

requirements on third-party and proprietary soft dollar arrangements.

#### A. The Annual Report in General

The Commission is proposing a new rule under the Advisers Act, rule 204-4, that would require any adviser, registered or required to be registered under the Advisers Act, that has brokerage discretion<sup>29</sup> over any client account and that receives soft dollar services to deliver an annual report to clients on its use of client brokerage. The contents of the annual report would be specified in new Form ADV-B.

The core of the annual report would be a table disclosing information regarding the adviser's direction of client brokerage. The table would list the twenty brokers other than execution-only brokers ("research brokers") to which the adviser directed the greatest amount of client commissions,<sup>30</sup> and the three execution-only brokers to which the adviser directed the greatest amount of client commissions during its most recent fiscal year.<sup>31</sup> For each broker listed, the table would disclose: the aggregate amount of commissions directed by the adviser to the broker; the percentage of the adviser's discretionary brokerage commissions that this represents; the average commission rate (in cents per share) paid to the broker; and a description of the soft dollar services provided by the broker.<sup>32</sup>

The table would provide an overview of the brokers used by an adviser to execute client transactions, the commissions charged by the brokers, and the soft dollar services received from research brokers. This disclosure is intended to assist an advisory client in evaluating the adviser's use of its brokerage, including whether the client could be paying lower commissions, whether the adviser is obtaining soft

dollar services that can be used to benefit the client, and whether the advisory fee charged to the client is appropriate in light of the services that the adviser pays for with client commissions. Institutional clients using the services of more than one adviser and prospective clients considering different advisers will be able to use the table to compare advisers' use of brokerage, including the commission rates that they negotiate and the types of services that they receive. The disclosure regarding execution-only brokers would assist clients in making these determinations by providing information about the availability of brokerage alternatives, and, by implication, the effect that soft dollar services may have on commission rates.<sup>33</sup>

The table would be followed by certain data concerning the adviser's direction of brokerage: the percentages of the adviser's total brokerage that are directed (1) by the adviser to research brokers, (2) by the adviser to execution-only brokers, and (3) pursuant to specific client instructions.<sup>34</sup> This data would provide clients with an overall picture of how the adviser directs brokerage.

#### B. Disclosure of Brokers

As noted above, the report would be required to include information about twenty research brokers and three execution-only brokers.<sup>35</sup> Limiting the required disclosure to this number of brokers is intended to result in reports that provide useful information in a relatively concise manner. Comment is requested whether the proposed numerical thresholds are appropriate. Comment is also requested whether, as an alternative, disclosure should be required about brokers to which the adviser directed more than a specified percentage of its brokerage, such as one percent.

For the purposes of the amendments, a broker would be considered an "execution-only" broker if substantially all of the services that the broker provides to the adviser are execution

services, *i.e.*, effecting securities transactions and performing functions incidental to or required in connection with effecting those transactions.<sup>36</sup> Consequently, a broker would not be permitted to be considered an execution-only broker if it provided any significant amount of soft dollar services to the adviser, even if the services were not solicited or used by the adviser.<sup>37</sup> If a broker provided only execution services to an adviser, however, the adviser would include the broker as execution-only even if the broker provided additional services, such as research, to its other customers. The definition of execution-only broker would include automated trading systems (e.g., the Instinet and Lattice systems) if the adviser received only execution and execution-related services as a result of using the system, regardless of whether the system itself is required to be registered as a broker-dealer under the 1934 Act.<sup>38</sup>

An adviser that did not utilize any research brokers or that did not utilize any execution-only brokers would be required to so state under the appropriate heading in the table.<sup>39</sup> An adviser that directed client commissions to fewer than twenty research brokers and/or fewer than three execution-only brokers would be required to disclose under the appropriate headings those brokers to which it did direct client commissions. As a result, an adviser's annual report would always include some reference to the existence of execution-only brokers. Comment is requested whether there are better ways to disclose to clients the availability and cost of brokerage alternatives. For instance, comment is requested whether an adviser should be required to disclose execution-only brokers that offered to execute client transactions. Similarly, comment is requested whether the table should include

<sup>29</sup> The definition of "brokerage discretion" is discussed at notes 58-59 and accompanying text *infra*.

<sup>30</sup> For the purposes of the amendments, "commissions" would include amounts of mark-ups and mark-downs on principal transactions if those amounts are included on the confirmation of the transaction required under rule 10b-10 under the 1934 Act. See Section II.E *infra*. These mark-ups and mark-downs, however, are not commissions for purposes of Section 28(e). See note 10 *supra*.

<sup>31</sup> The definition of "execution-only broker" is discussed at notes 36-38 and accompanying text *infra*.

<sup>32</sup> Items 2-3 of proposed Form ADV-B. For purposes of determining the amount of commissions and the corresponding percentage of the adviser's discretionary brokerage that this amount represents, sales loads on transactions in investment company shares would be considered commissions. Because sales loads typically are not calculated on a cents per share basis and could potentially distort the average commission rate data, sales loads would not be considered in calculating average commission rates. Instruction 3 to Item 2 of proposed Form ADV-B.

<sup>33</sup> The Commission recognizes that the use of execution-only brokers would not be appropriate or possible in many circumstances. The proposed disclosure about execution-only brokers is not intended to imply that such brokers could have been used in all circumstances. Furthermore, an adviser would be permitted to explain its policies regarding the use of execution-only brokers in a narrative portion of the annual report. See General Instruction 6 to Proposed Form ADV-B.

<sup>34</sup> Item 4 of proposed Form ADV-B.

<sup>35</sup> For purposes of the annual report, a "broker" would include a bank that is not registered as a broker-dealer under the 1934 Act. Instruction 1 to Item 2 of proposed Form ADV-B.

<sup>36</sup> Instruction to Item 3 of proposed Form ADV-B. The definition of execution-only broker is derived from Section 28(e)(3)(C) of the 1934 Act [15 U.S.C. 78bb(e)(3)(C)]. Under that section, custody of securities is a function incidental to effecting a transaction in the securities.

<sup>37</sup> A broker would be permitted to be considered an execution-only broker if it provided a minimal amount of soft dollar services to the adviser, such as a single research report or a single contact with a securities analyst.

<sup>38</sup> Instruction to Item 3 of proposed Form ADV-B. Typically, the sponsor of an automated trading system will be required to be registered as a broker-dealer under the 1934 Act. An automated trading system would be included in the definition of broker in Form ADV-B if a fee is charged for using the system, regardless of the basis for the fee (e.g., a flat usage fee or transaction-based fees).

<sup>39</sup> Items 2 and 3 of proposed Form ADV-B.