SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 275 and 279

[Release No. 34–35375; IA–1469; S7–5–95]

RIN 3235–AG36

Disclosure by Investment Advisers Regarding Soft Dollar Practices

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule and form.

SUMMARY: The Commission is proposing for comment a new rule and form under the Investment Advisers Act of 1940 that would require certain investment advisers to provide clients with an annual report regarding their use of client brokerage. The proposed report would include disclosure about an adviser's use of its clients' brokerage commissions during the previous year, including information about research and other services obtained by the adviser with those commissions. The proposed annual report is intended to provide investment advisory clients with important information about the brokerage commissions they pay and their advisers' receipt of ''soft dollar'' benefits from those commissions.

DATES: Comments should be received on or before May 19, 1995.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. All comment letters should refer to File No. S7–5–95. All comments received will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549.

FOR FURTHER INFORMATION CONTACT: Eric C. Freed, Special Counsel, or Robert E. Plaze, Assistant Director, (202) 942–0721, Office of Disclosure and Investment Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission today is proposing for comment:

(1) rule 204–4 (17 CFR 275.204–4) under the Investment Advisers Act of 1940 (15 U.S.C. 80b–1 *et seq.*) (''Advisers Act''), which would require an investment adviser registered or required to be registered under the Advisers Act to deliver to its clients an annual report on the adviser's direction of client brokerage transactions and its receipt of research and other services in connection with those transactions; and

(2) Form ADV–B under the Advisers Act, which would set forth the information required to be included in the annual report.

Executive Summary

The Commission is proposing a new rule and form under the Advisers Act to require each investment adviser (''adviser''), registered or required to be registered under the Advisers Act, that has the discretion to direct client brokerage transactions and receives services other than execution in exchange for that brokerage, to provide its clients with a report that would contain information about its use of client brokerage. The report would disclose for the adviser's most recently completed fiscal year, (1) the twenty brokers to which the adviser directed the largest amounts of commissions and certain other transaction-related payments (collectively, ''commissions''), (2) the three brokers substantially all of whose services for the adviser were execution services (''execution-only brokers'') to which the adviser directed the largest amounts of commissions, (3) the aggregate amount of commissions directed by the adviser to each broker listed and the percentage of the adviser's total discretionary brokerage this amount represents, (4) the average commission rate paid to each broker listed, and (5) for each broker other than an execution-only broker, information concerning products or services obtained from the broker. The report would also disclose the percentages of the adviser's total commissions that are directed to execution-only brokers, to other brokers, and at the request of clients. The report would require only information about an adviser's use of client brokerage on an aggregate basis; it would not require separate information about the brokerage of the adviser's various clients. The report would be provided to existing advisory clients annually and to prospective advisory clients no later than the time that an advisory agreement is entered into.

I. Background

Soft dollar practices are arrangements under which products or services other than execution of securities transactions (''soft dollar services'') are obtained by an adviser from or through a broker in exchange for the direction by the adviser of client brokerage transactions to the broker.[1] Soft dollar practices are common in the institutional brokerage market. According to an informal annual survey of investment advisers and other institutions, nearly ninety percent of these institutions engage in soft dollar arrangements, and more than forty percent of commissions are directed primarily for the purpose of obtaining research services.[2]

Soft dollar practices originally developed as a means by which brokers provided discounts on brokerage commissions that were fixed pursuant to exchange and commission rules. In 1975, the Commission prohibited fixed commission rates[3] and, later that year, Congress codified the Commission's action.[4] After the Commission abolished fixed rates, concerns were raised whether the soft dollar practices that had developed in the context of fixed rates would continue to be consistent with various state and federal laws, including the Advisers Act.[5]

Underlying these concerns is an adviser's fundamental obligation under the Advisers Act (and state law) to act in the best interest of its clients.[6] This duty requires the adviser to obtain best execution of client transactions,[7] and precludes the adviser from using client assets for its own benefit or the benefit of other clients, at least without client consent.[8] Upon the Commission's eliminating fixed commission rates, some argued that an adviser could be deemed to have violated this duty if the adviser caused a client's account to pay anything but the lowest commission rates. If this view was upheld, soft dollar arrangements could have been effectively precluded by the decision to eliminate fixed commission rates.

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[1] See Securities Exchange Act Rel. No. 23170 (Apr. 23, 1986) [51 FR 16004 (Apr. 30, 1986)] (''Release 23170'') at § I; Robert J. Moran & Cathy G. O'Kelly, Soft Dollars and Other Traps for the Investment Adviser, 1 DePaul Bus. L.J. 45, 45 n.5 (1989).

[2] Greenwich Associates, Soft-Dollars: Opportunities and Challenges (special presentation of May 10, 1994); Greenwich Associates, Institutional Equity Investors 1994 (statistical supp.) 3, 17.

[3] Securities Exchange Act Rel. No. 11203 (Jan. 23, 1975) (40 FR 7394 (Feb. 20, 1975)).

[4] Securities Acts Amendments of 1975, Pub. L. No. 94–29, 89 Stat. 97, 107–08 (enacting Section 6(e)(1) of the 1934 Act (15 U.S.C. 78f(e)(1))).

[5] S. Rep. No. 75, 94th Cong., 1st Sess. 70 (1975).

[6] *See SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963).

[7] *Delaware Management Co.*, 43 S.E.C. 392, 396 (1967). An adviser is obligated to use reasonable diligence to select a broker who will ''execute securities transactions for clients in such a manner that the client's total cost or proceeds in each transaction is most favorable under the circumstances.'' Securities Exchange Act Rel. No. 23170 (Apr. 23, 1986) [51 FR 16004 (Apr. 30, 1994)] (''Release 23170'') at § V (citing *Kidder, Peabody & Co.*, 43 S.E.C. 911, 915 (1968)). An adviser should consider the full range and quality of the broker's services, including the value of research received, in assessing whether a broker will provide best execution. *Id.*

[8] Restatement (Second) of Trusts § 170 comment a, § 216 (1959).