilities under the following reasoning: since a computer itself can qualify as research under Section 28(e) because it provides access to other research products, the power needed to run the computer and the dedicated phone line used to receive information into the computer also could certainly qualify as research. We believe that, based on these findings, the Commission should provide interpretive guidance setting forth distinctions between research and "overhead" items, particularly with respect to computer hardware and peripherals.

5. Assistance in Trade Execution

As discussed in the Background section of this report, Section 28(e) protects both research and brokerage services. Under Section 28(e)(c), brokerage is defined as "effecting securities transactions and performing functions incidental thereto (such as clearance, settlement and custody)", or functions required by law in connection therewith.

The technological explosion in the money management industry has been met with an increasing use of soft dollars to purchase state-of-the-art computer and communication systems that may facilitate trade execution. These products, among the most expensive in our survey, included on-line quote systems, pricing services, direct data feeds from stock exchanges around the world, on-line trading systems (e.g., Reuters and Instinet), front-end compliance systems (which alert advisers to possible compliance limits before trades are entered), and global communications links between research and trading departments. Products available also include comparative analyses of execution quality in various markets and by various market makers. For example:
One large fund adviser purchased dedicated telephone cables linking research and trading departments in the U.S., Tokyo and London. The adviser designated the product as mixed-use, paying approximately $120,000 in soft dollars and $32,000 in hard dollars for the cable.

As noted, when relying on the safe harbor, advisers must make a reasonable allocation between hard and soft dollars for mixed-use products. The use of soft dollars to purchase these products may present advisers with questions similar to those surrounding computers purchased for research and analysis, i.e., how should an adviser distinguish between "brokerage" services and

"overhead" expenses. We recommend that the Commission provide interpretive guidance to assist money managers in distinguishing between brokerage and "overhead" items with respect to items that may facilitate trade execution.

D. Third-Party Research

As stated above, an adviser can receive third-party research through a broker-dealer (i.e., research not produced in-house by the broker-dealer) within the safe harbor. Soft dollars have provided a way for research analysts to work on their own while receiving payment for their services through soft dollar broker-dealers. As a result, hundreds of analysts are providing independent research for payment in soft dollars. Listed below are the most commonly employed third-party vendors based on our sample:

- Standard and Poor's
- Bloomberg
- Dow Jones
- Advent
- Factset
- First Call
- Reuters
- Barra
- Interactive Data Corporation
- Moody's

In 78% of the arrangements that we examined, the adviser received a single copy or version of a product or service. Vendors provided a variety of products to the advisers including, but not limited to: pricing services, news services, portfolio management/ accounting, equity analysis, and fixed-income analysis. The examinations also revealed that 95% of advisers that obtained products or services from third parties received duplicate copies of invoices sent to broker-dealers for payment of third-party products and services.

E. Soft Dollar Transactions

1. Types of Transactions

We analyzed the types of transactions used to generate soft dollar credits. The table below summarizes the types of transactions used by advisers to generate soft dollar credits:73

Types of Soft Dollar Trades

Transaction Type	Percent of Advisers Earning Soft Dollar Credits
Equities: Listed Agency	91.1%
Equities: OTC Principal	7.4%
Equities: OTC Agency	41.2%
Fixed-Income: Principal	3.6%
Fixed-Income: Agency	21.3%
New Issue Offerings	20.3%
International Equities	2.0%
Options	3.0%

a. Principal Transactions

Any type of transaction can be used to generate soft dollar benefits, provided that the broker-dealer is willing to provide credit on the transaction. Section 28(e), however, affords safe harbor protection only for research paid for with commissions on agency transactions in securities. As stated in the Background section, the staff has long taken the position that advisers cannot claim the protection of Section 28(e) when generating soft dollar credits through principal trades.74

We found, however, that 7.4% of the advisers that we examined generated soft dollar credits on OTC principal trades, and 3.6% earned soft dollar credits on principal trades of fixed-income securities. The arrangements that advisers have with their broker-dealers to generate soft dollar credits on principal trades vary. For example, one adviser received soft dollar credits by trading in U.S. Treasury securities purportedly on an agency basis. The confirmations on such trades, however, disclosed only the net amount of the trades and did not disclose commission amounts paid by clients, indicating that the trades were likely conducted on a principal or a riskless principal basis. In another example, an adviser instructed a dealer to increase/decrease bond prices by 1/4 to 1/2 point depending on whether the trade was a purchase or sale. The additional mark-up or mark-down generated soft dollar credits for the adviser. In other arrangements, the price quoted may include an express or imputed mark-up or mark-down, a portion of which is used to generate soft dollar benefits. We also found an arrangement in which an adviser generated soft dollar credits from financing transactions involving reverse repurchase agreements.

b. OTC Agency Transactions

We found that 41% of advisers that we examined received soft dollar benefits on over-the-counter ("OTC") agency trades for equity securities, and 21% of advisers earned research credits based on OTC agency trades for fixed-income securities. Because the OTC market is a dealer market (i.e., securities are normally traded on a principal, and not an agency basis), the practice of receiving soft dollar credits based on OTC agency transactions raises disclosure and best execution issues. In such transactions, because an agent is being interposed between an adviser's client and an OTC market maker, the adviser is possibly causing the client to pay more than the lowest available cost to execute the trade. These concerns are heightened in the fixed-income market due to limited quote, trade and mark-up information available to advisers and their clients.

While Section 28(e) may apply to the receipt of soft dollar credits earned on such trades, it should be emphasized that an adviser's decision to effect such transactions on an agency basis must be consistent with its duty to obtain best price and execution on client trades. Since the 1986 Release, the Commission and the courts have continued to stress the obligations of broker-dealers and advisers to obtain best execution on all customer and client trades.75

2. Cross-Subsidization

Section 28(e) contemplates the possibility that commissions from one set of clients may be used to purchase research that benefits another set of clients. In such circumstances, however, advisers must make adequate disclosure of this "cross subsidization." Item 12B of Form ADV requires advisers to disclose whether research is used to service all of the adviser's accounts or only those accounts paying for it. We found that numerous advisers cross-subsidized research benefits among clients. For example, 14% of the advisers had arrangements in which equity client commissions paid for fixed-income research services in amounts ranging from $100 to $1,128,000. In these situations, the fixed-income research benefited a group of clients different from the group whose commissions generated the soft dollar credits. In addition, at least one fund adviser used commissions generated by private (non-fund) clients to subsidize fund expenses. For most of these advisers, disclosure was non-existent or boilerplate.

3. Step-Out Transactions

Approximately 8% of the advisers that we examined used step-out transactions to fulfill their third-party soft dollar commitments. In a typical step-out arrangement, an adviser directs trades to a broker-dealer with the instruction that the broker-dealer execute the transaction and that another broker-dealer provide soft dollar products/services. The broker-dealer that provides the execution of the trade "steps out" of a portion of the commission in favor of the broker-dealer that provides the soft dollar product/service.

As mutual fund distribution becomes increasingly competitive, step-out trades have become an additional incentive used by fund advisers to reward broker-dealers for selling fund shares. Advisers who seek to do business with broker-dealers that have sold fund shares must still fulfill their duty of best execution, however, and must disclose the practice if it is a factor considered by the adviser in selecting broker-dealers.76 The process of having an executing broker step out of a portion of a trade in favor of another broker can reduce or eliminate this conflict for an adviser. By telling a broker executing a trade to step-out a portion of the commission to another broker, an adviser can use the broker that provides best execution to execute the trade, and can pay commissions on the trade to other brokers from which it receives research or other services, even if those brokers have inferior execution capability.

A conflict would exist if an adviser asks executing broker-dealers to step-out of trades for its private clients to increase the compensation received by broker-dealers that are involved in distribution activities of shares of funds sponsored by the adviser. While we did not observe this scenario during the examination sweep, we will continue looking closely at this issue.

