



SEC Interpretation: Commission Guidance on the Scope of Section 28(e) of the Exchange Act

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 241

[Release No. 34-45194]

Commission Guidance on the Scope of Section 28(e) of the Exchange Act

Agency: Securities and Exchange Commission

Action: Interpretation

Summary: We are publishing interpretive guidance on the application of Section 28(e) of the Securities Exchange Act of 1934 ("Exchange Act"). This section provides a safe harbor to money managers who use the commission dollars of their advised accounts to obtain research and brokerage services. The guidance we are publishing today clarifies that the term "commission" for purposes of the Section 28(e) safe harbor encompasses, among other things, certain transaction costs, even if not denominated a "commission."

Effective Date: The guidance is effective on the date of publication in the *Federal Register*.

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Supplementary Information:

I. Background

If money managers use commission dollars of their advised accounts to obtain research and brokerage services, Section 28(e) prevents them from being held to have breached a fiduciary duty, provided the conditions of the section are met.¹ Previously, the Commission interpreted Section 28(e) to be available only for research and brokerage services obtained in relation to commissions paid to a broker-dealer acting in an "agency" capacity.² That interpretation prevented money managers from relying on the safe harbor for research and brokerage services obtained in relation to fees charged by market makers when they executed transactions in a "principal" capacity.

The Nasdaq Stock Market, Inc. ("Nasdaq") asked us to reconsider this interpretation of Section 28(e). In particular, Nasdaq urged us to interpret the Section 28(e) safe harbor to apply not just to research and brokerage services obtained in relation to commissions on agency transactions, but also to such services obtained in relation to fully and separately disclosed fees on certain riskless principal transactions effected by National Association of Securities Dealers, Inc. ("NASD") members and reported under certain NASD trade reporting rules.³ In Nasdaq's view, the recent

amendments to its trade reporting rules for certain riskless principal transactions support a modification of the Commission's interpretation of Section 28(e).⁴

II. Discussion

Section 28(e) of the Exchange Act prevents a person who exercises investment discretion with respect to an account from being "deemed to have acted unlawfully or to have breached a fiduciary duty . . . solely by reason of his having caused the account to pay a [broker-dealer] an amount of commission for effecting a securities transaction in excess of the amount of commission another [broker-dealer] would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such [broker-dealer]. . . ." ⁵

This release clarifies the meaning of the term "commission" in the context of Section 28(e), and, therefore, the type of fees paid by a managed account to a broker-dealer for a securities transaction that may be used by the money manager to obtain research and brokerage services within the safe harbor. As noted above, the Commission to date has interpreted the term "commission" to include fees paid by a managed account to a broker-dealer for effecting a transaction in an agency capacity. This interpretation is based on the understanding that the term "commission" generally connotes an agency transaction.⁶ However, that interpretation is not mandated by the language of the statute. In fact, the reference to "dealer" in Section 28(e) might suggest that the term "commission" includes fees paid to a broker-dealer acting in other than an agency capacity.

The meaning of the term "commission" in Section 28(e) is informed by the requirement that a money manager relying on the safe harbor must determine in good faith that the amount of "commission" is reasonable in relation to the value of research and brokerage services received. This requirement presupposes that a "commission" paid by the managed account is quantifiable in a verifiable way and is fully disclosed to the money manager. When we issued our guidance in 1995, an agency transaction had more cost transparency than a principal transaction because frequently embedded within the cost of a principal transaction was undisclosed compensation to the dealer. In other words, fees on principal transactions were not quantifiable and fully disclosed in a way that would permit a money manager to determine that the fees were reasonable in relation to the value of research and brokerage services received.

Since that time, the NASD has modified its trade reporting rules for certain riskless principal transactions. Currently, NASD Rule 4632 (applicable to Nasdaq National Market securities), NASD Rule 4642 (applicable to Nasdaq SmallCap Market securities), and NASD Rule 6420 (applicable to "eligible securities") require a riskless principal transaction in which both legs are executed at the same price ("Eligible Riskless Principal Transaction") to be reported once, in the same manner as an agency transaction, exclusive of any markup, markdown, commission equivalent, or other fee.⁷ Coupled with Exchange Act Rule 10b-10, this form of trade reporting means that a money manager agreeing to an Eligible Riskless Principal Transaction receives the same price as received in the offsetting trade and that this price is disclosed on a confirmation that also fully discloses the remuneration to the NASD member for effecting this transaction.⁸ Thus, a money manager opting for an Eligible Riskless Principal Transaction would now be informed of the entire amount of a market maker's charge for effecting the trade.

In recognition of the transparency achieved in the Nasdaq market for certain riskless principal transactions, which allows a money manager to

make the necessary determination under Section 28(e), we are modifying our interpretation of Section 28(e). Specifically, we now interpret the term "commission" in Section 28(e) of the Exchange Act to include a markup, markdown, commission equivalent or other fee paid by a managed account to a dealer for executing a transaction where the fee and transaction price are fully and separately disclosed on the confirmation and the transaction is reported under conditions that provide independent and objective verification of the transaction price subject to self-regulatory organization oversight.

