CHARLES LERNER, ESQ.

Securities Exchange Act of 1934 -- Section 28(e)

Oct 25, 1988

Charles Lerner, Esq.

TOTAL NUMBER OF LETTERS: 2

SEC-REPLY-1:
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 200549
October 25, 1988

Charles Lerner, Esq.
Director of Enforcement
Pension and Welfare Benefit Administration
U.S. Department of Labor
Washington, D.C. 20210

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

Dear Mr. Lerner:

This is in response to your letter dated August 4, 1988 in which you request the staff's advice regarding the applicability of Section 28(e) of the Securities Exchange Act of 1934 (the "Exchange Act") to certain commission practices discovered by investigators of the Department of Labor ("DOL") involving employee benefit plans covered by the Employee Retirement Income Security Act ("ERISA"). In your letter and subsequent telephone conversations, you presented the following generalized set of facts.

An investment management firm handles investments for both ERISA and non-ERISA accounts. On occasion the investment manager errs in ordering trades. For example, the orders given to a broker by a trader for the investment manager cause: (1) the purchase or sale of the wrong security (e.g., common stock of AT&T, instead of IT&T); (2) the purchase or sales of an incorrect amount of shares of a security; (3) the purchase or sale of a security at a price not in accordance with the instructions provided to the investment manager; or (4) a purchase of a security when the intent was to sell, or vice versa.

When the investment manager discovers the mistake, he works out an arrangement with the broker-dealer who originally executed the trade. As a result, the broker-dealer reverses or offsets the trade. If the cost of correcting the trade is the same as the original order, or if there is a gain, then that completes the arrangement. However, if a loss is incurred, the broker-dealer agrees to carry the loss temporarily. In return, the investment manager commits to direct to the broker-dealer sufficient commission revenues to cover the amount of the loss. Under this commitment the investment manager may direct to the broker-dealer commission revenues one and one-half to two times the amount of loss temporarily carried by the broker-dealer. The compensating commissions under this "soft dollar" arrangement can originate from trades for any account under the investment manager's control, and not just from the accounts involved in the original order. The individual commissions charged generally do not exceed those charged by the broker for other trades. Nor is there any indication that the investment manager increases its volume of trading in order to generate the compensating commissions.

You state that DOL is considering litigation against investment management firms engaging in such practices. You anticipate that investment management firms and broker-dealers might maintain that the practice qualifies for protection under Section 28(e) of the Exchange Act as a "brokerage service" on the ground that an error correction is one of the functions incidental to a securities transaction similar to settlement, clearance, or custody functions. 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 states 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 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. The standard for determining if brokerage and research services are within the confines of Section 28(e) depends on whether the product or service "provides lawful and appropriate assistance to the money manager in the performance of his responsibilities." n1

The Division believes that an investment manager has an obligation to place orders correctly for its advised and non-advised accounts. n2 Accordingly, if an investment manager makes an error while placing a trade for an account, then the investment manager, in order to comply with its obligation to its customer, must bear any costs of correcting such trade. Because an investment manager itself is responsible for any losses resulting from an inaccurate or erroneous order placed for an advised account, a broker provides no value to that advised account by offsetting the trade and carrying the loss. Instead, this conduct solely benefits the investment manager. Therefore, because the use of commission dollars to compensate for manager errors would not provide any benefit or assistance to an advised account, the Division does not believe that the broker's error correction functions should be viewed as providing "lawful and appropriate assistance" to the investment manager in the carrying out of his responsibilities to advised accounts. Nor can the "error correction" trade be considered "incidental" to the initial trade for the client within the meaning of Section 28(e)(3)(C); it is an entirely separate transaction effected to correct the manager's error, not to benefit the advised account. Thus, in the Division's view these error correction functions would not constitute "brokerage services" for purposes of Section 28(e).

Similarly, in the Division's view, a broker's function in correcting an error made by the investment manager does not constitute "research" because it does not contribute to the investment manager's decision-making process. Such error correction services would not constitute "lawful and appropriate assistance" to the investment manager in the performance of its decision-making responsibilities on behalf of the account beneficiary.