We noted that broker-dealer confirmations to advisers did not clearly indicate which broker-dealer actually executed the step-out trade, which broker-dealer received a step-out portion of the commission and what portion of the commission was stepped-out. This made it difficult for advisers to track their soft dollar payments made through step-out trades. This limited disclosure also raises concerns under the antifraud provisions of the federal securities laws and rules thereunder, particularly Rules 10b-5 and 10b-10 under the Exchange Act.77

Rule 10b-10 requires broker-dealers to send a written confirmation of each securities transaction with a customer at or before completion of the transaction, containing certain material information about the transaction. In a step-out transaction, Rule 10b-10 requires both the executing broker-dealer and the broker-dealer providing the soft dollar services to send a written confirmation containing all of the information required by the rule.78

F. Disclosure

Nearly all advisers that we examined (94%) made some form of disclosure regarding their soft dollar practices as required by Items 12B and 13A of Form ADV, Part II. At a minimum, most advisers used boilerplate to disclose that the receipt of research products or services is a factor considered in selecting broker-dealers.79 It appears that many advisers have concluded that their use of soft dollars to acquire certain products was not material information required to be disclosed. We analyzed the disclosures made by a sample of 220 advisers in their Forms ADV regarding their soft dollar arrangements. All of the advisers in the sample had some kind of soft dollar arrangements. Our conclusions are summarized below.80

- Only 48% of advisers disclosed information about products and services that the advisers obtained through soft dollars with sufficient specificity to enable clients or prospective clients to understand what was being obtained. While 28% of advisers obtained products or services outside of the safe harbor, in our view, none of these advisers provided client disclosure about those products and services with sufficient specificity.81
- Only 50% of advisers made any disclosure concerning whether clients pay higher commissions than those obtainable from other brokers in exchange for products and

services (39% of advisers disclosed that clients may pay higher commissions than those obtainable from other broker-dealers for effecting such transactions; 11% of advisers disclosed that clients do not pay a higher commission as a result of the adviser receiving research from broker-dealers); the remaining 50% of advisers did not make any disclosure regarding the level of commissions paid to broker-dealers in exchange for research or other products.

- While we noted numerous instances where advisers used commissions generated by some clients to acquire research for the benefit of other clients' accounts, only 38% of advisers disclosed this fact as required by Form ADV. For example, in this context, we found at least one mutual fund adviser failed to disclose that commission dollars generated by one type of client (private clients) were subsidizing another client's (a mutual fund's) expenses. In addition, 14% of the advisers that we examined used equity client commissions to pay for research benefiting fixed-income clients; none of these advisers disclosed that research would be used to service other clients' accounts.
- We also found that while 68% of the advisers that we examined had at least one mixed-use arrangement, a smaller number (8%) of advisers disclosed that where research products or services have a mixed use, the advisers will make a reasonable allocation of the use and pay for the non-research portion with hard dollars. None of the advisers disclosed the allocation determination. We also generally noted little or no disclosure by advisers to clients regarding clients' ability to recapture commissions via directed brokerage arrangements (this disclosure is not specifically required by Form ADV).

Form ADV does not at present elicit explicit disclosure concerning the nature of the conflicts of interest created by soft dollar arrangements. Some advisers, however, do identify conflicts of interest, although with varying degrees of specificity, in their Form ADV disclosure. One adviser acknowledged, for example, that it used client brokerage to obtain research and suggested one aspect of the conflict of interest by noting that "[t]he advisory fee paid by an individual account is not reduced because [the adviser] and its affiliates receive such services." The disclosure in another Form ADV was more pointed:

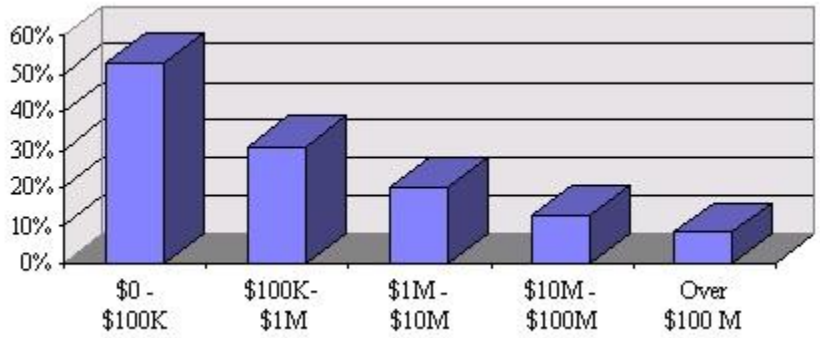
Certain brokers or dealers selected by [the Adviser] provide or have agreed to provide [the Adviser] with certain research and statistical services of the kind contemplated by Section 28(e) of the Securities Exchange Act of 1934 -- services which would otherwise be available to [the Adviser] for a cash payment . . . As a result of receiving such services . . . [the Adviser], therefore, has an incentive to continue to use such brokers and dealers to effect transactions for accounts . . . as long as such brokers and dealers continue to provide services to [the Adviser].

G. Commissions

We found that the total commissions (research and execution) paid in third-party soft dollar transactions comprised about 12% of the total commissions generated by advisory clients ($274.6 million out of $2.26 billion). We also found that the ratio of soft dollar commissions to total commissions paid varied substantially depending on each adviser's volume of trading. For example, small advisers generating less than $100,000 in total commissions used over 50% of their commissions to earn soft dollar credits. Larger advisers generating more than $100 million in commissions used only 8.3% of their commissions for soft dollar credits. This finding is depicted graphically below:

Average Soft Dollar Commissions/Total Commissions

(Based on Total Commissions Generated by Adviser)



For most large institutional advisers that we examined, the total amount paid in soft dollars compared to total operating expenses was minimal. For example, an institutional adviser with $60 billion under management used 20% of its commissions to generate soft dollar credits. These credits amounted to less than 5% of the adviser's operating expenses and less than 1% of the adviser's operating income. Similar numbers existed at other large advisers. For smaller advisers, the amounts were more substantial. For example, a small adviser with $2.5 million under management used 86% of its commissions to generate soft dollar credits. The adviser earned less than $30,000 in management fees and paid $26,490 in soft dollars in exchange for products.

As noted in this report, advisers on average paid six cents per share for "free-brokerage" (non-client directed) whether or not the commissions were used to generate soft dollar credits. In cases where clients directed advisers to use low-cost brokers, advisers were often able to pay just three cents per share. One head equity trader at an adviser claimed that he couldn't possibly negotiate broker-dealers down to three cents per share when broker-dealers are receiving six cents per share or more from other advisers. According to this trader, to do so would put him at the back of broker-dealers' lists for research, information flow and trading. Other advisers and traders expressed similar conclusions -- that what commission dollars really pay for is access to analysts, traders and other staff at large brokerage firms as well as access to execution skills for large, sensitive or difficult trades. These relationships between advisers and broker-dealers providing proprietary research are not captured in this report's numbers reflecting soft dollar arrangements.

H. Soft Dollar Ratios

We computed average soft dollar/hard dollar ratios using commission targets and information regarding the hard dollar cost of each product. A soft dollar ratio is the comparison of a product's hard dollar price to the total amount in soft dollar commissions (including execution) that must be paid to acquire the product. The average soft dollar/hard dollar ratio for all advisers in the study was 1.6 :1. This means that advisers had to direct $1.60 in commissions to equal $1.00 in soft dollars. The ratios utilized by advisers and broker-dealers ranged from a low of 1:1 to a high of 10:1 which was paid for a bi-monthly subscription to technical stock charts. In most cases, ratios for agency and OTC trades were comparable. While almost half of the advisers had a ratio as high as 2:1 in at least one arrangement, only 12% had any arrangements with ratios higher than 2:1.

I. Monitoring Compliance with Section 28(e) and Recordkeeping

Most of the large advisers that we examined did not have centralized management or control over the receipt of products and services for soft dollars. Rather, soft dollar decision-making commonly occurred in an uncoordinated fashion at several functional levels, including the research, trading and portfolio management departments. In addition, we found that many advisers did not maintain adequate documentation of soft dollar transactions, the products received, their uses, and

allocation decisions concerning mixed-use items. The combination of fractionalized management oversight and poor record-keeping made it difficult, if not impossible, for these advisers to adequately supervise and control their soft dollar activities, and to ensure that their disclosure to clients was appropriate.

