PENSION AND WELFARE BENEFIT ADMINISTRATION

Securities Exchange Act of 1934 -- Section 28(e)
July 25, 1990
Pension and Welfare Benefit Administration

TOTAL NUMBER OF LETTERS: 2

SEC-REPLY-1:
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

July 25, 1990

Charles Lerner, Esq.
Director of Enforcement
Pension and Welfare Benefit Administration
U.S. Department of Labor
Washington, D.C. 2021077

Re: Section 28(e) of the Securities Exchange Act of 1934

Dear Mr. Lerner:

This is in response to your letter dated March 23, 1990 in which you request the staff's advice regarding the application of Section 28(e) of the Securities Exchange Act of 1934 ("Exchange Act") to certain soft dollar practices observed by investigators of the Department of Labor ("DOL") involving employee benefit plans covered by the Employee Retirement Income Security Act of 1974 ("ERISA"). In your letter and subsequent telephone conversations, you presented the following generalized set of facts.

A pension fund manager handling investments for ERISA accounts that seeks to purchase fixed income securities will solicit offers from several broker-dealers, including a broker-dealer that provides research credits ("soft dollar broker-dealer"). The soft dollar broker-dealer, which does not maintain an inventory of securities, will obtain price quotations from a number of other dealers. The soft dollar broker-dealer will add a markup to the best quote that it receives from these dealers and report back to the pension fund manager with its net quote, which includes the markup. If the soft dollar broker-dealer's net quote is less than or equal to the best independent quote received by the pension fund manager, the pension fund manager may determine to purchase the fixed income securities from the soft dollar broker-dealer. The soft dollar broker-dealer will effect the transaction by selling the security for its own account, charging a markup, and contemporaneously purchasing the security from a dealer (i.e., a so-called "riskless principal" transaction). The pension fund manager receives a credit for a portion of the markup charged, which can be used to pay for research or other products or services provided by the soft dollar broker-dealer.

In addition, a pension fund manager may effect transactions in financial futures through a soft dollar broker-dealer. The soft dollar broker-dealer will execute the transaction as an agent, charging a commission. The pension fund manager will receive a research credit for a portion of the commission charged on the transaction, which can be used to pay for research or other products or services provided by the soft dollar broker-dealer.

You state that DOL is considering enforcement proceedings against investment management firms engaging in such practices. You anticipate that investment management firms and broker-dealers might claim that these practices qualify for protection under the safe harbor of Section 28(e). You therefore request the staff's views concerning the application of Section 28(e) to these facts.

Response:

Section 28(e) provides a safe harbor to investment managers who use the commission dollars of their advised accounts to obtain investment research and brokerage services. The section 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 under state or federal law solely by reason of his having caused an account to pay more to a broker-dealer than the lowest available commission if that 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 by that broker-dealer. The standard for determining if brokerage and research services, as defined in Section 28(e)(3), are within the confines of the safe harbor is whether the product or service "provides lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities." n1

The Division believes that transactions executed in a principal (including a riskless principal) capacity are not afforded the protection of the Section 28(e) safe harbor. In particular, the Division notes that Section 28(e) refers to "commissions" only, which connote transactions effected on an agency basis, and does not refer to markups or markdowns, which would more clearly have suggested that Congress intended to extend the safe harbor to principal transactions. n2 In addition, the extensive legislative history of this section indicates that the safe harbor was designed to address anticipated problems in the exchange market for equity securities potentially resulting from the impending demise of fixed commission rates on exchange-listed securities. Furthermore, although the need for legislation to address the fiduciary concerns in an era of unfixed commission rates was strongly urged on the Congress, no mention was made of analogous problems fiduciaries might face in transactions executed in a principal or riskless principal capacity or of the need for the safe harbor to apply to such transactions. Finally, as the Commission has explained:

Since Section 28(e) involves a statutory exemption for conduct which might otherwise constitute a breach of fiduciary duty owed by a money manager to his client, the Commission believes that the section should be construed in light of its limited purposes. n3

The Division believes that this statutory exemption should not be expanded by interpretation to encompass an area not clearly envisioned by Congress.

The Division also believes that transactions in futures are not afforded the protection of the safe harbor of Section 28(e). There is no reference to futures transactions in the legislative history, and the Division believes that transactions in futures were not intended to be covered by the protections of the safe harbor for essentially the same reasons discussed above. n4

Therefore, the Division does not believe that an investment management firm and broker-dealer engaging in the practices described in your letter would be able to rely on the safe harbor of Section 28(e).

Of course, Section 28(e) simply provides a "safe harbor." n5 Evaluation of the consequences of being outside of the safe harbor provided by Section 28(e) requires analysis of the requirements imposed by particular applicable statutes, such as ERISA and the Investment Company Act of 1940, and by general fiduciary principles embodied in the federal securities laws and relevant state law.

