
Securities Law Developments

SEC ISSUES FIRST SANCTION AGAINST BROKER-DEALER FOR AIDING AND ABETTING SOFT DOLLAR VIOLATIONS

On February 10, 1999, the Securities and Exchange Commission issued a consent order sanctioning Republic New York Securities Corporation (“Republic”), a registered broker-dealer, and the firm’s CEO, James Edward Sweeney, for aiding and abetting and causing an investment adviser’s violations of the Investment Advisers Act of 1940 (“Advisers Act”) in connection with its use of soft dollar benefits.^{1/} *Republic New York* breaks new securities law ground as the first case in which the SEC has sanctioned a broker-dealer for such conduct.

Between 1994 and 1995, Republic paid approximately \$84,000 in soft dollar benefits to or on behalf of Sweeney Capital Management (“SCM”), a registered investment adviser unrelated to James Edward Sweeney of Republic. The SEC found that, during this period, SCM and its principals misappropriated soft dollar benefits from their advisory clients by failing to disclose the use of those benefits for personal expenses and business expenses unrelated to research. According to the SEC, Republic’s and Sweeney’s “knowing or reckless participation in a course of conduct that should have alerted them to the likelihood that SCM was violating its fiduciary obligations to its clients” created aiding and abetting liability.

An adviser may lawfully receive research and execution-related benefits even if those benefits do not inure to a particular client, so long as the adviser complies with the safe harbor provided by Section 28(e) of the Securities Exchange Act of 1934 (“Exchange Act”). Section 28(e) only covers the receipt of research and execution related services “provided by” a broker-dealer in connection with agency transactions. The receipt of benefits by an investment adviser outside of this safe harbor “may constitute a breach of fiduciary duty as well as a violation of

^{1/} *In re Republic New York Sec. Corp. and James Edward Sweeney*, Exchange Act Release No. 41036, Admin. Proceeding File No. 3-9823, 1999 WL 58934, at *1 (Feb. 10, 1999).

specific provisions of the federal securities laws.”^{2/} In the view of the SEC staff, the receipt of benefits outside of the safe harbor may require extensive disclosure to, and consent from, advisory clients.^{3/}

According to the order, Republic maintained an oral agreement with SCM under which SCM agreed to direct brokerage business to Republic in exchange for a soft dollar credit of \$1.00 for every \$1.75 in brokerage commissions generated by SCM’s trades. The order states that Republic aided and abetted and caused SCM’s fraudulent conduct by processing SCM’s trades and paying its soft dollar invoices even though there were numerous red flags indicating that SCM may have been violating the anti-fraud provisions of the Advisers Act. These red flags included the following:

- Invoices submitted to Republic related to non-research expenses;
- Payments made directly to SCM and SCM’s principals, as well as payments to soft dollar vendors with whom Republic did not maintain contractual privity;
- Invoices that, on their face, contained indications of fraud (e.g., some of the invoices stated that a SCM principal had provided consulting services when Republic knew that this individual was a full-time employee); and
- Inadequate documentation that expenses were actually incurred by SCM.

The order noted that 80% of the expenses submitted by SCM and paid by Republic were not related to research or brokerage expenses within the scope of the safe harbor for soft dollar benefits. As just one example, Republic “paid invoices that stated the expenses were for rent, insurance, federal and state licensing, postage, accounting fees, telephone bills, client gifts, and satellite television installation.”

^{2/} *Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934*, Exchange Act Release No. 23170, 51 Fed. Reg. 16004 (Apr. 30, 1986).

^{3/} *See, e.g.,* Office of Compliance, Inspections and Examinations, SEC, *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds* (Sept. 22, 1998) <<http://www.sec.gov/news/studies/softdolr.htm>>.

After eliminating its soft dollar department in May 1994, Republic “had no formal procedures in place to insure that soft dollar payments were in compliance with applicable securities laws.” In early 1995, an attorney with Republic’s corporate parent informed an officer of Republic that the payment of an adviser’s non-research expenses with soft dollars could lead to aiding and abetting liability for Republic. Nevertheless, Republic continued to pay the non-research expenses of SCM for several months afterwards. The SEC concluded that, given all of these red flags, Republic “should have inquired into SCM’s authority to engage in these types of soft dollar transactions but failed to do so.” It also noted specifically that Republic had not inquired into SCM’s disclosures to its advisory clients.

Republic consented to a censure, a cease-and-desist order, and a civil penalty of \$50,000. Sweeney, who approved all of the soft dollar invoices for Republic, consented to a censure, a cease-and-desist order, and a civil penalty of \$25,000. The enforcement sanctions in *Republic New York* represent a clear statement to the securities industry that the SEC will hold broker-dealers responsible for policing the use of soft dollar benefits by advisers that execute trades with those broker-dealers. Specifically, the SEC appears to expect that broker-dealers will adopt and enforce internal controls reasonably designed to ensure that soft dollar benefits are within the statutory safe harbor, and that any soft dollar benefits outside the safe harbor are disclosed to and authorized by advisory clients. This responsibility may require broker-dealers to make specific inquiries into, and judgments about, the policies and disclosures of the advisers with which they do business.

If you would like a copy of the enforcement order or have any questions, please call Jeremy Rubenstein (202) 663-6159, Robert Bagnall (202) 663-6974, or Lyle Roberts (202) 663-6877.

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