In addition, the lack of recordkeeping made it difficult for many advisers to provide the examiners with a complete list of all soft dollar products and services received within the firm. As a threshold matter, in cases in which an adviser or broker-dealer is unable to provide a complete list of soft dollar products and services, the examination staff cannot have any confidence in that registrant's control environment relating to the legitimacy of soft dollar activities. For example:

- A large money manager was not reviewing, in a timely manner, copies of invoices that it received for third-party research that it was obtaining through soft dollar arrangements. The firm could not identify the soft dollar products that it had received. The adviser could not ensure that it was in compliance with the law, and examiners could not perform a thorough review of all soft dollar arrangements because of a general lack of supporting documentation.
- No employee at a medium-sized adviser was responsible for reviewing the monthly soft dollar credit/debit balances maintained by the adviser with the four broker-dealers with which the adviser had arrangements. In addition, no employee was responsible for supervising the soft dollar expenditures or whether the firm's soft dollar policies/ procedures were being followed. Because of the lack of supervision and recordkeeping concerning the soft dollar arrangements, examiners could not be certain that the soft dollar information provided to them was complete or accurate.
- An adviser employed several unaffiliated sub-advisers to manage several of its funds. The funds' boards of directors failed to review and consider any soft dollar arrangements these sub-advisers may have had in their annual review of the funds' contracts with these sub-advisers. As a result of this weakness in control, the sub-advisers may have been receiving additional, undisclosed compensation for managing the funds' assets.
- A fund adviser established two separate internal tracking systems for its numerous soft dollar arrangements, though failed to periodically reconcile the two systems. As a result, we found discrepancies between the items that the adviser was reporting it had obtained from third-party vendors, and the items that the funds were actually purchasing. This control weakness could result in the funds obtaining products and services that were not reported to the adviser or to the funds' board of directors and not considered in evaluating the fees paid to the adviser by the funds.
- An adviser did not have adequate internal control procedures over the use of equipment acquired for soft dollars. The staff found that several on-line services (that would be research if used in the investment decision-making process) had also been installed and were being used for administrative purposes by staff responsible for client services and quality control. Because of the lack of adequate controls over the use of soft dollar products, the adviser was not allocating the cost of these mixed-use products appropriately and was not paying for their use with hard dollars.

VI. Investment Company Examination Findings

During our review of investment company soft dollar practices, we focused on fund directors' review of funds' soft dollar usage and on the disclosure of soft dollar arrangements by funds and their advisers.82 Section 15(c) of the Investment Company Act requires the board of directors of a registered investment company to request and review, and the fund's adviser to supply, such information as may reasonably be necessary for the fund's board to evaluate the terms of the advisory contract between the adviser and the investment company. Research and other services purchased by the adviser with the fund's brokerage bear upon the reasonableness of the advisory fee because the research and other services would otherwise have to be created by the adviser itself or be purchased with its own money. Therefore, investment company advisers that have soft

dollar arrangements must provide their funds' boards with information regarding their soft dollar practices.

Our examinations found that the extent of information provided by advisers to fund boards varies widely. Some boards receive periodic disclosure that is extensive and detailed and includes summaries designed to permit the directors to evaluate the benefits that the adviser received from its use of fund brokerage. We found that most fund boards, however, are simply given a copy of the fund adviser's Form ADV. The Form ADV disclosure requirement, however, were not designed to fulfill the obligations that fund directors have under Section 15(c). Based on our inspections over the past several years, we have compiled a list of information that some boards request and advisers provide, which is summarized in Appendix G.

We found that most investment companies have not entered into directed brokerage arrangements to offset fund expenses such as audit, legal and custodial fees. Of those advisers with fund clients, fewer than 15% had arrangements with broker-dealers to pay these types of investment company expenses. Of these, about half disclose the practice in the prospectus, the statement of additional information, and/or the annual report to shareholders. The remainder used the footnotes to the investment company's financial statements to make the disclosure.

Finally, only half of the funds with directed brokerage arrangements (or about 7% of the total advisers with fund clients) "grossed up" their expenses on financial statements, with accompanying explanation in the footnotes, to disclose the effect of using fund commission payments to reduce certain fund expenses. It appears that funds which did not record the benefit deemed the amounts to be immaterial in relation to the fund's other expenses. In 1995, the Commission adopted accounting rules which require investment companies to report all expenses gross of off-sets or reimbursements pursuant to a directed brokerage arrangement.83 This requirement is designed to allow investors to compare expenses among funds. While the rules do not indicate a materiality threshold, it appears that some funds are interpreting the rules to allow an exception in cases where per share NAV is not affected. We recommend that the Division of Investment Management provide clarification with respect to this issue.

VII. Unregistered Entities Examination Findings

We found several examples of soft dollar abuses by advisers who serve as the general partner of a limited partnership or as the adviser to a hedge fund. In these situations, the adviser used client brokerage to pay for the operating expenses of the partnership or hedge fund. We also found instances where advisers serving as general partners used client brokerage to pay for personal expenses.84

Because limited partnerships, hedge funds and their managers typically are not required to be registered with the Commission as investment advisers or investment companies, these entities are not subject to the same requirements under the federal securities laws as registered entities or to routine inspections by Commission staff. These entities are, however, subject to the antifraud provisions of the federal securities laws and to state fiduciary laws, which may mandate disclosure of soft dollar practices to participants. These required disclosures may include the use of clients' brokerage commissions. In several cases in which such offering documents were available for review, we found that disclosure regarding soft dollar practices was minimal or non-existent. As a result, it appeared that the adviser/general partner was engaged in questionable soft dollar arrangements without the limited partners' knowledge.

VIII. Recommendations

Based on the results of the sweep, and our experience over recent years in examining soft dollar practices of advisers, we make the recommendations described below.

A. The Commission Should Reiterate and Provide Additional Guidance With Respect To Soft Dollars

Our findings evidence the range of soft dollar practices that exist today and the changes, since 1986, in the types of products available and the methods of their transmission. The findings also indicate that broker-dealers and advisers are not consistently applying the standards articulated in the 1986 Release. Based on these findings, and particularly the number of advisers purchasing non-research and mixed-use items with soft dollars without disclosure to or consent of clients, we conclude that there may be a need to reiterate the interpretation of Section 28(e). Because we found that the disclosure of soft dollar arrangements by investment advisers too often was inadequate, there also may be a need to reemphasize the Commission's guidance relating to the disclosure required for advisers in soft dollar arrangements.

Similarly, while most broker-dealers monitored their soft dollar activities to some extent, they generally expressed the view that nearly all responsibility in this area rests with advisers, regardless of the types of products or services that they provided to advisers. Moreover, many broker-dealers and advisers also have ignored the "provided by" concept articulated in the 1986 Release while claiming safe harbor protection.

Thus, we recommend that the Commission publish this report in order to:

- Reiterate the guidance provided in the 1986 Release concerning what constitutes research products and services within the safe harbor.
- Reiterate the guidance provided in the 1986 Release with respect to advisers' obligation to make a reasonable allocation of research and non-research uses of mixed-use items, to maintain records to justify the allocation, and to disclose the practices to clients and prospective clients.
- Reiterate the obligations of investment advisers to clearly disclose their soft dollar practices in Plain English. In addition, reiterate the guidance provided in the 1986 Release with respect to advisers' disclosure obligations concerning the nature, breadth and depth of disclosure, including:
    - whether the adviser pays higher commissions than those obtainable from other broker-dealers in exchange for research or other products or services; and
    - whether one client's commissions are used to obtain research or products that benefit other clients (cross-subsidization).

- Reiterate the guidance in the 1986 Release that broker-dealers must be contractually liable to pay for the product or service in order for the arrangement to fall within the safe harbor.
- Reiterate that a broker-dealer may incur aiding and abetting liability in soft dollar transactions if it causes or assists an investment adviser in a fraudulent or deceptive act or practice.
- Emphasize the requirements of Rule 10b-10 with respect to adequate disclosure of step-out transactions.
- Reiterate the obligation of investment companies' boards of directors to review all aspects of advisers' compensation, including benefits received in soft dollar arrangements and for investment advisers to provide such information.
- Remind investment companies of their obligation to disclose the effect of using fund commissions to reduce fund expenses.

We also found that the types of products available for purchase with soft dollars have greatly expanded since 1986. Industry participants are now grappling with decisions as to whether these various products are "research" or "brokerage" within the safe harbor, or whether these products should be considered part of advisers' overhead expenses to be paid for by advisers with hard dollars. Therefore, we recommend that:

- The Commission reiterate and provide further guidance with respect to the scope of the safe harbor, particularly concerning (a) the use of electronically provided research and the various items used to send, receive and process research electronically, and (b) the use of items that may facilitate trade execution.

