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Client Advisory

March 2002

SEC Revises Interpretation of Soft-Dollar Safe Harbor to Include Certain Riskless Principal Transactions

The Securities and Exchange Commission (the "SEC") recently published interpretive guidance (the "Interpretation") regarding application of the soft-dollar safe harbor found in Section 28(e) of the Securities Exchange Act of 1934 (the "Safe Harbor"). The Interpretation modifies the SEC's long-held view that the use of the term "commission" in the Safe Harbor limits its application to agency transactions. Instead, the SEC will now include fees paid to broker-dealers in connection with certain riskless principal transactions as commissions for purposes of the Safe Harbor. The Interpretation, Exchange Act Release No. 34-45194, can be found at www.sec.gov/rules/interp/34-45194.htm.

I. Introduction

The Safe Harbor provides that persons exercising investment discretion are not deemed to have acted unlawfully or breached a fiduciary duty solely by paying "a member of an exchange, broker, or dealer an amount of commission" that is higher than might have been charged by another "member of an exchange, broker, or dealer," provided that the person "determined in good faith that the amount of such commission was reasonable in relation to the value of the brokerage and research services provided."[1] The SEC traditionally has viewed the use of term "commission" in the Safe Harbor as limiting its application to brokerage and research services received from a broker-dealer in connection with agency transactions.[2] This is because the term "commission" generally indicates an agency transaction, while the fees paid in connection with principal transactions are more correctly referred to as markups, markdowns or commission equivalents. The Nasdaq Stock Market, Inc. ("Nasdaq") requested the SEC to reconsider this position in the context of certain riskless principal transactions executed by members of the National Association of Securities Dealers Inc. ("NASD"), in light of changes in NASD rules for reporting such transactions.

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[1] 15 U.S.C. 78bb(e)(1).

[2] *See, e.g.*, Investment Investment Advisers Act Release No. 1469 at 16 (February 14, 1995), 60 FR 9750 (February 21, 1995) ("principal transactions are not afforded the safe harbor provided by section 28(e)"); Letter from Richard G. Ketchum, Director, Division of Market Regulation, Securities and Exchange Commission to Ronald H. Hoenig, President, Hoenig & Co., Inc. (October 15, 1990); Letter from Richard G. Ketchum, Director, Division of Market Regulation, Securities and Exchange Commission to Charles Lerner, Esq., Director of Enforcement, Pension and Welfare Benefit Administration, U.S. Dep't of Labor (July 25, 1990).

II. The Revised Interpretation

In the Interpretation, the SEC states that the position that the Safe Harbor applies solely to agency transactions is not necessarily mandated by the language of the Safe Harbor. First, the Safe Harbor's references to the term "dealer" as well as "broker" could be an indication that the term "commission" was intended to apply to compensation paid to a firm acting as a dealer (*i.e.,* principal transactions). Moreover, according to the SEC, the historical limitation to agency trades was grounded in the Safe Harbor's additional requirement that a money manager must determine in good faith that the amount of commission is reasonable in relation to the value of the services received. A commission on an agency trade customarily is fully disclosed, while principal transactions are often priced with embedded markups or markdowns. Thus, the fees on principal trades have been viewed as not quantifiable and fully disclosed in a manner that permits the required determination that they are reasonable.

In recent years, however, the NASD has modified its rules for reporting certain riskless principal transactions, such that a riskless principal transaction in which both legs are executed at the same price (defined as an "Eligible Riskless Principal Transaction" in the Interpretation) is now reported once, in the same fashion as an agency transaction, without any markup, markdown or commission equivalent, whether executed by a market maker or non-market maker.[3] Moreover, SEC Rule 10b-10(a)(2)(ii) requires disclosure of the reported price, the price to the customer and the difference. Consequently, in an Eligible Riskless Principal Transaction, the money manager receives the same price that the broker-dealer received in the offsetting trade, and this price is disclosed on the confirm, which also fully and separately discloses the entire amount of the remuneration to the broker-dealer.

In the Interpretation, the SEC distinguishes fees paid for Eligible Riskless Principal Transactions from fees paid on other riskless principal trades and ordinary principal trades with a dealer.

In light of this enhanced transparency for Eligible Riskless Principal Transactions, the SEC has modified its view and now interprets the term "commission" for purposes of the Safe Harbor to include a markup, markdown, commission equivalent or other fee paid 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 price subject to self-regulatory organization oversight."

The quoted language would appear to lend itself to other principal trades as well, so long as the markup, markdown, commission equivalent or other fee is separately disclosed on the confirm (*i.e.,* a principal trade that is not executed on a "net" basis). However, in the Interpretation, the SEC distinguishes fees paid for Eligible Riskless Principal Transactions from fees paid on other riskless principal trades and ordinary principal trades with a dealer. According to the SEC, fees on other riskless principal trades can

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[3] NASD Marketplace Rule 4632(d) (Nasdaq National Market securities); NASD Marketplace Rule 4642(d) (Nasdaq SmallCap securities); NASD Marketplace Rule 6420(d) (OTC transactions in exchange-listed securities); *see also* NASD Notice to Members 99-65 (August 1999) (changes to riskless principal trade reporting rules for Nasdaq and OTC Equity securities); NASD Notice to Members 99-66 (August 1999) (changes to riskless principal trade reporting rules for OTC trades in exchange-listed securities).

include undisclosed compensation, *i.e.,* the profit on the price difference between the first and second legs. Fees on ordinary principal trades also can include such undisclosed compensation. Moreover, with such trades, the reported price is, to some degree, within the dealer's control. Conversely, fees on Eligible Riskless Principal Transactions must be fully and separately disclosed and the price to the customer can be independently validated by reference to the price of the other side of the trade. The SEC believes that this provides money managers with sufficient information to determine whether the fees being paid are reasonable in relation to the services received, making it appropriate to treat them as "commissions" for purposes of the Safe Harbor.[4]

The SEC appeared to leave the door open to the inclusion of other principal trades, stating that "[a]s 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." This could provide the basis for a future interpretation that includes as commissions under the Safe Harbor markups, markdowns and commission equivalents paid in connection with other principal trades, provided that they are fully and separately disclosed to the customer on the trade confirm.

We Can Help

We will continue to monitor developments in this area. Please contact Edward J. Johnsen at (212) 792-4194 or edward.johnsen@kmzr.com, or Wesley G. Nissen at (312) 902-5365 or wesley.nissen@kmzr.com, if you have any questions regarding the matters discussed in this Advisory.

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[4] Specifically excluded by the SEC in the Interpretation are riskless principal trades in debt securities, which are not subject to confirm and reporting rules satisfying the conditions of the Interpretation, and riskless principal trades in other securities that have similar reporting requirements, but different confirm requirements for market makers (e.g., OTC Bulletin Board stocks, Pink Sheet stocks, and convertible securities).

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04/12/2002