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**CONSULTATION PAPER ON  
CASH COMMISSION REBATES AND  
"SOFT DOLLAR" BENEFITS  
RECEIVED BY PORTFOLIO MANAGERS  
FROM BROKERS**

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July 1994

Hong Kong

**Securities and Futures Commission (SFC)**  
**Consultation Paper on Cash Commission Rebates and "Soft Dollar"**  
**Benefits Received by Portfolio Managers from Brokers**  
**in Exchange for Brokerage Business**

**EXECUTIVE SUMMARY**

1. The SFC is consulting the public on proposed conduct standards for portfolio managers in relation to cash commission rebates and "soft dollar" practices. These practices involve portfolio managers receiving cash rebates, or certain goods or services (known as "soft dollars"), from brokers in exchange for brokerage business placed with them by managers. The proposals in paragraphs 76 to 80 of this Paper are designed to be in line with international standards and to protect investors.
2. In relation to unit trusts and mutual funds authorized by the SFC, the proposals would prohibit the retention of cash commission rebates by portfolio managers. The proposals would regulate soft dollar practices by (1) requiring acceptable goods or services to be of demonstrable benefit to clients, (2) requiring transactions for the fund to be executed on the best available terms; and (3) requiring managers to make prior and periodic disclosure of soft dollar practices to investors.
3. In relation to private discretionary accounts, such as pension funds and unauthorized unit trusts, the proposals would initially be based on a disclosure regime - if clients are prepared to agree to the manager retaining cash rebates the clients would have to give their written consent and be provided with periodic disclosure of the value of rebates involved. In the long run, the SFC intends to prohibit cash rebates for discretionary accounts, so the disclosure regime should be viewed as an interim measure. Soft dollar standards of conduct would be similar to those described above for unit trusts. The proposals would also require that portfolio-related transactions with persons connected with the portfolio manager be undertaken at arm's length terms and in the best interests of the client.

**BACKGROUND**

4. The SFC has pursued a policy of supplementing the Hong Kong statutory framework applicable to the securities and futures markets with non-statutory codes. The codes have been formulated after consultation with market practitioners and are designed to provide guidance to the marketplace in the form of minimum acceptable standards of business conduct in line with international standards. Examples of

such codes now in place are the Code on Unit Trusts and Mutual Funds and the Code of Conduct for Persons Registered with the SFC.

5. One area of market practice in Hong Kong not specifically addressed by statute or code provisions concerns the rebate of cash commissions and "soft dollar" practices. These practices typically involve a broker providing cash rebates or certain goods or services ("soft dollars") to a portfolio manager in consideration of the portfolio manager paying the broker commissions to execute portfolio transactions. Such practices have been the subject of intensive study and debate internationally and are now regulated in most major markets.
6. In response to suggestions from local market participants and having regard to the developing international standards in this area, the SFC is now considering how the Hong Kong regulatory system should address cash rebates and soft dollar practices. As described below, the SFC has examined local and overseas practices and regulations, and the views of selected market participants. The SFC's proposed conduct standards address cash rebates and soft dollar practices in the Hong Kong context.
7. The SFC invites interested persons to submit comments on this Consultation Paper by 1 August 1994. Comments should be sent to :

Securities and Futures Commission  
12th Floor, Edinburgh Tower  
15 Queen's Road Central  
The Landmark  
Hong Kong

For the attention of the Secretary to the Commission

## **HONG KONG MARKET PRACTICES AND REGULATION**

8. Hong Kong is a prominent centre for portfolio management activity, including unit trusts and mutual funds authorized by the SFC and on a greater scale other accounts managed primarily for local and overseas institutions such as pension funds and also individuals or family trusts. The value of assets managed in over 900 SFC authorized vehicles is approximately HK\$350 billion. The SFC estimates that roughly 3 times this amount, or approximately HK\$1,000 billion, in other institutional portfolios is managed from Hong Kong.

