WILMER, CUTLER & PICKERING

Securities Law Developments NEWSLETTER

JANUARY 18, 2002

SOFT DOLLAR CREDITS IN THE OVER-THE-COUNTER ("OTC") MARKET: SEC SIGNIFICANTLY EXPANDS THE SCOPE OF THE SECTION 28(e) SAFE HARBOR

On December 19, 2001, the Securities and Exchange Commission ("Commission") held an open meeting at which it voted to issue interpretive guidance on the application of Section 28(e) of the Securities Exchange Act of 1934 ("Exchange Act"), which provides a safe harbor to money managers who use the commission dollars of their managed accounts to pay for research and brokerage services.[1] The interpretive release ("Release") was issued on December 27, 2001, and is effective as of January 2, 2002. It reverses the Commission's previous position that Section 28(e) only protects soft dollar use of commissions paid on transactions executed on an agency basis. The new guidance states that the term "commission" for purposes of Section 28(e) now encompasses other fully and separately disclosed transaction costs on eligible OTC transactions.

The Release comes in response to a request from the Nasdaq Stock Market, Inc. ("Nasdaq"), arguing that recent amendments to Nasdaq's trade reporting rules for certain riskless principal transactions supported a modification of the Commission's position. The potential implications of the Release are far-reaching. The new interpretation marks a significant expansion in the types of transactions qualifying for the Section 28(e) safe harbor. While the immediate applicability of the Release is limited to eligible riskless principal transactions in Nasdaq National Market and SmallCap Market securities and exchange-listed securities, the Commission indicated that other types of OTC transactions could become eligible in the future, provided that they are effected subject to similar trade reporting and customer confirmation requirements.

<u>Background.</u> Section 28(e) provides a safe harbor for the application of commissions to obtain investment research and brokerage services. The safe harbor protects investment managers from breach of fiduciary duty claims arising from the use of commissions to pay for brokerage and research. Specifically, Section 28(e) provides that a person who exercises investment discretion over 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 the account to pay [a broker

[1] *Commission Guidance on the Scope of Section 28(e) of the Exchange Act,* Exchange Act Release No. 45194 (Dec. 27, 2001), 67 Fed. Reg. 6 (Jan. 2, 2002), ("Interpretive Release"), available at *http://www.sec.gov/rules/interp/34-45194.htm.*

more than the lowest available commission] if such person determine[s] in good faith that such amount of commission [is] reasonable in relation to the value of brokerage and research services provided by such [broker] . . . ."[2] The standard for determining whether particular brokerage and research services fall within the safe harbor is whether the product or service "provides lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities."[3]

The Commission and its staff previously took the view that the safe harbor of Section 28(e) would not extend to transactions executed by a broker acting in a principal (including a riskless principal) capacity.[4] In 1990, in response to an inquiry by the Department of Labor, the staff of the Commission's Division of Market Regulation reasoned that "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 also reasoned that the legislative history of Section 28(e) "indicate[d] that the safe harbor was designed to address anticipated problems in the exchange market for equity securities potentially resulting from the impending demise of fixed commission rates on exchange-listed securities," while no mention was made of analogous problems arising in transactions executed in a principal or riskless principal capacity.[5] The Commission adopted the staff's position in a 1995 release, stating that "[t]he safe harbor does not encompass soft dollar arrangements under which research services are acquired as a result of principal transactions."[6]

<u>New Interpretive Guidance</u>. The Release reverses this position, based on the view that the term "commission" as used in Section 28(e) should be interpreted in a more flexible manner, consistent with the underlying statutory requirement. In general, the availability of the safe harbor is premised on the notion that the money manager must determine, in good faith, that the amount of commission is reasonable in relation to the value of the research and brokerage services received — a requirement presupposing that the broker-dealer's compensation is fully disclosed and quantifiable. The Release notes that when the Commission issued its earlier guidance in 1995, only agency transactions had adequate cost transparency, because the cost of a principal transaction frequently included undisclosed compensation to the dealer. As a result, money managers could not determine that the fees on principal transactions were reasonable.

Nasdaq argued that various amendments to NASD trade reporting rules adopted since 1995 should support extending the scope of Section 28(e) to certain riskless principal transactions in the OTC market. In general, a riskless principal transaction is one where a broker-dealer, after having received an order to buy (sell) a security, purchases (sells) the security as principal at the same price to satisfy the order to buy (sell). Under various NASD trade reporting rules as amended, such a transaction must be reported as one trade, similar to the manner in which an agency trade is reported. In response to Nasdaq's arguments, the Commission now takes the view that the term "commission" in Section 28(e) should include a "markup, markdown, commission equivalent or other fee paid by a managed account to a dealer for executing a transaction where the

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2 15 U.S.C. § 78bb(e).