B. The Commission Should Consider Adopting Recordkeeping Requirements Related to Soft Dollars

As described in this report, most large advisers did not exercise central control over their soft dollar purchases, with one department sometimes ignorant of the products and services received by another department. We also found poor recordkeeping by many advisers. We believe that this lack of comprehensive internal controls and poor recordkeeping contributed to incomplete disclosure, using soft dollars for non-research purposes absent disclosure and inadequate mixed-use analyses. We also found that most broker-dealers lacked comprehensive controls. This made it very difficult for examiners to ascertain the true extent and nature of soft dollar practices at each adviser and broker-dealer. Thus, we recommend:

- That the Commission adopt a rule requiring all broker-dealers to provide to each investment adviser a statement, at least annually, of all products, services and research provided to the adviser in exchange for soft dollars. A sample statement is located in Appendix E.
- That the Commission adopt a rule requiring advisers to keep the statements of products and services provided by broker-dealers (see above recommendation) and that, where advisers obtain soft dollar benefits from multiple broker-dealers, they maintain their own detailed list of all products and services received for soft dollars.
- That the Commission adopt a rule requiring advisers to maintain a written record of the basis for allocations of mixed-use products and services between their hard and soft dollar components.

Considered jointly, these recommendations would require broker-dealers and investment advisers to document their soft dollar transactions. The recordkeeping requirement for advisers and broker-dealers would make it easier for advisers to ensure that their activities conform to their disclosures, and ensure that advisers have adequate support for their ADV disclosure. Further, these recommendations would allow Commission staff, on every examination, to easily reconcile the various broker-dealer lists of soft dollar items with each adviser's own list of soft dollar items received.

In addition, despite the guidance in the 1986 Release stating that advisers must make a good faith effort to make a reasonable allocation with respect to mixed-use items, and must keep adequate books and records concerning allocations, we found unrealistic allocations and little documentation. We believe that a "mixed-use" recordkeeping requirement may cause advisers to more realistically assess the non-research value of their mixed-use items, without creating a significant burden on advisers. This recommendation may encourage advisers to make more reasonable allocations and memorialize their allocation decisions.

C. The Commission Should Modify Form ADV to Require More Meaningful Soft Dollar Disclosure

Meaningful and effective disclosure is necessary to permit clients to supervise use of their brokerage. Form ADV currently requires disclosure of key information about soft dollar practices.85 While Form ADV does not require that each product or service be described,86 the disclosure is required to be specific enough such that clients can understand the types of products or services being purchased with their commission dollars and to permit them to evaluate any conflicts of interest in the adviser's policies and practices. The disclosure requirement exists regardless of whether an adviser is deemed to be paying up for benefits received, and whether the product is inside or outside of the safe harbor.

Unfortunately, we found that advisers' disclosure was often poor: less than half of the advisers that we examined provided clear disclosure; and disclosure often consisted of boilerplate.87 The information provided to clients was very general and seemingly designed to provide the adviser with the widest possible latitude to use client brokerage. We also found a great deal of disclosure that seemed drafted more to protect against litigation than to inform clients. Advisers can and should do better, and we recommend that the Commission revise Form ADV to require better disclosures. Therefore, we recommend that:

- The Commission revise Form ADV to clarify information required in that form about the products and services purchased by the adviser with soft dollars. These revisions should incorporate the disclosure standard set forth in the 1986 Release (disclosure should be specific enough for clients to understand the types of products being purchased and permit them to evaluate possible conflicts of interest), and should require more detailed disclosure about any products or services that are not used in the carrying out of the adviser's investment decision making responsibilities.88

Some clients may want or need more detailed information about the types of products or services than that which would be provided in Form ADV. Accordingly, we recommend that:

- Advisers that use soft dollars be required to provide more detailed information about the use of client brokerage upon the request of any client. This information could be on a client-specific basis, could include more detailed itemization of the research and products obtained with soft dollars during the previous period, and could include total commission commitments, and total expenses during the period. It may be necessary for advisers also to provide additional information about their money management activities in order to put the soft dollar information into context.

Finally, we found that some clients took advantage of commission recapture programs, which in effect permit the client, instead of the adviser, to reap the benefit of the cost of soft dollars apparently built into institutional brokerage. The availability of these recapture programs should be made known to all clients, and not just some advisory clients. Therefore, we recommend that:

- Form ADV be amended to require disclosure of the availability of commission recapture to clients if any client of the adviser directly receives cash rebates, products, services, expense payments or expense reimbursements from one or more broker-dealers based on commissions generated by the client's trades placed by the adviser.

D. The Commission Should Encourage Firms to Adopt Internal Controls Relating to Soft Dollars

We observed a wide range of internal control environments at broker-dealers and advisers relating to soft dollar activities -- ranging from close supervision to no controls at all. As part of their supervisory obligations,89 advisers and broker-dealers should have in place reasonable controls and a system of supervision to ensure compliance with the law by the firm and its employees. We believe that many problems can be avoided by the use of good, sound compliance procedures. Therefore, we recommend that:

- The Commission published this report in order to encourage registrants to establish and implement internal controls relating to soft dollar practices. A summary of control procedures, many of which examiners observed as effective during examinations, is located in Appendix F.

Appendix A: List of Reasons for Selecting Adviser Soft Dollar Examination Candidates

- purchase of mixed-use items with soft dollars
- non-research items purchased with soft dollars
- consulting services purchased with soft dollars
- possible questionable travel purchased with soft dollars
- proxy voting services purchased with soft dollars
- computer hardware purchased with soft dollars
- invoices sent directly from vendor to adviser (not to broker-dealer)
- commission rate issues
- adviser paying higher commissions in order to generate soft credits
- soft dollars used for mutual fund expense reduction
- broker-dealer refused to pay for consultant's travel
- adviser's rent paid with soft dollars
- payments to a limited partnership or questionable use of LP's commissions
- questionable product or practice or payment under section 28(e)
- possible payment of sub-advisory fees paid with soft dollars
- cash reimbursement of commission dollars to adviser or broker-dealer
- accounting, tax preparation and/or legal services purchased with soft dollars
- hotel bills paid with soft dollars
- direct cash payments or possible payments to adviser
- adviser paying two times normal commission rate charged to other clients
- computer conference fees paid with soft dollars
- "service fees" paid with soft dollars
- "training/license fees" paid with soft dollars
- "maintenance & support" invoice paid with soft dollars
- telephone service/bills paid with soft dollars
- OTC principal trades or fixed-income principal trades used to generate credits
- apparent medical expense purchased with soft dollars
- e-mail invoice paid with soft dollars
- disaster recovery plan purchased with soft dollars
- possible churning of fund portfolio to meet soft dollar commitments
- broker-dealer referral arrangements involving soft dollars
- adviser's radio ad purchased with soft dollars
- high soft dollar ratio
- vendor and adviser contracted directly (i.e., not through broker-dealer) for the purchase of products with soft dollars

Appendix B: Number of Brokers Providing Soft Dollar Products/Services

(By Product Category)

Goods/Services	Total
Accounting Fees	10
Association Membership Fees	5
Cable Television	6
Commission Rebates	3
Computer Hardware	31
Computer Software	31
Conferences/Seminars	15
Consulting Services	23
Courier/Postage/Express Mail	7
Custodial Fees	2
Electronic Databases	28
Employee Salary/Benefits	4
Execution Assistance	30
Industry Publications	43
Legal Fees	5
Management Fees	1
Miscellaneous Expenses	7
Office Equipment/Supplies	10
On-line Quotation and News Services	58
Portfolio Management Software	39
Rent	5
Research/Analysis Reports	47
Telephone Expenses	32
Travel Expenses	8
Tuition/Training Costs	6
Utilities Expenses	3

Appendix C: Categorization of Products Purchased With Soft Dollars

(Sample of 4,731 Soft Dollar Arrangements by 180 Advisers)

Category
Sample %

Category	*Sample %*
Research	
Reports	53.5%
News	13.6%
Pricing Services	5.5%
Computer Hardware	2.9%
Portfolio Mgmt.	1.8%
Miscellaneous	1.2%
Computer-Other	1.1%
Total Research	**79.7%**
Mixed-Use	
Portfolio Management	1.8%
Reports	1.7%
Computer-Other	1.3%
Computer Hardware	1.2%
Miscellaneous	1.0%
Pricing Services	0.6%
News	0.4%
Total Mixed-Use	**7.9%**
Non-Research	
Miscellaneous	1.7%
Pricing Services	0.2%
Computer-Other	0.2%
News	0.1%
Total Non-Research	**2.2%**
Trade Assistance	
Pricing Services	5.7%
Miscellaneous	4.1%
Computer Hardware	0.2%
Computer-Other	0.1%
Total Trade Assistance	**10.2%**

