Expanding Safe Harbors for Soft Dollars

by Steve W. Stone and Jack P. Drogin*

In 2001's final days, the SEC expanded the safe harbor for "soft dollar" arrangements under Section 28(e) of the Securities Exchange Act to cover "flat" riskless principal trades (trades in which both buyer and seller pay the same price) by market makers in Nasdaq securities.[1] This action reversed a longstanding SEC position—based on a technical and narrow view of what a "commission" is for Section 28(e) purposes—that riskless principal trades fell outside the Section 28(e) safe harbor. The SEC's new approach broadens the concept of "commission" and focuses on what level of transparency a money manager needs to determine that the commissions paid for soft dollar trades are reasonable. The SEC's action provides money managers and broker-dealers with added flexibility to structure trades in Nasdaq securities within the Section 28(e) safe harbor while minimizing interpositioning and best execution concerns.

Background

Section 28(e) of the Exchange Act provides a safe harbor to money managers that use commission dollars from accounts they advise to obtain research and brokerage services. Specifically, Section 28(e) protects a person who exercises investment discretion over an account from being "deemed to have acted unlawfully or to have breached a fiduciary duty ... solely by reason of his having caused the account to pay a [broker-dealer] *an amount of commission* for effecting a securities transaction in excess of the amount of commission another [broker-dealer] would have charged for effecting that transaction, if [the money manager] determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such [broker-dealer]." (Emphasis added.) This excess commission amount is commonly known as "soft dollars."

Consistent with the SEC's view that a preemptive provision like Section 28(e) should be construed narrowly, the SEC and its staff have, until now, interpreted the safe harbor as covering only agency trades in which commissions were paid; the term "commission" was read as specifically *excluding* commission equivalents paid in riskless principal trades. This position, which was first announced in a July 25, 1990, letter from SEC staff to the Department of Labor's Pension and Welfare Benefit Administration, was ultimately adopted by the SEC in 1995.[2]

In its 1990 letter, the staff reasoned that Section 28(e)'s reference to "commission" was intentionally restrictive: "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." The staff went further in a letter to Hoenig & Co. later that year, saying that "the fact that the broker-dealer imposes a charge that is denominated as a 'commission' or 'commission equivalent,' rather than a mark-up, would not be relevant to the application of Section 28(e) if the firm, in fact, acted in a principal or riskless principal capacity."[3]

The New Approach

In response to a request from Nasdaq,[4] the SEC reconsidered its earlier position and ultimately agreed it was too limited, particularly given the transparency achieved in the Nasdaq market for certain riskless principal trades. Accordingly, the SEC clarified that the term "commission" for purposes of Section 28(e)

* Steven W. Stone (sstone@morganlewis.com) is a partner, and Jack P. Drogin (jdrogin@morganlewis.com) is Of Counsel, in the Washington office of Morgan, Lewis & Bockius LLP (www.morganlewis.com). Copyright © 2002 Morgan, Lewis & Bockius LLP. All rights reserved.

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includes a markup, markdown, commission equivalent or other fee paid by a managed account to a dealer for executing a trade where there is adequate transparency of both price and trading costs to enable the money manager to make its requisite "reasonableness" determination. To achieve this transparency:

- The commission and trade price must be "fully and separately disclosed on the confirmation"; and
- The trade must be "reported under conditions that provide independent and objective verification of the transaction price subject to self-regulatory organization oversight."

The SEC artfully dispatched its earlier interpretation, which had been based on the generally understood meaning of "commission" as a fee in an agency trade, by stating that the earlier interpretation "is not mandated by the language of the statute." In support, the SEC pointed to Section 28(e)'s reference to "dealer" as suggesting that the term "commission" may include fees paid to a broker-dealer acting in a principal capacity.