3 Exchange Act Release No. 23170, 51 Fed. Reg. 16004, 16006 (Apr. 23, 1986).

4 Department of Labor (Charles Lerner) Letter, SEC No-Action Letter, 1990 WL 304860, at *3 (Jul. 25, 1990) ("Department of Labor Letter"). *See also* Hoenig and Co., SEC No-Action Letter, 1990 WL 287014, at *1 (Oct. 15, 1990); Instinet Corporation, SEC No-Action Letter, 1992 WL 672345, at *8 (Jan. 15, 1992).

5 Department of Labor Letter at *3.

6 *Disclosure by Investment Advisers Regarding Soft Dollar Practices,* Exchange Act Release No. 35375, 60 Fed. Reg. 9750, 9755 n.52 (Feb. 14, 1995). *See* Interpretive Release at n.2.

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."

Qualifying OTC Transactions. Currently, NASD Rules 4632, 4642, and 6420 (generally applicable to *Nasdaq National Market securities, SmallCap Market securities, and exchange-listed securities*) require a riskless principal transaction in which both legs are executed at the same price to be reported once, in the same manner as an agency transaction, exclusive of any markup, markdown, commission equivalent, or other fee.[7] These trade reporting requirements, along with the trade confirmation requirements of Exchange Act Rule 10b-10, result in full disclosure to the money manager of the entire amount of a market maker's charge for effecting a trade. At the same time, the transaction price is externally and objectively validated by the offsetting leg of the transaction. Accordingly, the money manager may now treat a markup, markdown, commission equivalent or other fee charged to a managed account by a broker-dealer for executing a riskless principal transaction in these types of securities as being eligible for soft dollar credits under Section 28(e).

Non-Qualifying OTC Transactions. The Release, by its terms, is not limited in scope to transactions involving Nasdaq National Market or SmallCap securities or exchange-listed securities. As emphasized by Chairman Pitt at the open meeting and reiterated in the Release, any market or type of trade that meets the specified criteria is eligible. The Release notes that riskless principal transactions in *OTC Bulletin Board stocks, Pink Sheet stocks, and convertible securities* currently are not eligible for soft dollar credits at this time.[8] While such transactions are subject to similar trade reporting requirements under the relevant NASD rules, they are not subject to the same confirmation requirements under Exchange Act Rule 10b-10. In addition, the Release points out that *riskless principal transactions in the debt markets* also do not meet the necessary conditions for cost transparency at this time, because they are not currently subject to comparable trade confirmation or reporting requirements.

Implications for "Net Trading" and NASD NTM 01-85. The Commission's new interpretive guidance is expected to invite both money managers and broker-dealers to re-examine the manner in which a broker-dealer is compensated for executing OTC trades. The advent of decimal pricing, with a resulting reduction in the "spread," already has caused many Nasdaq market makers to reconsider their traditional business models and explore alternative compensation structures based on a commission-like fee model. Recently, the NASD has issued a Special Notice to Members, clarifying that there are no NASD/Nasdaq rules or interpretations that would prohibit a market maker from charging its customers a commission equivalent when acting in a principal or riskless principal capacity.[9]

The newly expanded scope of the Section 28(e) safe harbor is likely to further spur the adoption of a commission-like fee model by broker-dealers in the OTC market. Most money managers who seek to take advantage of soft dollar credits for eligible riskless principal transactions will find the practice of so-called "net trading"[10] less attractive in the future, and may well

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[7] NASD Rules 4632(d)(3)(B), 4642(d)(3)(B), and 6420(d)(3)(B).

[8] Note that convertible securities, including those traded on Nasdaq, are subject to different trade confirmation requirements than those applicable to other Nasdaq equity securities under Exchange Act Rule 10b-10.

[9] *Compensation and Mixed Capacity Trading,* NASD Notice to Members 01-85 (Dec. 2001).

[10] A "net trade" takes place when a market maker that is working an institutional (or block-sized) customer order to buy (sell) executes a buy (sell) as principal at one price (from the street or another customer) and then executes an offsetting sell to (buy from) the customer at a different price. The difference between the price of the market maker's transaction and the price of the offsetting transaction to the customer is the market maker's compensation in the form of a "spread," and such compensation is generally not separately disclosed to the customer on the trade confirmation. The practice of net trading is only permissible for market makers who have received customer consent.

request that broker-dealers facilitate the execution of their orders differently, in a manner that would require the broker-dealer to effect a riskless principal trade where appropriate. In practical terms, this means that such money managers should review the terms of any negative consent letter[11] that they may have received from broker-dealers in the past and determine whether, and under what circumstances, they may want to revoke their existing consent to net trading.

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If you would like a copy of the Release, or if you have any questions, please contact:

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[11] In August 2000, the Commission approved the NASD's rule filing clarifying that a market maker may use a so-called "negative consent" letter to document the customer's consent to trading on a net basis. Exchange Act Release No. 43103, 65 Fed. Reg. 48774 (Aug. 1, 2000).

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