Appendix D: Sub-Categorization of Soft Dollar Products

(Sample of 4,731 Soft Dollar Arrangements by 180 Advisers)

Research	
General Company	13.5%
General Economic	7.7%
Industry/Sector	6.5%
Equity	6.4%
Pricing used for research	5.5%
On line news services	4.6%
Magazines/Journals	4.4%
Fixed-Income	4.2%
International	3.5%
Fundamental Analysis	3.4%
Technical Analysis	3.2%
Newspapers	2.5%
Performance Measurement	2.2%
Mutual Fund Data	1.8%
Portfolio Accounting/Management	1.4%
CPUs	1.3%
Modem phone lines	1.0%
Seminars/Conferences	1.0%
Consulting (General)	0.9%
Newsletters	0.8%
Asset Allocation	0.6%
Other Software	0.4%
Cables	0.4%
Commodities	0.4%
Daily faxes	0.3%
Real Estate	0.3%
Derivatives	0.3%
Proxy Services	0.2%
Network Support	0.2%
Upgrades (*i.e.*,-software, memory, etc.)	0.2%
Maintenance Agreements	0.2%
Printers	0.1%
Market Timing	0.1%
Total Research	**79.7%**

Mixed-Use	
Portfolio Accounting/Management	1.8%
Performance Measurement	0.8%
CPUs	0.7%
Pricing service used partly for research	0.6%
Trading Facilitation	0.4%
Network Support	0.4%
General Company	0.3%
Proxy Services	0.3%
Maintenance Agreements	0.3%
On-line services	0.2%
Consulting (General)	0.2%
General Economic	0.2%
Other Software	0.2%
Upgrades (*i.e.*,-software, memory, etc.)	0.2%
Printers	0.2%
Mutual Fund Data (marketing uses)	0.1%
Seminars/Conferences	0.1%
Monitors	0.1%
Cables	0.1%
Total Mixed-Use	**7.9%**

Non-Research	
Proxy Services	0.4%
Membership/License Fees	0.4%
Office Administration	0.3%
Compliance Information	0.2%
Pricing used solely to value portfolio for fee purposes	0.2%
Internet Access/Information	0.1%
Seminars/Conferences	0.1%
CFA Books/Review Course	0.1%
Total Non-Research	**2.2%**

Trade Assistance	
Pricing Services used for execution	5.7%
Trading Facilitation	4.0%
Maintenance Agreements	0.1%
Total Trade Assistance	**10.2%**

Appendix E: Sample Annual Statement From Full Service or Third-Party Broker-Dealer to Adviser

ABC Brokerage, Inc.
New York, NY 10020

January 14, 1999

Mr. John Smith
President, XYZ Capital Management Ltd.
Chicago, IL

Dear John:

For the fourth quarter of 1998, our firm provided the following third-party/ proprietary products/services to XYZ Capital Management Ltd. in exchange for commission dollars from XYZ's clients:

Product/Service	Annual Soft Dollar Commitment (where applicable)
Access to Analysts	$0
Intnl Data Corp	$12,125
John Olsen	$2,080
Dow Jones	$5,000
Lexis/Nexis	$40,000
Reuters	$6,320
Research Reports	$0
Jones Consultants	$6,200
Totals	**$71,725**

According to our records, XYZ directed sufficient brokerage to fully meet its soft dollar commitments for 1998.

Appendix F: Broker-Dealer And Adviser Internal Controls

Based on our inspections of broker-dealer and investment adviser soft dollar arrangements, we observed many good internal control procedures. We are providing this compilation of internal control procedures related to soft dollar arrangements to assist broker-dealers and advisers in reviewing and enhancing their compliance activities in this area. Each broker-dealer and investment adviser has a unique organizational structure and operating environment, such that all of the internal control procedures described below may not be appropriate for each broker-dealer or adviser. Moreover, other procedures may be just as effective. Set forth below are internal control procedures that broker-dealers and advisers should review and consider.

Broker-Dealer Controls

- A designated person or committee is responsible for overseeing the firm's soft dollar and client-directed brokerage activities and for establishing the firm's operating policies for these activities.
- At the time that a soft dollar arrangement is being established, the broker-dealer determines whether the adviser has discretionary management authority for its clients' assets and requests and obtains a written description of the adviser's authority, and the types of products and services the adviser is authorized to obtain.
- Established procedures are used to determine whether products and services requested by advisers are consistent with the adviser's authority over clients' commissions.
- At the time that a client of an adviser begins negotiations to establish a directed brokerage arrangement, the broker-dealer determines whether the rebates of commissions or products/services to be supplied are within the advisory client's authority to request and that the party receiving the benefits under the arrangement is authorized to receive such benefits. The firm requests and obtains from the client a written description of its authority to enter into the arrangement and to receive the indicated products/services.
- The broker-dealer establishes a contractual relationship with each third-party vendor of research products and services so that it is obligated for payment under all such contracts.
- An appropriate unit of the broker-dealer produces a master approved list of all third-party soft dollar arrangements and client-directed brokerage arrangements. No payments are made to third-party vendors or to clients under rebate programs unless the arrangement appears on this list.
- Invoices for products and services submitted by advisers for which the broker-dealer is not contractually liable for payment are not paid.
- Commissions paid under each soft dollar arrangement by advisers are periodically reviewed in relation to the products and services provided to the advisers, and advisers are informed if their commission situations are materially out of balance.
- The broker-dealer sends each adviser a periodic statement of all proprietary and third-party research and non-research services provided, including commitment amounts and year-to-date commissions directed.

Adviser Controls

Brokerage Allocation/Soft Dollars Committee

- A designated person or committee oversees all aspects of the firm's soft dollar and client-directed brokerage arrangements. The person or committee serves as the control point for all decisions relating to commission allocations and soft dollars.
- Every employee knows what his or her responsibilities are regarding soft dollars and directed brokerage, and those responsibilities are reduced to writing.
- At the beginning of each year, a master brokerage allocation budget is established. The budget includes a list of all broker-dealers to which the adviser plans to give commission business that year. It lists targeted commission amounts per broker (in percentage or dollar terms) and purpose for the allocations. Purpose categories may include proprietary

research, third-party soft dollar arrangements, underwritings, client direction or execution capability.

- An annual list of third-party soft dollar arrangements is prepared. This list serves as the control document for all third-party soft dollar arrangements entered into by the adviser. Current justifications for each existing arrangement are reviewed to determine if the product or service is needed and whether it provides legitimate assistance in the investment decision-making process. Requests and justifications for additional arrangements are reviewed. The list includes, by broker, all approved soft dollar arrangements including the name of the product or service, the name of the third-party provider, the amount of the annual soft dollar commitment, and the soft dollar-hard dollar ratio.
- Responsible persons periodically review, approve or deny any changes to either the brokerage allocation budget or the list of third-party soft dollar arrangements. Requests to approve additional soft dollar arrangement include approvals by the department head of each person submitting a request.
- If a product/service is determined to be a mixed-use item, appropriate documentation is requested to be able to make a decision on a reasonable allocation of cost between hard and soft dollars. Adequate records are created and maintained to support these allocation decisions.
- Form ADV disclosures concerning brokerage allocation and soft dollar activities are reviewed by persons responsible for soft dollar activities and brokerage allocations to ensure consistency with actual practice. If the adviser's current disclosure does not adequately address the nature and extent of soft dollar activities together with any conflicts posed by those activities, amended disclosures are made.
- The committee or senior manager ensures that written brokerage allocation and soft dollar procedures are maintained and distributed to all appropriate levels of the firm.

Trading Area

- Periodically, a report is prepared which shows for each broker-dealer that has received commissions on advisory client trades, the budgeted amount of annual commissions, the total amount of commissions year-to-date, variation from the budgeted amount, the amount of client directed brokerage and the amount of commissions generating soft dollar credits.
- Periodically, a report is prepared which shows for each client who has instructed the adviser to direct brokerage, the name of the client, the broker-dealer(s), the amount of commissions directed to the broker-dealer, the percent of the client's total commissions directed to the broker, the client's requested percentage and the variance from the client's request.
- Periodically, a report is prepared which shows, for each broker providing third-party products or services to adviser, the name of the broker, the name of the products or services, the annual commitment, any soft-dollar debit or credit balance carryover from a previous period, total commissions expected for the current year, the amount of commissions paid year-to-date, and the remaining soft dollar commitment for the year.

