

required to be disclosed, but it may be inappropriate and misleading to reflect services that the adviser did not solicit or use as having no value.⁴⁷

An adviser could be required to make a good faith estimate of what the proprietary soft dollar services would have cost in an arms-length transaction.⁴⁸ This approach would require advisers to report positive values for unsolicited and unused services, which could lead investors to believe that the adviser (or the client) substantially benefited from the direction of the brokerage when, in fact, receipt of the services was incidental to brokerage direction decisions made wholly on the basis of the broker's execution capabilities. In addition, good faith estimates may be very difficult to make if the services provided are unlike those available for hard dollars. In this regard, the Commission is concerned with the burden that a good faith estimate requirement would impose on advisers and brokers and the accuracy of the information that would be reported to clients.⁴⁹

The disclosure that the Commission is proposing to require is designed to alert a client that the adviser receives soft dollar services from directing client commissions, and provide some indication of the extent to which the client benefits from that direction. The commission rate information, including the commission rates of execution-only brokers, may provide valuable information on the costs of soft dollar arrangements and may render valuation

⁴⁷ An adviser could be required to report only those proprietary soft dollar services for which it specifically directed brokerage. Such a limitation, however, would require highly subjective determinations by advisers, and, as a practical matter, might elicit disclosure about only third-party soft dollar services.

⁴⁸ This approach was suggested by one commenter on the Commission's recent proposal to require that mutual fund expenses paid by brokers should be included in fund expense and performance data. See Investors Research Letter, *supra* note 25. In that proposal, the Commission requested comment whether the value of research services received by a fund's adviser should also be included in fund expenses, and how the research should be valued. See Investment Company Act Rel. No. 20472 (Aug. 11, 1994) (59 FR 42187 (Aug. 17, 1994)), at §II.A.1. Most commenters on the proposal, however, opposed the inclusion of research services in fund expenses, and those commenters that favored it generally provided little guidance regarding how to value proprietary services.

⁴⁹ In proposing rule 28e2-1, the Commission proposed that the fair value of non-research services be disclosed, and requested comment on the feasibility and desirability of requiring disclosure of specific dollar amounts of brokerage commissions paid to receive research services. Commenters asserted that it would be impracticable to value soft dollar services or to separate commissions into their research and execution components. See Release 10569, *supra* note 41.

estimates unnecessary. If additional information is desired, the client can request it from the adviser.

Comment is requested whether the commission price and fair market value of particular soft dollar services, or the soft dollar services obtained from a broker in the aggregate, should be required in the annual report. Commenters favoring inclusion of this information should discuss how the price and value of proprietary soft dollar services should be determined.

D. Client-Directed Brokerage

Many clients of investment advisers instruct their advisers to direct some or all of their transactions to a particular broker or brokers. A client may direct its brokerage, among other reasons, to obtain services for its own benefit or because of a pre-existing relationship with the broker.

In addition to disclosing the percentages of an adviser's total commissions that are directed to execution-only and research brokers, the proposed annual report would be required to disclose the percentage of commissions that is directed by clients.⁵⁰ Client restrictions on an adviser's brokerage discretion may be of interest to other clients of the adviser because they may cause a larger proportion of the brokerage of the other clients to be used to obtain soft dollar services for the adviser. Information on client-directed brokerage, therefore, may be useful to clients in determining the amount of brokerage available to the adviser to purchase soft dollar services. Comment is requested whether the proposed disclosure of the percentage of client-directed brokerage would be useful, and whether the Commission should require that the data be accompanied by disclosure explaining its usefulness.

E. Principal Transactions

Proposed Form ADV-B would require an adviser to include in the commission and commission rate in the table mark-ups and mark-downs paid in connection with principal transactions if the amounts of these mark-ups or mark-downs are included in the confirmations of the transactions required under rule 10b-10 under the 1934 Act. Rule 10b-10 requires that a dealer include transaction cost data in confirmations of (1) riskless principal transactions in equity securities if the dealer is not a market maker in the securities, and (2) transactions in a

listed equity securities and certain Nasdaq securities.⁵¹

Proposed Form ADV-B would not require disclosure of information about other principal transactions or the mark-ups, mark-downs or spreads paid on these transactions. It may be difficult to accurately determine transaction costs associated with these principal transactions. Furthermore, disclosure about adviser direction of principal transactions may not be necessary, as soft dollar arrangements involving principal transactions may be less common than those involving agency transactions because principal transactions are not afforded the safe harbor provided by Section 28(e).⁵²

Comment is requested whether the annual report should include information on all principal transactions, and, if so, how the associated costs should be determined. Comment is also requested whether disclosure requirements that apply primarily to agency transactions would cause more transactions to be executed on a principal basis.

The proposal would require disclosure of the brokers to which the greatest amounts of commissions had been directed. Alternatively, the obligation to disclose information about a broker could be based on the dollar amount of transactions, both principal and agency, directed to the broker. The resulting disclosure might be more useful to clients in assessing any relationship that may exist between the adviser's use of principal transactions and its receipt of soft dollar services. Comment is requested whether the basis for requiring a broker to be listed in the annual report should be the dollar amount of transactions directed to the broker, rather than the amount of commissions.

F. Client-Specific Information

The proposed amendments would not require that an adviser provide each client with information about how that

⁵¹ Paragraph (a)(8) of rule 10b-10 [17 CFR 10b-10(a)(8)].

⁵² The safe harbor does not encompass soft dollar arrangements under which research services are acquired as a result of principal transactions. See note 10 *supra*. Notwithstanding the lack of availability of the safe harbor, the Commission understands that full service brokers sometimes provide research and other services based, at least in part, on principal transactions. If an adviser were required to list a broker in its annual report because the broker is used frequently for agency transactions, the adviser would be required to take all of the soft dollar services obtained from the broker into account in responding to the report's requirement to list the services obtained, even if some of the services could be deemed to be received as a result of principal transactions not within the scope of the proposed amendments. Instruction 7 to Item 2 of proposed Form ADV-B.

⁵⁰ Item 4 of proposed Form ADV-B.