Congress, in codifying the abolition of fixed commission rates, responded to these concerns by enacting Section 28(e) of the Securities Exchange Act of 1934 (the ''1934 Act'') [15 U.S.C. 78bb(e)], which provides a safe harbor for certain soft dollar arrangements.[9] Section 28(e) provides, in pertinent part, that an adviser with investment discretion over an account will not be deemed to have acted unlawfully or to have breached its fiduciary duty by causing the account to pay a higher commission to a broker that provides research benefiting the adviser's accounts. To rely on the Section 28(e) safe harbor, an adviser must determine in good faith that the commissions paid are reasonable in relation to the value of the brokerage and research services provided, either in terms of the particular transaction or the adviser's overall responsibilities towards its discretionary accounts.[10]

Section 28(e) modifies a fiduciary's strict duty to act in the best interest of each client with respect to the management of each client's assets. Thus, it permits an adviser to cause a client to pay higher commissions than otherwise are available to obtain research that may not be used exclusively for the benefit of the client or used to benefit the client at all. Section 28(e), however, does not afford a safe harbor with respect to all conflicts of interest between the adviser and its clients that may arise from soft dollar arrangements. For example, soft dollar arrangements may cause an adviser, in order to obtain soft dollar services, to violate its best execution obligations by directing client transactions to brokers who could not adequately execute the transactions. Soft dollar arrangements also may give advisers incentives to trade client securities inappropriately to generate credits for soft dollar services.[11]

Soft dollar practices also diminish the ability of a client to evaluate the expenses it incurs in obtaining portfolio management services and may hinder the ability of the client to negotiate fee agreements, because the costs of soft dollar services are ''hidden'' from investors in brokerage commissions. By permitting advisers to use their clients' transactions to pay for research services that they otherwise would have to purchase with ''hard dollars,'' soft dollar arrangements permit advisers to charge fees that do not fully reflect the cost of portfolio management. Advisers that do not engage in soft dollar arrangements may be put at a competitive disadvantage if they pay for services with hard dollars and attempt to pass the cost of these services on to clients through higher fees.

Congress recognized the conflicts that soft dollar practices present and provided in section 28(e) authority for the Commission to require advisers to disclose to their clients their policies and practices with respect to the use of client commissions.[12] The Commission has never adopted rules under section 28(e),[13] but has instead required certain disclosure in Part II of Form ADV, which specifies the content of the disclosure document or ''brochure'' that an adviser is required to provide to clients before entering into advisory relationships.[14] If soft dollar arrangements are a factor in selecting brokers to effect client transactions, the brochure must disclose the nature of the adviser's soft dollar practices, including: (i) the services that the adviser obtains through soft dollar arrangements; (ii) whether clients may pay higher commissions (''pay up'') as a result of the arrangements; (iii) whether soft dollar services are used to benefit all client accounts or only those accounts the brokerage of which was used to purchase the services; and (iv) any procedures that the adviser uses to allocate brokerage.[15]

Two broker-dealers, Goldman, Sachs & Co. and Morgan Stanley Group Inc., themselves providers of research services to advisers, have strongly criticized the effectiveness of current disclosure requirements.[16] Current disclosure primarily focuses on the policies and practices that the adviser intends to follow with respect to the use of client brokerage.[17] This disclosure does not, Goldman, Sachs and Morgan Stanley assert, adequately disclose to clients the extent to which an adviser has soft dollar commitments or the specific benefits that accrue to the adviser from the use of the client brokerage. These brokers have proposed that the Commission adopt a requirement that advisers periodically report to clients the soft dollar benefits that they have received and the specific value of those benefits, as well as certain information about how the brokerage of each client was directed (the ''Goldman/Morgan Proposal'').[18] Other participants in soft dollar arrangements, organized by the Alliance in Support of Independent Research, have argued that current client disclosure by advisers is adequate and that the Goldman/Morgan Proposal is anticompetitive and discriminatory.[19]

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[9] Securities Acts Amendments of 1975, Pub. L. No. 94–29, 89 Stat. 97, 161–62.

