ALERTS

SEC Confirmation that Fixed-Income Commissions Can Satisfy the Section 28(e) "Soft Dollars" Safe Harbor

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Registered investment advisers in the process of planning an annual compliance review will generally include a review of their best execution processes and their use of so-called "soft dollars." Managers that trade in fixed-income securities may find it useful to review a no-action letter issued earlier this year by the Division of Trading and Markets of the U.S. Securities and Exchange Commission. This letter, granted to Carolina Capital Markets Inc.,[1] confirmed that institutional asset managers, in reliance on the safe harbor of Section 28(e) of the Securities Exchange Act of 1934, may purchase eligible third-party brokerage and research services with commissions generated by qualifying transactions in fixed-income securities.

Background on the Section 28(e) Safe Harbor

Section 28(e) of the Securities Exchange Act of 1934 creates a safe harbor that allows private fund managers (and other investment advisers), under certain circumstances, to use client commission payments to purchase eligible brokerage and research services. The Section 28(e) safe harbor protects a manager from a claim that it breached its "best execution" fiduciary duty by not selecting, in conjunction with a purchase of eligible brokerage and research services, the lowest commission rate available.

The portion of a client commission that is used to purchase eligible research or brokerage services by a manager is referred to as "soft

dollars." To qualify for the Section 28(e) safe harbor, a "soft dollared" product or service must satisfy a three-step test:

1. The manager must determine that the product or service is *eligible* "research"[2] or "brokerage."[3]

2. The manager must determine that the eligible research or brokerage product or service provides "lawful and appropriate assistance"[4] to the manager in making investment decisions.

3. Finally, the manager must determine that the applicable commissions are reasonable in relation to the value of the products or services received.

The Eligibility of Fixed-Income Commissions Under the Section 28(e) Safe Harbor

The 1998 OCIE Soft Dollars Study. The use of fixed-income trades to generate soft dollars has been scrutinized for some time. In a 1998 study,[5] the SEC's Office of Compliance Inspections and Examinations focused on fixed-income trades in two contexts:

First, OCIE noted in its review of problematic principal transactions that a small, but notable, percentage of the trades utilized to generate soft dollars in their sample came from fixed-income principal transactions. The study stated that the SEC staff "has long taken the position that advisers cannot claim the protection of Section 28(e) when generating soft dollar credits through principal trades[,]" and then went on to report that 3.6 percent of the advisers in its sample had earned soft dollar credits on principal trades of fixed-income securities. The study further noted that these fixed-income principal transactions were worrisome, among other reasons, because the confirmations of some of these trades

> "disclosed only the net amount of the trades and did not disclose commission amounts paid by clients . . . [and 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."

Second, the study also scrutinized fixed-income soft dollar commissions in the context of a review of over-the-counter transactions. It found that 21

percent of the advisers in its sample earned research credits based on OTC agency trades for fixed-income securities, but

> "[b]ecause 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 . . . because an agent is being interposed between an adviser's client and an OTC market maker, [and therefore] 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."

In other words, the study effectively concluded that the lack of transparency in commission rates and compensation amounts being paid to broker-dealers in fixed-income transactions, whether principal transactions or interposed OTC agency transactions, effectively put a client at risk of paying excessive commissions and therefore placed the transactions outside of the Section 28(e) safe harbor.

2001 SEC Soft Dollars Guidance. Three years later, however, the SEC reconsidered its general policy of restricting the Section 28(e) safe harbor to agency transactions.[6] In the 2001 release, in recognition of advances in OTC transaction reporting, the SEC modified the interpretation of the term "commission" in Section 28(e) to include "a markup, markdown, commission equivalent or other fee paid by a managed account to a dealer for executing a transaction where 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."

The effect of the 2001 release was to bring a subset of OTC transactions, i.e., those subject to an effective commission disclosure and reporting regime, within the Section 28(e) soft dollars safe harbor. This relief, however, did not expressly extend to fixed-income OTC transactions that were not part of the transaction reporting systems that the relief was predicated upon.

2006 SEC Soft Dollars Guidance. In 2006, the SEC issued a release that provided a new set of comprehensive guidance on soft dollar practices.[7] The 2006 release reiterated the requirement that "money managers

must make a good faith determination that commissions paid are reasonable in relation to the value of the products and services provided by broker-dealers[.]" It also clarified that "research services" are restricted to Section 28(e) "advice," "analyses" and "reports" and that "brokerage services" within the safe harbor are those products and services that relate to the execution of the trade from the point at which the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution, through the point at which funds or securities are delivered or credited to the advised account.