Compliance Area

- Compliance personnel monitor execution of brokerage allocation and soft dollar policies and bring material deviations to the attention of responsible persons.
- Periodic statements are received from broker-dealers showing all proprietary and third-party research and non-research services provided to the adviser.
- Broker-dealer statements are reconciled to the master soft dollars list. Discrepancies are followed-up including products and services listed on broker statements but not shown on the master list, items budgeted but not received, etc. This reconciliation serves as the key control against unauthorized or inappropriate soft dollar arrangements.
- Periodic reviews are undertaken of brokerage allocation reports and directed brokerage reports, monitoring all appropriate matters including average per-share commission rates

paid to each broker-dealer. The information on these reports is checked against the master brokerage allocation budget and the client directed brokerage files.

- Appropriate sanctions and remedial actions are implemented in cases of unauthorized receipt of soft dollar benefits or other breaches of the adviser's soft dollar policy.
- Periodic training of all appropriate personnel is undertaken regarding soft dollars and brokerage allocation policies. All employees sign yearly compliance statements stating they have read adviser's policies and are in compliance.

Appendix G: Compilation of Information Reviewed by Some Fund Boards of Directors

Based on inspection data, compiled below is a list of information requested and reviewed by some fund boards in connection with the boards' review of brokerage allocation practices:

- Portfolio turnover rate
- List of brokers used and total commission dollars paid to each broker
- Aggregate average commission rate per share and average commission rate per share by broker
- List of brokers with which the fund adviser has soft dollar arrangements (both for proprietary and third-party research) that includes description of product or service received, total commissions directed to the broker by the fund and all of the adviser's clients and the total estimated annual cost of each soft dollar arrangement
- Written attestation from the fund's adviser that all fund trades during the period received best execution
- Total commissions paid to all brokers compared with average net assets expressed in basis points and presented in relation to the fund's expense ratio expressed in basis points
- An estimate of the average spread paid by the fund on principal trades and the aggregate value of principal trades completed to provide a sense of the costs incurred on portfolio transactions effected on a principal basis
- List of fund operating expenses paid through directed brokerage arrangements, including amount of each expense paid with commissions

Footnotes

1 Greenwich Associates gauged the size of the third-party soft dollar industry at around $760 million in 1996, although other sources have estimated the volume to be around $1 billion. Greenwich also estimated that soft dollars comprise 27% of all listed commissions. See Gregg Wirth, Greenwich: Institutions are Uncomfortable with their Soft Dollar Arrangements, Investment Dealers Digest, June 9, 1997, at 15. The estimate, however, excludes brokerage commitments made by advisers in order to secure proprietary research or execution services.

2 The inspection universe represents a diverse group of advisers that actively use client commissions to generate soft dollar credits. This universe should not be considered representative of the adviser population as a whole.

3 With current recordkeeping requirements, it is not possible to determine the amount of proprietary research obtained by advisers through soft dollar arrangements during this period.

4 This report was prepared by the Office of Compliance Inspections and Examinations in consultation with the Divisions of Investment Management and Market Regulation and the Office of the General Counsel.

5 Our inspections caused some advisers to revisit their use of soft dollars. As a direct result of the sweep and several other inspections conducted just prior to the sweep, advisers with various undisclosed soft dollar arrangements voluntarily repaid approximately $4 million to clients.

6 Based on these findings, the Commission may wish to consider other rule or policy proposals not described in this inspection report. Many of the recommendations described in this report could be implemented by Commission rulemaking. Pursuant to the Administrative Procedure Act, new or amended rules are proposed for public comment prior to adoption.

7 Disclosure by Investment Advisers Regarding Soft Dollar Practices, Advisers Act Release No. 1469 (Feb. 14, 1995).

8 A "give-up" is a payment by the executing broker to other broker-dealers of a part of the minimum commission that the executing broker is required to charge its customers. The recipient of a give-up payment may have had nothing whatsoever to do with the actual transaction for which the commission was charged and, in fact, may not have known where or when it was executed. Before 1975, executing brokers used "reciprocal practices" to provide compensation at the direction of institutional investors to other brokers, i.e.,

they permitted such other brokers to participate in the commissions generated from the execution of orders, in the over-the-counter market or on regional exchanges, that the institutional broker received from its customers. Exchange Act Release No. 8239 (Jan. 26, 1968). See also Division of Market Regulation, U.S. Securities and Exchange Commission, Market 2000: An Examination of Current Equity Market Developments (Jan. 1994) at V-9.

9 Id.

10 The Commission adopted Rule 19b-3 under the Exchange Act, which required securities exchanges to eliminate fixed commission rates for public customers of their members effective on May 1, 1975. As early as April 1971, at the direction of the Commission, national securities exchanges adopted competitive commission rates for trades exceeding $500,000. This made commission rates negotiable for advisers of institutional accounts, in particular. The dollar amount of trades enjoying competitive commission rates was reduced over the next few years, until April 1974, when the New York Stock Exchange and other national securities exchanges adopted competitive commission rates for transactions involving less than $2,000. Exchange Act Release No. 11203 (Jan. 23, 1975). Rule 19b-3 was codified in certain respects by Section 6(e)(1) of the Exchange Act, enacted as part of the Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97, 107-08 (1975)[15 U.S.C. 78bb(e)].

11 The concern over "paying up" arose in part out of litigation relating to whether investment company advisers had an obligation to recapture commission rebates for the benefit of their investment company clients. See Tannenbaum v. Zeller, 552 F.2d 402 (2d Cir.), cert. denied, 434 U.S. 934 (1977); Arthur Lipper Corp. v. SEC, 547 F.2d 171 (2d Cir. 1976), cert. denied, 434 U.S. 1009 (1978); Fogel v. Chestnutt, 533 F.2d 731 (2d Cir. 1975), cert. denied, 429 U.S. 824 (1976); and Moses v. Burgin, 445 F.2d 369 (1st Cir. 1970), cert. denied, 404 U.S. 994 (1971).

12 Interpretive Release Concerning Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Exchange Act Release No. 23170 (Apr. 23, 1986) (the "1986 Release") at 4-5.

13 Interpretations of Section 28(e) of the Securities Exchange Act of 1934: Use of Commission Payments by Fiduciaries, Exchange Act Release No. 12251, (March 24, 1976) (the "1976 Release").

14 See Section 28(e)(2). In 1976, the Commission proposed disclosure rules under Section 28(e)(2), Exchange Act Release No. 5772 (Nov. 30, 1976). Later, the Commission incorporated the disclosure in Form ADV, Advisers Act Release No. 664 (Jan. 30, 1979). In 1995, the Commission proposed, but did not adopt, more specific disclosure requirements, Advisers Act Release No. 1469 (Feb. 14, 1995).

15 1986 Release at 3.

16 See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963).

17 Restatement (Second) Trusts § 170 comment a, § 216 (1959). See also Advisers Act Release No. 1469 (February 14, 1995), at fn. 8 and accompanying text. As discussed herein, the Investment Company Act of 1940 generally prohibits fund advisers from using fund commissions to acquire any product or service outside of the Section 28(e) safe harbor.

18 In the Matter of Kingsley, Jennison, McNulty & Morse Inc., Advisers Act Release No. 1396 (Dec. 23, 1993). See also In the Matter of Kidder, Peabody & Co., Inc., Advisers Act Release No. 232 (Oct. 16, 1968) ("whenever trading by an investment adviser raises the possibility of a potential conflict with the interests of his advisory clients, the investment adviser has an affirmative obligation before engaging in such activities to obtain the informed consent of his clients on the basis of full and fair disclosure of all material facts."); In the Matter of Portfolio Management Consultants, Inc., Advisers Act Release No. 1568 (June 27, 1996) ("a fiduciary in a potentially conflicting position with the beneficiary must refrain from putting its interests ahead of the beneficiary's, absent informed consent."); In the Matter of Arleen W. Hughes, Exchange Act Release No. 4048 (Feb. 18, 1948) (adviser has "an affirmative obligation to disclose all material facts to her clients in a manner which is clear enough so that a client is fully apprised of the facts and is in a position to give his informed consent. And this disclosure, if it is to be meaningful and effective, must be timely. It must be provided before the completion of the transaction so that the client will know all the facts at the time that he is asked to give his consent.").