[10] The Commission has stated that a product or service may legitimately be considered a ''brokerage or research service'' covered by the safe harbor if it provides ''lawful and appropriate assistance to the [adviser's] decision-making process.'' Release 23170, *supra* note 1. The Commission's Division of Market Regulation has addressed the types of transactions that are afforded the protection of the safe harbor. *See* U.S. Department of Labor (pub. avail. July 25, 1990) (safe harbor does not extend to principal, riskless principal and futures transactions); Hoenig & Co. (pub. avail. Oct. 15, 1990) (same); Instinet Corporation (pub. avail. Jan. 15, 1992) (safe harbor does apply to agency transactions in equity securities on a computer-based real time market information and brokerage system and after-hours order matching system).

[11] See *Securities and Exchange Commission* v. *Galleon Capital Management,* Litigation Rel. No. 14315 (Nov. 1, 1994). The Commission's complaint in *Galleon,* in addition to alleging excessive trading in order to generate soft dollar credits, alleged that the adviser requested brokers to make soft dollar payments to a consulting firm, and that these payments eventually were rebated to the adviser. See also Letter from Bradford P. Schaaf, Chairman, and Victor J. Fontana, President and Chief Executive Officer, Autranet, Inc. to Barry P. Barbash, Director, Division of Investment Management and Brandon Becker, Director, Division of Market Regulation (Nov. 10, 1994) (''Autranet Letter'') (proposing that the Commission prohibit a broker from requiring an adviser, by contract or understanding, to commit to direct any specified amount of commissions to the broker in order to receive soft dollar services).

[12] Section 28(e)(2) (15 U.S.C. 78bb(e)(2)).

[13] In 1976, the Commission proposed rule 28e2–1 under the 1934 Act, but the rule was never adopted. See note 41 infra.

[14] Rule 204–3 under the Advisers Act (17 CFR 275.204–3) requires that a registered investment adviser deliver the brochure to a prospective client before entering into an advisory contract with the client, and, annually thereafter, provide or offer to provide the client with the brochure. The Commission is not at this time proposing to amend the Form ADV requirements regarding disclosure of soft dollar arrangements. The Commission, however, is considering whether changes to these requirements would be appropriate, and may propose changes in connection with future revisions to Form ADV.

[15] Item 12 of Part II of Form ADV. Registered investment companies are required to include similar disclosure in their Statements of Additional Information. See, e.g., Item 17 of Form N–1A (17 CFR 239.15A, 274.11A).

[16] See Future of the Stock Market: Soft Dollars, Hearing Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce, 103d Cong., 1st Sess. (1993) (''1993 Hearings'') (testimony of David M. Silfen, Partner, Goldman, Sachs & Co. and Anson M. Beard, Jr., Managing Director, Morgan Stanley Group Inc.).

[17] The Commission has instituted a number of enforcement actions against advisers based, at least in part, on the failure to disclose soft dollar arrangements adequately. See, e.g., Securities and Exchange Commission v. Galleon Capital Management, supra note 11; Kingsley, Jennison, McNulty & Morse, Inc., Investment Advisers Act Rel. No. 1396 (Dec. 23, 1993); DeMarche Associates, Investment Advisers Act Rel. No. 1392 (Nov. 23, 1993); Jack Allen Pirrie, Investment Advisers Act Rel. No. 1284 (July 29, 1991); Robert Michael Lee, Investment Advisers Act Rel. No. 1249 (Sept. 17, 1990); Patterson Capital Corp., Investment Advisers Act Rel. No. 1235 (June 25, 1990).

[18] The Goldman/Morgan Proposal will be placed in the public comment file for the Commission's proposal.

[19] *See* Letter from The Alliance in Support of Independent Research to Jonathan G. Katz,

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