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

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

Sincerely,
Richard G. Ketchum
Director

Footnotes

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

n2 Section 28(e) provides a non-exclusive safe-harbor from liability under state or federal fiduciary law to investment managers making reasonable use of client commission dollars to obtain brokerage and research services. In addressing the applicability of the Section 28(e) safe-harbor to the facts that you have presented, the Division expresses no opinion regarding the ultimate lawfulness of the investment manager's commission practices under ERISA or any other statutory provision. Moreover, the Division is not addressing the effect on the investment manager's responsibilities to its client of disclosure to the client of the investment manager's commission practices, or of contractual provisions expressly designed to modify these responsibilities.

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

Richard Ketchum, Director
Division of Market Regulation
Securities and Exchange Commission
Stop 5-1
450 5th St. N.W.
Washington, D.C. 20549
Attn: Robert L. D. Colby
Chief Counsel

Dear Mr. Ketchum:

I am writing to request your assistance in determining the application of section 28(e) of the Securities Exchange Act of 1934 to certain practices involving employee benefit plans covered by the Employee Retirement Income Security Act ("ERISA"). The central issue concerns the manner in which investment management firms have handled correction of their errors, in particular where a loss results, in transactions of employee benefit plan accounts.

The following is a general description of what our investigators have encountered. An investment management firm handles investments for both ERISA- and non-ERISA accounts. From time to time the firm errs in ordering trades. For example, the investment manager's trader mistakenly orders to a broker result in 1) the purchase or sale of the wrong security (e.g. common stock of AT&T, instead of IT&T); 2) the purchase or sale of an incorrect amount of a security; 3) the purchase or sale at a price not in accordance with instructions; or 4) a purchase when the intention was to sell, or vice versa.

When the investment manager discovers the mistake he works out an arrangement with the broker-dealer who originally executed the trade. First, the broker executes the proper trade. If the cost of the correcting trade is the same as the original, or if there is a gain, that completes the matter. However, if a loss is incurred, the broker-dealer agrees to absorb it temporarily. The investment manager then agrees to a soft dollar commitment with the broker to cover the amount of the loss which may generate commissions worth one and a half to two times the amount of the loss absorbed by the broker-dealer. Although it is possible that at the time of any particular compensating trade another broker-dealer might have offered a lower commission, we have no evidence indicating that investment management firms have paid any premium in commission fees to broker-dealers for these error corrections. n1 We have noted that the compensating trades can come from any account under management and not just the account involved in the original error.

The investment management firms and broker-dealers might defend this practice in two ways. First, in practical terms, they might maintain that this is an effective way to correct errors without anyone (e.g. the investment firm or its client) having to suffer a loss for a transaction that would have been effected in any event. Second, in legal terms, they might maintain that the practice qualifies for protection under section 28(e) as a "brokerage service". Based on the definition of "brokerage and research services" in section 28(e)(3)(C), an investment management firm might assert that error correction should be seen as one of the functions incidental to a securities transaction similar to settlement, clearance or custody functions.

The Department is considering litigation against investment management firms engaging in such practices. However, if the use of "soft dollars" commissions for error correction is a form of brokerage service then section 28(e) would appear to protect such firms against charges of breach of fiduciary duty under ERISA. Thus, any case we might bring appears to be dependent on whether using soft dollars to correct trading errors qualifies as a brokerage service under section 28(e).

The Pension and Welfare Benefits Administration requests consideration of this matter and for an opinion as to whether the error correction practices described above constitute "brokerage services" within the meaning of section 28(e). If you have any questions please contact Richard Mounts, an attorney in the Plan Benefits Security Division of the Office of the Solicitor, at 523-8297.

Sincerely,
Charles Lerner
Director of Enforcement

Footnote

n1 Nor does it appear that firms have engaged in "churning"; it appears that the transaction would have been made in any case. The error commitment meant only that trades would be directed to the specific brokers.