### **Authorized Unit Trusts/Mutual Funds**

9. A typical unit trust involves a set of underlying governing documents, such as a trust deed and agreements appointing an independent trustee/custodian and a management company. Mutual Funds are structurally different from, but analogous to, unit trusts. The management company generally acts as the portfolio manager for the trust or "fund" and if it carries on business in Hong Kong will typically be registered with the SFC as an investment adviser. The overall organization and operation of authorized unit trusts are governed by the SFC's Code on Unit Trusts and Mutual Funds.
10. Units in a fund are offered to the public through an offering document such as a prospectus or explanatory memorandum. Annual audited reports, and at least one interim report each year, must be provided to unit holders. A core requirement of the SFC's Code is that the manager must manage the fund in accordance with the underlying documentation in the exclusive interests of the holders and in compliance with the general law.
11. The compensation of the management company generally comes from an initial charge paid by the investor and from an annual management fee expressed as a percentage of assets under management and payable out of fund assets. These fees are described in the offering document and generally range up to 5% for the initial charge and from 1% to 2% for the annual management fee for diversified stock funds.
12. The trust deed and explanatory memorandum also provide that other fees and expenses are payable out of fund assets. These charges typically include, among other things, the trustee's fee, custodial fees, the auditor's fee, legal costs, registration fees, and brokerage commission. It is in relation to brokerage commission expenses as a charge against fund assets that the issues of cash rebates and soft dollar practices arise.

### **Commission Rebates**

13. Some unit trusts specifically authorize the manager to retain cash commission rebates; the underlying documentation usually includes a provision stating that the manager is entitled to retain any commission rebates it may receive concerning transactions entered into by the fund. Managers who are authorized to retain cash commission rebates may derive a significant amount of revenue from this source.

14. Other unit trusts do not authorize the manager to retain cash commission rebates. This is usually because the fund managers or their affiliates are prohibited in their home jurisdictions from retaining such rebates, or otherwise choose not to engage in this practice.
15. In a recent survey of portfolio managers, the SFC examined, among other things, management fees and brokerage commission rebates. For those managers who retain cash commission rebates, the SFC found that although commission rebate revenues were negligible for some funds, for other managers rebates ranged from 25% to well over 100% of management fee revenues. These figures are aggregates for both authorized unit trusts and institutional accounts, and are not necessarily representative of overall unit trust activity in Hong Kong.
16. The SFC understands that brokerage commission rates for institutional-size transactions in Hong Kong stocks usually range from .25% to .50% of transaction value. For managers of unit trusts who are authorized to retain cash commission rebates, brokers usual practice is to invoice a .50% commission and separately rebate .125% to .25% of transaction value in cash to the portfolio manager. Unit trusts that do not accept cash rebates can usually negotiate in Hong Kong full-service brokerage rates from .25% to .35% of transaction value.
17. Authorized unit trusts are required to provide unit holders with an independently audited annual report and accounts and at least one interim report. A required revenue statement must itemize expenses which have been debited to the fund, including, among others, fees paid to the management company, directors' fees and remuneration, safe custody and bank charges, auditors' remuneration, and any other expenses borne by the fund. There is no requirement that brokerage commission expenses be separately itemized nor that the amount of any cash commission rebates retained by the manager be disclosed. In practice, brokerage commission expenses are usually not itemized in unit trust reports and where cash commission rebates are retained by the manager no disclosure of the amounts involved is made to unit holders.
18. Another practice of some managers of unit trusts in Hong Kong is the use of affiliated brokers for the execution of portfolio transactions. Affiliates may also be used for banking or custodial services and foreign exchange transactions. The SFC's Code on Unit Trusts and Mutual Funds imposes certain restrictions on transactions with connected persons. For example, all transactions carried out by

or on behalf of the fund must be at arm's length. In addition, no single connected stockbroker should account for 50% or more of the fund's transactions in any one year. Transactions with connected persons are also subject to disclosure requirements.