Fees paid for Eligible Riskless Principal Transactions that are reported under NASD Rule 4632, 4642, or 6420 would fall within this interpretation.⁹ Fees paid to an NASD member for effecting an Eligible Riskless Principal Transaction are distinguishable from fees paid on traditional riskless principal transactions as well as traditional principal transactions involving a dealer's inventory. Fees on other riskless principal transactions can include an undisclosed fee (reflecting a dealer's profit on the difference in price between the first and second legs of the transaction). Fees on traditional principal transactions also can include an undisclosed fee based on some portion of the spread. In addition, the price of the trade, if reported, is to some degree within the control of the dealer. In contrast, fees on Eligible Riskless Principal Transactions that are reported under NASD Rule 4632, 4642, or 6420 must be fully and separately disclosed. Moreover, the price of the trade is validated by the offsetting leg of the transaction.

Required disclosure of fees under confirmation rules and reporting of the trade under self-regulatory organization rules at a single price for both offsetting transactions, which provides independent verification of this price, give money managers information about fees and trade prices sufficient to make the determination of reasonableness of these charges. It is therefore reasonable to treat such fees as a "commission" for purposes of Section 28(e) only. As other markets develop equivalent regulations to ensure equivalent transparency, transaction charges in those markets that meet the requirements of this interpretation will be considered to fall within the interpretation.

III. Conclusion

For the foregoing reasons, we find that this interpretation is consistent with Section 28(e) of the Exchange Act and the requirements of that section.

List of Subjects

17 CFR Part 241

Securities.

Amendments to the Code of Federal Regulations.

For the reasons set forth above, the Commission is amending title 17, chapter II of the Code of Federal Regulations as set forth below:

PART 241 - INTERPRETATIVE RELEASES RELATING TO THE SECURITIES EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS THEREUNDER

1. Part 241 is amended by adding Release No. 34-45194 and the release date of December 27, 2001 to the list of interpretative releases.

By the Commission.

Jonathan G. Katz
Secretary

Dated: December 27, 2001

Endnotes

¹ 15 U.S.C. 78bb(e).

² Investment Advisers Act Release No. 1469 (February 14, 1995), 60 FR 9750 (February 21, 1995). In this release, the Commission stated, "[t]he safe harbor does not encompass soft dollar arrangements under which research services are acquired as a result of principal transactions," adopting a position originally outlined in a 1990 staff letter, authorized by the Commission, to the Department of Labor. See Letter re: *Section 28(e) of the Securities Exchange Act of 1934* (July 25, 1990). See also Investment Company Act Release No. 20472 (August 11, 1994), 59 FR 42187 (August 17, 1994).

³ See Letter from Hardwick Simmons, Chief Executive Officer, The Nasdaq Stock Market, Inc. to Harvey L. Pitt, Chairman, Commission, dated September 7, 2001.

⁴ See Exchange Act Release Nos. 41208 (March 24, 1999), 64 FR 15386 (March 31, 1999) (File No. SR-NASD-98-59); 41606 (July 8, 1999), 64 FR 38226 (July 15, 1999) (File No. SR-NASD-98-08); 43303 (September 19, 2000), 65 FR 57853 (September 26, 2000) (File No. SR-NASD-00-52). These filings amended NASD Rules 4632 (the trade reporting rule for Nasdaq National Market securities), 4642 (the trade reporting rule for Nasdaq SmallCap Market securities), and 6420 (the trade reporting rule for eligible securities).

⁵ 15 U.S.C. 78bb(e). See also Exchange Act Release No. 23170 (April 23, 1986), 51 FR 16004 (April 30, 1986).

⁶ In adopting the position in 1995 that Section 28(e) does not encompass principal transactions, we noted a 1990 staff letter to the Department of Labor. In that letter, the Division of Market Regulation stated that, "Section 28(e) refers to 'commissions' only, which connote transactions effected on an agency basis, and does not refer to markups or markdowns, which would more clearly have suggested that Congress intended to extend the safe harbor to principal transactions." See *supra* note 2.

⁷ See NASD Rules 4632(d)(3)(B) (for Nasdaq National Market securities), 4642(d)(3)(B) (for Nasdaq SmallCap Market securities), and 6420(d)(3)(B) (for eligible securities). Each of these rules defines a riskless principal transaction as a "transaction in which a member, after having received an order to buy a security, purchases the security as principal at the same price to satisfy the order to buy or, after having received an order to sell, sells the security as principal at the same price to satisfy the order to sell."

⁸ Exchange Act Rule 10b-10(a)(2)(ii), 17 CFR 240.10b-10(a)(2)(ii). Nasdaq SmallCap Market securities are subject to Exchange Act Rule 10b-10. See Exchange Act Release No. 45081 (November 19, 2001), 66 FR 59273 (November 27, 2001).

⁹ Riskless principal transactions in the debt market, however, are not currently subject to confirmation and reporting requirements that meet these conditions, under either NASD or Commission rules, and therefore would not be within the Section 28(e) safe harbor. Such transactions do not afford money managers the level of transparency necessary to determine if the remuneration paid is reasonable in relation to the value received, as required to rely on Section 28(e). The interpretation does not currently

extend to other securities that may have similar reporting requirements, but that do not have the same confirmation requirements for market makers, *e.g.*, OTC Bulletin Board stocks, Pink Sheet stocks, and convertible securities.

<http://www.sec.gov/rules/interp/34-45194.htm>

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