CORE COMPLIANCE & LEGAL SERVICES, INC.

Risk Management Update
June 2014

SOFT DOLLARS AND DISCLOSURE

In an era when the use of "soft dollars" has taken on a negative connotation, how do firms effectively take advantage of the benefits soft dollars provide without alarming the public or inviting regulatory scrutiny? In sum, there are three general considerations to factor: evaluation of the soft dollar usage, providing effective disclosures and recordkeeping of soft dollar practices.

What are Soft Dollars?

The term "soft dollars" is used to describe that research, brokerage services and/or other benefits provided by a brokerage firm to an investment adviser as a result of commission revenue generated by securities transactions executed by that broker-dealer, in lieu of direct payments by the manager (also known as "hard dollars"). Investors have come to cast a leery eye towards the use of soft dollars, in part because of a prevailing attitude that paying for these services through the use of commissions passes that cost on to the investor rather than being a business expense of the firm.

The history of soft dollars goes back to the mid-1970s when investment managers posed to regulators the question that if they were to pay more than the lowest commission rate available to a broker-dealer in return for services other than execution, such as research, would they be accused of violating their fiduciary duties to the client.

Prior to 1975, commission rates were fixed and research was the basis upon which brokers would differentiate themselves and attract business. When fixed rates were eliminated, the investment community was fearful that the flow of quality research would be restricted and brokers would be selected based on price alone. Congress agreed, and passed Section 28(e) of the Securities Exchange Act of 1934 (the "Act") specifically to allow fiduciaries to use commissions on portfolio transactions to acquire research and investment services. In other words, Congress sought to create a safe harbor for firms to use commissions to pay for research and execution. This type of arrangement came to be known commonly as "soft dollars."

The Safe Harbor

Section 28(e) provides guidance as to what services would fall under a "safe harbor" in examinations and enforcement proceedings. There have been several interpretive releases provided (the 1986 Release,[1] 2001 Release[2] and 2006 Release[3]), which clarify those brokerage and research services eligible under the safe harbor. Firms should take the time to review these

[1] *See* http://www.sec.gov/rules/interp/34-23170.pdf
[2] *See* http://www.sec.gov/rules/interp/34-45194.htm
[3] *See* http://www.sec.gov/rules/interp/2006/34-54165.pdf

releases, and in particular the 2006 Release,[4] which provides the latest guidance on the scope of the safe harbor and restrictions relating thereto. In short, Section 28(e) provides that eligible brokerage and research services provided by a broker include:

- advice furnished directly or through publications or writing as to the value of securities, the advisability of investing in, purchasing or selling securities, or the availability of purchasers or sellers of securities;
- furnished analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy and performance of accounts; or
- effectuation of securities transactions and functions incidental thereto (such as clearance, settlement, and custody), including those functions required by rules set forth by the SEC or a self-regulatory organization.

As previously stated, in current times, the use of soft dollar arrangements by firms has come to invite investor scrutiny due in large part to several high-profile regulatory actions against firms that abused soft dollar arrangements. So how do firms properly evaluate, disclose, and document their soft dollar arrangements in a way that protects their interests?

Evaluating the Use of Soft Dollars

The process should begin with an internal review of any soft dollar arrangement the firm is considering. Compliance, who may be assisted by legal counsel, should assist in making a determination as to whether or not the arrangement falls within and is provided safe harbor in accordance with Section 28(e) of the Act. While not all-encompassing, the following provides examples of the services that are eligible and ineligible for the Safe Harbor:

Eligible:

- Market Data, Economic Data, and Research Reports including quotes, trading volume, etc.
- Seminars and conferences where the content satisfies the requirements of the Safe Harbor
- Analytical software, order management systems, and software that provides analysis relating to the subject matter detailed in Section 28(e)
- Financial newsletters and trade journals relating to the subject matter of Section 28(e) that are not mass-marketed

Ineligible:

- Computer hardware
- Office equipment
- Mass marketed publications
- Compliance tools
- Travel expenses including entertainment and meals

[4] *Id.*

Once the initial eligibility review is completed, the investment team along with senior management so that they may approve or disapprove of the proposed arrangements, as necessary.

Disclosure

The disclosure of the firm's soft dollar arrangements, particularly in Form ADV Part 2A (also known as the firm's "Brochure"), can serve to keep your clients and prospects informed of potential conflicts of interest, provide for transparency as to soft dollar usage and discuss the benefits that a firm and its clients receive as a result of the soft dollar arrangements..

The Safe Harbor of Section 28(e) must be considered when properly disclosing soft dollar arrangements. For example, in Item 8.G.2 of Form ADV Part 1A, the application specifically asks, "are all the "soft dollar benefits" you or any *related persons* receive eligible research or brokerage services under section 28(e) of the Securities Exchange Act of 1934?" Firms should utilize the evaluations of their soft dollar arrangements and answer these important disclosure questions accordingly.

In addition, Form ADV Part 2A requires the firm to provide for a detailed description of any soft dollar arrangements that the firm may engage. This disclosure should be provided under the "Brokerage Practices" of Item 12. When drafting the soft dollar disclosure, remember to describe, among other things, the factors that are considered when selecting a broker; how commission rates are analyzed; what product or service benefits are received by the firm in the soft dollar arrangement; the fact that clients may in fact pay higher commissions than are otherwise available due to the arrangement; whether or not all clients benefit from products or services received; and what policy or procedure is used to direct clients to a particular broker with whom the firm has a soft dollar arrangement. Firms must also take care to create policies and procedures regarding soft dollar usage and adequately document these policies and procedures within their compliance manuals.

Recordkeeping

In order to demonstrate your soft dollar protocols during a regulatory examination, firms should take care to meticulously document and archive all records relating to the soft dollar benefits they receive, including research, analysis, meeting minutes and/or other evidence of review conduct by compliance, the investment committee and senior management team. The archiving of this information also may prove valuable if there is any civil litigation due to soft dollar arrangements.

Among the records that should be maintained are:

- The Broker-Dealers through which trades have been executed
- The Broker-Dealers that provide soft dollar benefits
- The products and or services received through soft dollar arrangements
- Any internal memos regarding the use of soft dollars
- A record of whether or not the client paid a higher commission based on the receipt of soft dollar benefits

- A record of whether or not the soft dollar use benefited all clients or just those who paid the commission

Conclusion

Soft dollars provide many benefits to both the asset manager and the client. However, in an age where these arrangements have come under scrutiny, firms must be cautious when entering into these arrangements and carefully analyze whether or not the proposed arrangements fall under the Safe Harbor of Section 28(e) of the Act. When conducting such analysis, Firms should be mindful of their fiduciary responsibilities to their clients and ask themselves, "does this arrangement best serve client?" If so, proceed by documenting your analysis, review with senior management, take all the steps necessary to properly disclose these arrangements and take steps to archive all related books and records on an ongoing basis.

For more information, please contact us at (619) 278-0020.

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