### **Soft Dollars**

19. Apart from cash commission rebates, brokers may provide certain goods and services ("soft dollars") to portfolio managers in exchange for brokerage business. Overseas markets such as the United Kingdom and United States generally prohibit cash rebates, but allow the provision of soft dollar benefits subject to certain regulatory requirements. The soft dollar industry has grown dramatically in overseas markets and is now fairly well developed in Hong Kong.
20. A number of brokers now operating in Hong Kong specialize in providing portfolio managers with a wide range of investment-related goods and services in exchange for brokerage business. Commission levels charged by soft dollar brokers are usually the same as those charged by traditional brokers. Goods and services provided by soft dollar brokers to managers include Reuters and Telerate services and other market data and price information, publications, specialized computer hardware and software, and portfolio analysis and performance services. The provision of specific goods or services is usually tied to a specified level of transactions being directed to the broker. These goods and services can be contrasted with, but are also analogous to, the research and other services provided by traditional "full-service" brokers.
21. The SFC understands that many managers of unit trusts in Hong Kong accept a wide range of soft dollar goods and services, such as those mentioned above. In particular, managers who do not accept cash commission rebates typically accept soft dollars. A portfolio manager generally divides his brokerage business among both full-service brokers and soft dollar brokers to obtain both traditional research and other soft dollar benefits. Several market participants have estimated that approximately 10% of commission dollars paid in Hong Kong are rebated to portfolio managers in the form of soft dollars. Some managers due to their affiliations or internal policies follow overseas regulations governing soft dollars. However, the SFC has observed that most unit trust documentation and offering documents in Hong Kong provide little or no information or disclosure concerning soft dollar practices.

### **Institutional Accounts**

22. A typical institutional arrangement involves a local or overseas institution such as a pension fund, which engages the services of a Hong Kong portfolio manager. The arrangement generally is governed by an investment management agreement (IMA). The Hong Kong portfolio manager will typically be registered with the SFC as an investment adviser. Hong Kong portfolio managers who act as management companies for authorized unit trusts also manage institutional portfolios. For most portfolio managers, institutional business accounts for a greater portion of their overall business than do authorized unit trusts.
23. The institutional portfolio management business in Hong Kong is competitive. Many institutions employ sophisticated professionals or outside consultants to negotiate their IMAs and to evaluate their portfolio managers. However, a number of smaller institutions and many private clients remain unsophisticated and unaware of cash rebates and soft dollar practices.
24. The typical IMA sets the compensation of the portfolio manager as a percentage of the value of portfolio assets. Management fees in Hong Kong generally range from .25% to .40% of assets under management for an institutional-size diversified stock portfolio, with higher rates applicable to smaller portfolios and private individual accounts. Management fees in Hong Kong are generally viewed as being low compared to institutional fees in other fund management centers. Some believe this is due to competition and economies of scale achieved by larger managers, while others believe this results from cash rebate practices maintaining disclosed fees at artificially low levels.
25. The IMA typically provides that specified expenses of managing the portfolio such as brokerage commission, custodial fees, transfer fees, and stamp duty will be payable out of the assets under management. As with unit trusts, the context of brokerage commission as an expense gives rise to cash rebate and soft dollar practices.
26. For institutional accounts, a number of different practices are adopted in Hong Kong in relation to cash rebates. As with unit trusts, some portfolio managers do not accept cash commission rebates for overseas regulatory reasons or because of internal policy. The IMAs for these accounts may specify that rebates are for the account of the fund. Some such agreements authorize the manager to retain rebates, but in practice the managers do not do so. As discussed below, managers

who do not take cash rebates are likely to accept soft dollars. Some managers who do not take cash rebates market themselves to clients as charging only "clean" fees.