The 2006 Release did not, however, specifically address fixed-income commissions other than to state that "[m]anagers may not use client funds to obtain brokerage and research services under the safe harbor in connection with fixed-income trades *that are not executed on an agency basis*, principal trades (except for certain riskless principal trades), or other instruments traded net with no explicit commissions" (italics added).

2013 Carolina Capital No-Action Letter

In 2013, Carolina Capital Markets Inc., which describes itself as a "leading provider of third party fixed income research with superior execution" requested a no-action letter, presumably to provide comfort to its clients, that would confirm that commissions from fixed-income trades can constitute eligible "soft dollars" under the Section 28(e) safe harbor.

This request addresses a lack of clarity in the marketplace regarding fixed-income commissions. In Carolina Capital's no-action request, its counsel stated:

> "Notwithstanding our view [that SEC guidance suggests that commissions from agency transactions in fixed-income securities can satisfy the Section 28(e) safe harbor] . . . CCM has indicated to us that there is a fairly widespread misconception among fixed-income asset managers that the Section 28(e) safe harbor is unavailable or its availability is in doubt for acquiring third-party research through fixed-income transactions executed on an agency basis."

By issuing its July 2013 no-action letter, the SEC staff confirmed that commissions from fixed-income trades conducted on an agency basis can qualify for the Section 28(e) safe harbor, and that commissions from these fixed-income trades may be used to purchase third-party research,

assuming compliance with the other requirements of Section 28(e) and overall best execution.[8]

This guidance will not extend to all fixed-income transactions, as many of these kinds of trades are conducted on a principal basis (or otherwise do not qualify), but for qualifying trades, private fund managers now have certainty on their ability to utilize the Section 28(e) safe harbor.

Authored by Brian T. Daly and Marc E. Elovitz.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] Carolina Capital Markets Inc., SEC Staff No-Action Letter (July 30, 2013).

[2] A product or service constitutes eligible research within Section 28(e) if a manager concludes that the product or service constitutes "advice," "analyses" or a "report" (as those terms are interpreted by the SEC) and the product or service relates to the subject matter of Section 28(e).

[3] In 2006, the SEC clarified the definition of eligible "brokerage" services and established a temporal standard to differentiate eligible brokerage services from eligible research and ineligible overhead expenses; the SEC determined that eligible brokerage services begin when the manager "communicates with the broker-dealer for the purpose of transmitting an order for execution" and end when "funds or securities are delivered or credited to the advised account or the account holder's agent."

[4] A product or service may otherwise qualify as an eligible research or brokerage product or service within the meaning of Section 28(e) but may still be ineligible for the Section 28(e) safe harbor if the product or service does not provide "lawful and appropriate assistance" to the manager's investment decision-making process. The SEC introduced the "lawful and appropriate assistance" standard in a 1986 release and stated that "what constitutes lawful and appropriate assistance in any particular case will depend on the nature of the relationships between the various parties involved and is not susceptible to hard and fast rules." Later (2006) guidance indicated that managers, in addition to complying with the statutory requirements of Section 28(e) and making a good-faith determination that the cost of the product or service is reasonable, must

also show that the product was actually used to assist in the investment decision-making process.

[5] U.S. Securities and Exchange Commission, The Office of Compliance, Inspections and Examinations, *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds* (Sept. 22, 1998).

[6] Commission Guidance on the Scope of Section 28(e) of the Exchange Act, Securities Exchange Act Release No. 34-45194 (Dec. 27, 2001).

[7] Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Securities Exchange Act Release No. 34-54165 (July 18, 2006).

[8] The guidance provided by the SEC in this no-action letter will also increase certainty for managers who are considered "plan asset managers" for purposes of ERISA that the use of fixed-income commissions within the Section 28(e) safe harbor will not give rise to prohibited transactions. The Department of Labor ruled in a 1986 technical release that the use of commissions falling within the safe harbor does not give rise to prohibited transactions, because Section 28(e) was enacted after ERISA and thus superseded that law. *See* U.S. Department of Labor, Statement on Policies Concerning Soft Dollars and Directed Commission Arrangements, ERISA Technical Release No. 86-1 (May 22, 1986). This ruling likewise applies to the use of fixed-income commissions of the type at issue in Carolina Capital, provided the commissions satisfy all requirements of the Section 28(e) safe harbor as outlined here.

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