19 1986 Release at 3.

20 See Statement of Policies Concerning Soft Dollar and Directed Commission Arrangements, Department of Labor, ERISA Technical Release No. 86-1, [1986-1987 Decisions] Fed. Sec. L. Rep. (CCH) ¶ 84,009 (May 22, 1986).

21 1976 Release at 1. Examples of such items included periodicals, newspapers, quotation equipment and general computer services.

22 Id. at 6.

23 1986 Release at 9.

24 Id. at 10.

25 Id. at 11.

26 See also 1976 Release and SEC No-Action Letter, Bankers Trust Co., (Dec. 7, 1976).

27 1986 Release at 15. See also SEC No-Action Letters, Investment Information, Inc., (Oct. 12, 1976) (broker may contract with third parties in order to supply products/services to a money manager) and Fund Monitoring Services, Inc., (Dec. 4, 1978) (broker should have a direct obligation to pay for third-party research).

28 1986 Release at 15. See also Report of Investigation in the Matter of Investors Information, Inc., Exchange Act Release No. 16679 (March 19, 1980) ("III Report"). In the III Report (pursuant to Section 21(a) of the Exchange Act), the Commission found that the brokers involved in the arrangement did not provide the advisers with any significant research services. The brokers merely executed the transactions and paid 50% of the commissions to Investors Information, Inc. ("III"), which represented various research originators. All arrangements for acquiring the services were made by the advisers and the vendors of the services. III simply held the money for the advisers and paid the bills as requested. The advisers were obligated to pay the vendors for the services, and the brokers generally were not aware of the specific services that the advisers acquired.

29 The staff has provided further guidance with respect to the safe harbor and correspondent relationships. See SEC No-Action Letters, SEI Financial Services Co., (Nov. 14, 1983) (correspondent relationship between clearing and introducing brokers under which customers of introducing broker may place trades directly through a clearing broker does not deprive an adviser of protection of Section 28(e)); Becker Securities Corp., (May 28, 1976) (Congress did not intend in enacting Section 28(e) to eliminate or restrict the use by brokers of normal correspondent relationships); and Robert John Gentry, (May 20, 1981) (a proposed correspondent relationship, in which the introducing broker had no other role than receiving part of the commission, was not a correspondent arrangement that was contemplated under Section 28(e)).

30 See 1986 Release at 21.

31 Id. See also SEC v. Capital Gains Research Bureau, Inc., supra note 16.

32 See 1986 Release at 20. See also In the Matter of S Squared Technology Corp., Advisers Act Release No. 1575 (Aug. 7, 1996).

33 The Commission has instituted a number of enforcement actions against advisers based, at least in part, on the failure to adequately disclose soft dollar arrangements or misrepresentations regarding soft dollar practices in Forms ADV or elsewhere. See, e.g., In the Matter of Oakwood Counselors, Inc., Advisers Act Release No. 1614 (Feb. 10, 1997); In the Matter of S Squared Technology Corp., Advisers Act Release No. 1575 (Aug. 7, 1996); In the Matter of Sheer Asset Management, Inc., Advisers Act Release No. 1459 (Jan. 3, 1995); SEC v. Tandem Management, Inc., et al ., Lit. Release No. 14670 (Oct. 2, 1995); SEC v. Galleon Capital Management, Lit. Release No. 14315 (Nov. 1, 1994); and In the Matter of Louis Acevedo, Advisers Act Release No. 1496 (June 6, 1995).

34 See 1986 Release at 19.

35 Steadman v. SEC, 603 F.2d 1126, 1130 (5th Cir. 1978), aff'd. 450 U.S. 91 (1981); In the Matter of Kingsley, Jennison, McNulty & Morse Inc., supra note 18 (amount of commissions involved in soft dollar transaction [less than one percent of total commissions generated] is not the sole test of materiality;

reasonable investor would have wanted to know of adviser's use of client commissions to fund adviser's corporate obligations).

36 See Advisers Act Rel. No. 665 (Jan. 30, 1979) (Form ADV "represents mandatory disclosure standards. More detailed or additional information and explanatory material could and should be provided where necessary. . .").

37 See 1986 Release at 23-24.

38 Disclosure is required by Item 17 of Part B of Form N-1A; and other registration and reporting forms used by investment companies (e.g., Form N-2 (Item 9); Form N-3 (Item 22); and Form N-SAR (Item 26). See also Rule 6-07 of Regulation S-X (requiring disclosure of fund expenses paid by broker-dealers in certain arrangements).

39 Form N-1A, Item 17.

40 The Supreme Court articulated the Congressional purpose in enacting Section 15(c) and related provisions of the Investment Company Act as placing "the unaffiliated directors in the role of independent watchdogs' entrusted with the primary responsibility for looking after the interest of the funds' shareholders." 1986 Release at 26-27.

41 Id. at 30-31.

42 See Payment for Investment Company Services with Brokerage Commissions, Investment Company Act Release No. 21221 (July 21, 1995). Some industry participants use the term "directed brokerage" to refer to arrangements whereby a broker-dealer agrees to pay customer expenses in exchange for commissions, and they contrast this with "commission recapture" which refers to cash rebates on commissions paid. In both scenarios, the client is receiving benefits from its own commissions. Here we use the terms interchangeably.

43 Id. at 3.

44 If a client directs her adviser to trade through a broker that is not offering best execution, the adviser would have a fiduciary obligation to inform the client that carrying out her instruction may not result in best execution.

In addition, advisers and plan sponsors may violate ERISA (and other fiduciary requirements, see, e.g., Restatement (Second) Trusts, § 170, supra note 17) if directed brokerage benefits are not received by the account whose transactions generated the benefits. ERISA Section 403(c)(1) provides, in part, that the assets of a plan shall be held for the exclusive purpose of providing benefits to the plan's participants and beneficiaries and defraying reasonable expenses of administering the plan. A fiduciary's use of one plan's assets to benefit another plan would contravene the exclusive purpose requirements of ERISA Sections 403(c)(1) and 404(a)(1). See Statement of Policies Concerning Soft Dollar and Directed Commission Arrangements, supra note 20.

45 See 1986 Release at 34-35. See also Section V.E.3. infra, regarding the application of Rule 10b-10 to step-out transactions.

46 See SEC No-Action Letters, U.S. Dept. of Labor (July 25, 1990) ("Dept. of Labor"); and Hoenig & Co., Inc. (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).

47 See Exchange Act Release No. 17371 (Dec. 12, 1980). See also NASD Notice to Members 88-72 (definition of "research") and NASD Rule 2740, "Selling Concessions, Discounts and Other Allowances."

48 See Dept. of Labor and SEC No-Action Letter, Instinet Corp. (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).

49 In the staff's view, Congress did not intend financial futures transactions to be covered by the safe harbor because the statute refers only to securities transactions. See SEC No-Action Letter, Charles Lerner, U.S. Department of Labor (Oct. 25, 1988).

50 Id. (the correction of trading errors does not constitute "brokerage services").

51 See In the Matter of Goodrich Securities, Inc., Exchange Act Release No. 28141, (June 25, 1990) and In the Matter of Patterson Capital Corp., et al., Advisers Act Release No. 1235 (June 25, 1995) (marketing consulting services are not "research").

52 See SEC v. Capital Gains Research Bureau, Inc., supra note 16.

53 See supra note 33.

54 See Hall v. Paine, 112 N.E. 153, 158 (Mass. 1916) ("broker's obligation to his principal requires him to secure the highest price obtainable"). See also Restatement (Second) Agency § 424 (1958) (agent must "use reasonable care to obtain terms which best satisfy the manifested purposes of the principal."); Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., et al., 135 F.3d 266 (3d Cir. 1998).

55 See 1986 Release at 32. See also Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., et al. , 135 F.3d 266, 269 (3d Cir. 1998) (the scope of the duty of best execution has evolved over time with changes in technology and transformation of the structure of the financial markets; the duty of best execution requires the execution of trades at the best reasonably available price.)

56 See, e.g., Exchange Act Release No. 34902 (October 27, 1994) (adopting payment for order flow disclosure obligations for broker-dealers); Exchange Act Release No. 37619A (September 6, 1996) (order handling rules adopting release). See also Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., et al., supra note 55.