If you have any additional questions, please contact Larry E. Bergmann, Associate Director, at 272-2836 or Robert L.D. Colby, Chief Counsel, at 272-2844.

Sincerely,

Richard G. Ketchum
Director

Footnotes

n1 Securities Exchange Act Release No. 23170 (April 23, 1986), 51 FR 16004, 16006; see also Senate Committee on Banking, Housing and Urban Affairs, Report to Accompany S.249, S. Rep. No. 94-123, 94th Cong., 1st Sess., 71 (1975).

n2 Section 28(e)(1) employs the phrase "member of an exchange, broker, or dealer." Because the terms "member of an exchange" and "dealer" are used, an argument can be made that the safe harbor was intended to include transactions executed in a principal capacity. The Division believes, however, that the conjunction of the terms "broker" and "dealer" in this context is a stylistic convention, since this form is often used in the Exchange Act. Furthermore, the Division believes that reference to the term "dealer" and "member of an exchange" indicated recognition of the fact that many brokers may also be dealers and members of an exchange. Cf. Section 11(d)(2) of the Exchange Act.

n3 Report of Investigation in the Matter of Investment Information, Inc. Relating to the Activities of Certain Investment Advisers, Banks and Broker-Dealers, Securities Exchange Act Release No. 16679, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 82,481 (March 19, 1980).

n4 In contrast, the Division believes that research on financial futures products can be obtained through soft dollar transactions within the safe harbor. In support of this position, the Division notes that the legislative history of this section provides that the definition of research and brokerage services "was intended to comprehend the subject matter in the broadest possible terms." Senate Committee on Banking, Housing and Urban Affairs, Report to Accompany S.249, S. Rep. No. 94-123, 94th Cong., 1st Sess., 71 (1975). The fundamental questions are whether such research constitutes "brokerage and research services" as defined in Section 28(e)(3), and whether such research "provides lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities."

n5 Section 28(e) does not shield a person who exercises investment discretion from charges of violations of the antifraud provisions of the federal securities laws or from allegations, for example, of churning of an account, failing to seek the best price, or failing to make required disclosures. See Release 34-23170, 51 FR at 16005.

INQUIRY-1:
U.S. Department of Labor
Pension and Welfare Benefits Administration
Washington, D.C. 20210

March 23, 1990

Richard Ketchum, Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Mr. Ketchum:

This is to request an interpretation as to whether principal transactions in fixed income trades, over-the-counter trades and futures transactions are protected by the limited safe harbor of Section 28(e) of the Securities Exchange Act of 1934. The Pension and Welfare Benefits Administration is responsible for the regulation and enforcement of certain provisions of the Employee Retirement Income Security Act of 1974 (ERISA). Since Section 28(e) by its terms preempts the application of other state and federal laws,

including ERISA, we request this interpretation before proceeding with enforcement consideration of cases involving these issues.

As we understand the circumstances, a money manager seeking to purchase securities or futures contracts will solicit offers from several firms including a broker-dealer who will provide soft dollar credits, i.e. a "soft dollar converter." The soft dollar converter will obtain price quotations from several other dealers including primary dealers and communicate the price to the manager. If the manager chooses to purchase from the soft dollar converter, acting as principal, then the manager will be credited with a portion of the mark up that the converter charges which then can be used to pay for services provided by a third party, that is soft dollar services. This is one type of principal transaction in issue that does not include a "commission" but rather invoices a "mark-up."

Over the past several months, we have had discussions with representatives of various organizations who have presented views on the issues of whether principal transactions and transactions in future contracts are within the purview of Section 28(e). Section 28(e) provides, as relevant here, that no person shall have breached a fiduciary duty under federal law solely by reason of having caused the payment to "a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission" was reasonable in relation to certain other services received. The Section would appear to be applicable only to transactions in which there is a "commission" and transactions in securities.

While the Department and the Securities and Exchange Commission have issued guidance in the area of the application of Section 28(e) in the past few years, there has not been any statement on these issues. The first question that is presented is whether Section 28(e) includes transactions with a dealer, acting as principal, in which a mark-up, which is not a commission, is charged. The second question is whether futures contracts are included within Section 28(e) which provides protection for transactions in "securities". Absent the safe harbor protection of Section 28(e) a fiduciary of an ERISA employee benefit plan may be in violation of the exclusive purpose, fiduciary and prohibited transactions provisions contained in Sections 403, 404 and 406 of ERISA.

If you have any questions please contact me at 523-8840.

Sincerely,

Charles Lerner
Director of Enforcement