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To be fair, the SEC observed that, when it developed its earlier guidance, principal trades had less transparency than agency trades "because frequently embedded within the cost of a principal trade was undisclosed compensation to the dealer. In other words, fees on principal trades were not *quantifiable and fully disclosed* in a way that would permit a money manager to determine that the fees were reasonable in relation to the value of the research and brokerage received." (Emphasis added.) The SEC concluded that recent changes in Nasdaq's trade reporting rules now provide enough transparency in flat riskless principal trades in Nasdaq securities to bring such trades within the safe harbor. In particular, new trade reporting rules require that a flat riskless principal trade (which the SEC dubs an "Eligible Riskless Principal Transaction") be reported once, in the same way as an agency trade, exclusive of any markup, markdown, commission equivalent or other fee.[5] In the SEC's view, reporting both legs of the trade at the same price provides independent verification of the price paid (and received).

Bolstering the changes in Nasdaq's internal trade reporting rules for flat riskless principal trades, Exchange Act Rule 10b-10 requires market makers in Nasdaq securities to disclose on the trade confirmation the reported price (the "flat" price), the price paid by the customer (the "flat" price plus the markup or minus the markdown), and the difference (if any) between the two (the trade cost). By comparison, broker-dealers are not required to disclose markups or markdowns on debt securities (in which there are no market makers for purposes of Rule 10b-10[6]) or on riskless principal trades by non-market makers in Nasdaq or non-Nasdaq equity securities. That is because there is no independent reporting requirement for those trades that distinguishes the price at which the customer bought or sold a security from the "reported price" disclosed by the market maker as the street price for the security.

Based on this reasoning, the SEC distinguished fees paid for Eligible Riskless Principal Transactions from fees paid on ordinary principal and riskless principal trades because the latter can include "undisclosed fees." The SEC also observed that, in contrast to a flat Eligible Riskless Principal Transaction, "the price of [a traditional principal] trade, if reported, is to some degree within the control of the dealer."

Scope of Revised Interpretation

At present, the SEC's broadened interpretation applies only to Eligible Riskless Principal Transactions in Nasdaq securities. Presumably in an effort to make it harder for firms (or their counsel) to interpret this relief broadly, the SEC added a footnote (number 9) to its guidance, which states that riskless principal trades in debt securities "would not be within the Section 28(e) safe harbor" because transactions in those securities are not now subject to confirmation and reporting requirements that provide the requisite transparency.[7] Similarly, the SEC warned that the interpretation does not "currently" extend to riskless principal trades in OTC Bulletin Board stocks, Pink Sheet stocks, con-

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vertible securities or other securities that may be subject to similar reporting requirements but not the same confirmation disclosure requirements for market makers. Nevertheless, the SEC held out the promise that "as other markets develop equivalent regulations to ensure equivalent transparency, transaction charges in those markets that meet the requirements of this interpretation will be considered to fall within the interpretation."

A Welcome Start, With Some Shortcomings

However welcome, the SEC's expansion of the Section 28(e) safe harbor suffers from several shortcomings. While properly refocusing the analysis on a money manager's reasonableness determination, the SEC's requirements for the information a money manager must have in hand are too rigid.

The interpretation assumes that a money manager's reasonableness determination can only be based on commission and trade price information where the commission is required to be disclosed under SEC or SRO confirmation rules and the trade is required to be reported under SRO rules. This assumption can be questioned on many levels.

[T]he SEC's requirements for the information a money manager must have in hand are too rigid.

First, a money manager's reasonableness determination is, under the terms of Section 28(e), supposed to be a flexible one—not requiring a trade-by-trade determination. Specifically, Section 28(e) allows a money manager to evaluate in light of "either [one] particular transaction *or* [the money manager's] overall responsibilities with respect to the accounts as to which [the manager] exercises investment discretion." This intended flexibility is reflected in Section 28(e)'s legislative history.[8]

Second, since the enactment of Section 28(e) in 1975, money managers have made reasonableness determinations for agency trades that would not stand up to the SEC's new test, without any SEC comment or question. When Section 28(e) was enacted, there was no SRO-mandated trade reporting for over-the-counter transactions, and Congress could scarcely be said to have believed that trade reporting was a prerequisite to a well-informed decision. Similarly, the SEC has never indicated that soft dollars can only be paid in transactions in liquid reported securities. Thus, the statutory basis for the SRO reporting requirement is unclear at best.