57 See, e.g., In the Matter of Edward Sinclair, 44 S.E.C. 523, 526 note 6 (interposing another broker in trade is a prima facie violation of the duty of best execution, imposing on broker "the burden of showing that the customer's total costs or proceeds of the transaction is the most favorable obtainable under the circumstances"), aff'd sub nom. Sinclair v. SEC, 444 F.2d 399 (2d Cir. 1971); In the Matter of Delaware Management Co., 43 S.E.C. 392, 398 note 13 (1967) ("even absent [an express] representation, the prospectuses would be materially misleading in failing to disclose that the Funds did not seek the most favorable prices and executions"); and In the Matter of Michael Smirlock, Advisers Act Release No. 1393 (Nov. 29, 1993); and Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., et al., supra note 55.

58 See, e.g., Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 45 (2d cir.), cert. denied, 439 U.S. 1039 (1978); Exchange Act Release No. 33743 (March 9, 1994); and Exchange Act Release No. 34962 (Nov. 10, 1994).

59 See III Report, supra note 28.

60 Id., quoting Confirmation of Transactions Under Fixed Commissions, Exchange Act Release No. 11629 (Sept. 3, 1975).

61 See III Report at 13.

62 Id.

63 See Section 15(b)(4)(E) of the Exchange Act and Section 203(e)(6) of the Advisers Act.

64 This inspection sweep heightened industry attention towards soft dollar practices. Several industry groups, including the Investment Company Institute, the Securities Industry Association, the Alliance In Support of Independent Research, and the Association for Investment Management and Research, have developed additional guidance and "best practices" for industry participants regarding soft dollar practices. The staff believes that the recommendations contained in this report, along with "best practices" guidelines, will help strengthen compliance by securities industry participants.

65 See Section 28(e).

66 The applicability of the safe harbor depends on how a product or service is used, and advisers' uses or intended uses of products were not always discernible from information available at the broker-dealers' offices. The 35% figure is conservative, however, in that it was based on products or services that we assume do not include possible Section 28(e) uses (e.g., travel, furniture, etc.).

67 We found twenty-six brokers that refused to pay for a product/service requested by an adviser and which the brokers believed to be inappropriate under a soft dollar arrangement. These products and services included: rent, travel and lodging expenses, legal services, a car phone, magazine subscriptions, office equipment, furniture and computers.

68 This broker-dealer has a routine procedure requiring a determination as to whether a soft dollar arrangement is eligible for the safe harbor. If an adviser's use of the product or service falls outside of the safe harbor, the firm will not provide it with products for soft dollars unless it verifies that the adviser has obtained the consent of its clients. When a product/service may have a mixed use, the broker-dealer informs the adviser that it may have to make an allocation of the cost of that product or service between its research and non-research uses. If the product or service is provided to an advisory client under a directed brokerage arrangement, this broker-dealer obtains a representation that the adviser's client is authorized to obtain the product or service prior to providing it.

69 On average, advisers directed $13,162 for each non-research arrangement ranging from $60 for a pricing service payment to $171,959 for a proxy voting system.

70 As noted, the 1986 Release stated that "the controlling principle to be used to determine whether something is research is whether it provides lawful and appropriate assistance to the money manager in the carrying out of his investment decision-making responsibilities." 1986 Release at 9.

71 Id. at 10-11.

72 1986 Release at 11-12. The Commission also stated that obvious "overhead" expenses, such as office space, typewriters, furniture and clerical assistance, are not research. 1986 Release at 9.

73 The information in the table is based on a sample of 202 inspections where complete information was available regarding the types of transactions used to generate soft dollar credits.

74 Supra note 46.

75 See discussion supra Section II.H.

76 Form ADV requires disclosure of whether the value of products, research or services provided to the adviser is a factor in the selection of the broker-dealer and in the commission rates paid. See also Form N-1A, Item 16 which requires similar disclosure in fund registration statements.

77 17 CFR 240.10b-10. The Commission has cautioned broker-dealers against effecting step-out transactions that do not meet the requirements of Rule 10b-10 or the requirements for the Section 28(e) safe harbor. See Exchange Act Release No. 29492 (July 26, 1991) (order approving NYSE Overnight Comparison System that facilitates step-out transactions).

78 The confirmation disclosure and delivery requirements for step-out transactions are different from the requirements for transactions involving introducing-clearing arrangements. In an introducing-clearing arrangement, the responsibilities of each broker-dealer are determined pursuant to a written agreement that is provided to the customer upon the establishment of the account or the establishment of the introducing-clearing arrangement. Customers thereafter have a reasonable expectation of the responsibilities of both the introducing broker-dealer and the clearing broker-dealer in transactions effected for their account. See NYSE Rule 382 and NASD Rule 3230. In a step-out transaction, customers may be unaware of their relationship to each broker-dealer and of the responsibilities of each broker-dealer in the transaction. The responsibilities of each broker-dealer presumably may vary on a transaction-by-transaction basis.

Because step-out transactions often do not involve ongoing relations to which the customer consents, it is unlikely that broker-dealers would be able to send a single joint confirmation on behalf of both broker-dealers. See SEC No-Action Letter, Prime Broker Committee (January 25, 1994). The staff of the Division of Maket Regulation, however, will consider requests for exemptive relief permitting broker-dealers in step-out transactions to send a joint confirmation in circumstances where the customer may reasonably consent to such use.

79 Advisers are required to provide sufficient information to enable a client or potential client to understand the adviser's brokerage allocation policies and practices. More detailed or additional information and

explanatory material could and should be provided where necessary, because of circumstances in particular cases, to ensure that all material information regarding brokerage placement practices and policies will be disclosed to investors. 1986 Release at 21.

80 These conclusions are based on examiners' review of Forms ADV. It was not always possible, based on the documents reviewed during the examinations, to determine whether advisers disclosed their uses of soft dollars in other documents provided to clients and potential clients.

81 For example, typical of the boilerplate disclosure that we observed was: Brokers or dealers who execute transactions on behalf of the [adviser] may receive commissions which are in excess of the amount of commissions which other brokers or dealers would have charged for effecting such transactions provided the [adviser] determines in good faith that such commissions are reasonable in relation to the value of the brokerage and/or research services provided by such executing brokers or dealers viewed in terms of a particular transaction or the [adviser's] overall responsibilities to [clients]. This disclosure does not provide clients with sufficient information about the products or services that the adviser is obtaining through its soft dollar arrangements or the conflicts of interest that such arrangements present to the adviser.

Another adviser who used principal trades to generate soft dollar credits, which it used to pay for its office rent, disclosed that: [Adviser] may enter into certain soft dollar' arrangements that pay soft dollars' to purchase certain products, research or services provided by brokers. [Adviser] views its receipt of soft dollars' as an ancillary benefit and generally will not direct client transactions to any broker in order to receive soft dollars.' [Adviser] will ensure that all such arrangements come under the safe harbor' of Section 28(e) of the Securities Exchange Act of 1934.

The staff is concerned that this disclosure may be false and misleading because principal trades do not generate soft dollar credits within the safe harbor of Section 28(e), and payment of rent is not within the safe harbor.

82 As noted in the Background section, advisers of investment companies generally are prohibited from acquiring items outside of the safe harbor of Section 28(e), irrespective of disclosure. We did not observe any instances in which fund commissions were used to purchase non-research items which did not directly benefit the funds themselves.

83 See Investment Company Act Release No. 21221 (Jul. 21, 1995) and supra note 38.

84 In an examination preceding the sweep, we found that an adviser whose principal acted as the general partner of a limited partnership used soft dollars to pay for personal credit card charges. Charges included: airfare, expensive hotel rooms, room service and health club costs, limousine services and clothing items. The offering materials for the limited partnership did not disclose that the general partner would use soft dollars in this manner.

85 See 1986 Release at 19.

86 Although as described herein, the antifraud provisions of the federal securities laws may require such specific itemization, depending on the product or service purchased.

87 The Commission already has stated that disclosure to the effect that "various research reports and products are obtained" does not provide the required specificity. See 1986 Release at 20.

88 Revised Form ADV also should require advisers to place disclosure about their soft dollar practices in a context in which clients and potential clients can comprehend the nature of the conflicts of interest created by the use of soft dollars.

89 Broker-dealers and advisers may be held liable for their failure to reasonably supervise, with a view to preventing violations of the federal securities laws by supervised persons. See discussion supra Section II.H. regarding Section 15(b)(4)(E) of the Exchange Act and Section 203(e)(6) of the Advisers Act.