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Third, the SEC approach is curiously premised on the notion that agency fees are completely transparent and principal fees are not. However, undisclosed compensation in agency trades has always been possible, subject to modest disclosure requirements that provide for notice of other compensation (but not necessarily any quantification).[9]

Fourth, the interpretation assumes that, in contrast to prices in ordinary riskless principal trades that the SEC claims are "within the control of the dealer," flat riskless principal trades in Nasdaq do not possess the same "wiggle room" and are independently verifiable. In fact, money managers and broker-dealers may negotiate the reported price and markup or markdown for flat riskless principal trades just as they currently do for other principal trades in reported securities.

Fifth, it is unclear why a broker-dealer could not certify the commission and trade price (on a confirmation or other document) in any type of trade, and why a money manager would not be acting reasonably in relying on this certification (unless, of course, it was on notice of problems in the information).[10] After all, the broker-dealer would be required to retain this certification under the SEC's books and records rules, the certification would be open to SEC and SRO review, and the certification would be subject to the applicable antifraud provisions of federal and state securities laws.

Finally, the SEC stayed silent on one additional area to which the safe harbor could easily be applied (and for which counsel for some firms have opined): fixed price offerings. In a fixed price offering, the dealer purchases the securities from the issuer at a discount and resells the securities to an investor at a fixed price. The dealer's selling concession is fully

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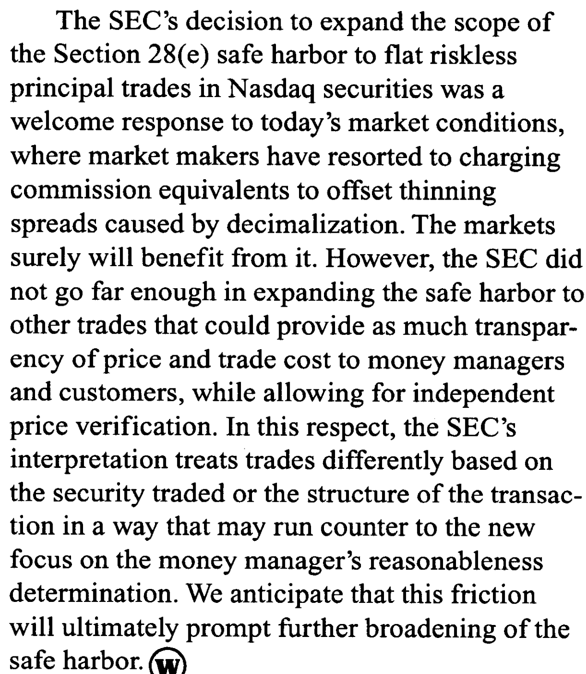
disclosed to the purchaser, and the dealer is prohibited by NASD rules from reselling the securities in the primary offering for any price other than the predetermined price.[11] Fixed price offerings, therefore, appear to meet the SEC's test that the "fee and transaction price are fully and separately disclosed on the confirmation and the transaction is reported under conditions that provide independent and objective verification of the transaction price subject to self-regulatory oversight."

Further Expansion

The SEC's decision to bring flat riskless principal trades within the Section 28(e) safe harbor hopefully will provide an impetus for the SEC to reexamine its positions on riskless principal trades in other areas. Indeed, the SEC's action was quickly recognized as providing an opportunity for change elsewhere: within days of the issuance of this guidance, the Investment Company Institute requested that the SEC reexamine the treatment of riskless principal transactions under Section 17 of the Investment Company Act of 1940.[12]

[T]he SEC did not go far enough in expanding the safe harbor to other trades.



The SEC's decision to expand the scope of the Section 28(e) safe harbor to flat riskless principal trades in Nasdaq securities was a welcome response to today's market conditions, where market makers have resorted to charging commission equivalents to offset thinning spreads caused by decimalization. The markets surely will benefit from it. However, the SEC did not go far enough in expanding the safe harbor to other trades that could provide as much transparency of price and trade cost to money managers and customers, while allowing for independent price verification. In this respect, the SEC's interpretation treats trades differently based on the security traded or the structure of the transaction in a way that may run counter to the new focus on the money manager's reasonableness determination. We anticipate that this friction will ultimately prompt further broadening of the safe harbor. Ⓦ

Notes

1 Commission Guidance on the Scope of Section 28(e) of the Exchange Act, Securities Exchange Act Release No. 45194 (Dec. 27, 2001) <www.sec.gov/rules/interp/34-45194.htm>.

2 *See* Disclosure by Investment Advisers Regarding Soft Dollar Practices, Investment Advisers Act Release No. 1469 (Feb. 14, 1995) (stating "[t]he safe harbor does not encompass soft dollar arrangements under which research services are acquired as a result of principal transactions").

3 *See* Hoenig & Co. (Oct. 15, 1990); *see also* Instinet Corporation (Jan. 15, 1992).

4 *See* Letter from Hardwick Simmons, Chief Executive Officer, The Nasdaq Stock Market, Inc., to Harvey L. Pitt, dated September 7, 2001.

5 *See, e.g.*, NASD Rule 4632 (applicable to Nasdaq National Market securities); NASD Rule 4642 (applicable to Nasdaq SmallCap Market securities); and NASD Rule 6420 (applicable to "eligible securities"); *see also* Special NASD Notice to Members 01-85 <www.nasdr.com/pdf-text/0185ntm.txt>; NASD Notice to Members 00-79 <www.nasdr.com/pdf-text/0079ntm.txt>; NASD Notice to Members 99-66 <www.nasdr.com/pdf-text/9966ntm.txt>; NASD Notice to Members 99-65 <www.nasdr.com/pdf-text/9965ntm.txt>.

6 *See* Public Securities Association (March 30, 1995).

7 In a recent speech, SEC Division of Market Regulation Director Annette L. Nazareth noted that implementation of the TRACE Transaction Reporting System "likely would not" satisfy the SEC's requirement of trade reporting that provides independent and objective verification of trade price subject to SRO oversight because TRACE requires trade reporting on a net basis. *See* Annette L. Nazareth, Remarks before The Bond Market Association Legal and Compliance Conference, dated January 8, 2002 <www.sec.gov/news/speech/spch532.htm>.

8 *See* S. Rep. No. 75, 94th Cong., 1st Sess. 70 (1975).

9 *See* Exchange Act Rule 10b-10(a)(ii)(C) & (D) (requiring notice of receipt of payment for order flow and other remuneration).

10 *Cf.* Securities Act of 1933 Rule 144A(d)(1)(iv) (permitting a seller to rely on a certificate of an officer of a prospective buyer regarding the buyer's status as a qualified institutional buyer).

11 *See* NASD Rule 2740 (Selling Concessions, Discounts and Other Allowances).

12 *See* Letter from Craig S. Tyle, General Counsel, ICI, to Harvey L. Pitt, dated January 4, 2002 <www.ici.org/riskless_princ_trans_com.html>. The ICI had twice requested that the SEC adopt an exemptive rule under Section 17(a) of the 1940 Act for riskless principal trades. In its January 4, 2002 letter, the ICI did not request relief from Section 206(3) of the Investment Advisers Act, which also restricts principal trades, although the same principles should apply here as well. To date the SEC staff has provided only limited relief from the provisions of Section 206(3) with regard to riskless principal trades. *See* Merrill Lynch Trust Company, FSB (July 6, 2000) (allowing riskless principal trades by placement agents).

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