27. Unlike the situation with unit trusts, some institutional clients will insist that their managers not take cash commission rebates and negotiate an IMA accordingly. Many of these clients are located in overseas markets which prohibit cash rebates. For these clients, the IMA will typically specify that any rebates received by the manager must be for the account of the fund. Most portfolio managers who take cash rebates on other accounts are willing to negotiate an IMA providing that rebates are for the account of the fund in order to compete for this segment of the market.
28. Other institutional clients are well aware of cash rebate practices and are willing to consider an IMA with or without restrictions on cash rebates, depending on the overall management fee and the reputation or performance of the portfolio manager. The client may, for example, consider a management fee of .25% where the manager may retain rebates and a .35% fee where rebates are for the account of the fund. In some instances where the client chooses to authorize the manager to retain rebates, the client may monitor portfolio transactions closely and insist on periodic reports from the manager detailing the amount of rebates generated for the manager.
29. Another category of clients consists of relatively small and unsophisticated institutions and private clients. The standard form IMA used by some managers will provide that rebates may be retained by the manager. This fact is not necessarily highlighted to the client who may retain the manager's services without fully understanding cash rebate practices or without receiving full information as to the amount of rebates the manager may receive.
30. Commission rates and soft dollar practices for institutional accounts are similar to those for unit trusts. One difference, however, is a practice termed "directed brokerage". Under this practice, which is growing rapidly overseas, the institutional client directs the manager to use a particular broker for say 25% of portfolio transactions. The client then arranges for soft dollar goods and services, or cash rebates, to be provided by that broker directly to the client rather than the manager.

### **Hong Kong Regulations**

31. The SFC's Code on Unit Trusts and Mutual Funds applies to all authorized unit trusts. It requires, among other things, the manager to act in the exclusive interests of holders, the use of an offering document or prospectus, and the issue of audited annual reports, and it restricts certain connected transactions and requires disclosures related thereto. The Code on Unit Trusts and Mutual Funds contains few provisions in relation to specific conduct requirements, the underlying principle being (as with many European jurisdictions) that the manager has a general fiduciary obligation to manage the scheme in the best interests of investors.
  
32. The management of institutional and other discretionary accounts is subject to the SFC's Code of Conduct for Registered Persons if the manager is registered with the SFC. This Code sets out a number of important principles providing, among other things, that -
  - . a registered person shall insure that any representations made and information provided to a client are accurate and not misleading;
  - . the general course of dealing or advising and the fees or charges affecting a client be fair and reasonable under the circumstances and characterized by good faith;
  - . client orders be executed on the best available terms (i.e. "best execution");
  - . a client agreement contain a description of any remuneration (and the basis for payment) paid by the client to the registered person, such as brokerage and any other fees and charges;
  - . a registered person provide a client with a statement of account at least quarterly in relation to the client's transactions and related dealings; and
  - . a registered person disclose actual or potential conflicts of interest and take all reasonable steps to ensure fair treatment of the client.

33. The provisions in the Code of Conduct for Registered Persons noted above could and perhaps should be interpreted to provide certain conduct standards in relation to cash commission rebates and soft dollar practices. However, these Code provisions are relatively new to Hong Kong and have not been the subject of specific interpretations regarding these practices. They have also not been specifically interpreted to provide standards concerning managers' use of connected persons in relation to portfolio matters (e.g. affiliated brokers, banks, and foreign exchange operations). Rather than interpreting the existing Code provisions to cover cash rebates and soft dollar practices, the SFC proposes specific new standards in paragraphs 76 to 80 of this Paper.

### **Common Law Principles**

34. At common law there is a fiduciary relationship between a portfolio manager and his client. This means the manager owes fiduciary duties to the client, including a duty to act in the client's best interests. The fiduciary relationship generally prohibits the manager from using the client's assets to benefit himself or from engaging in conduct which conflicts with his duties to act in his client's best interests. He is also restricted from using his client's assets to make a secret profit for himself.
35. The SFC understands that similar principles apply in other markets, including the United Kingdom, Singapore, Australia, and the United States. The consequence of these principles is discussed below in relation to the SFC's proposals, and the need for disclosure of cash commission rebates and soft dollar practices.

### **Prevention of Bribery Ordinance (PBO)**

36. Section 9 of the PBO generally makes it an offence for any agent to accept, without reasonable excuse, an advantage as an inducement for doing any act in relation to his principal's affairs or business. It may also be an offence for a third person to offer an agent an advantage in such circumstances. The SFC understands that some legal advisers believe that cash commission rebates and soft dollar practices could involve portfolio managers and brokers in breaches the PBO unless the client consents to these practices and disclosure is made. Disclosure and consent are discussed further in relation to the SFC's proposals.

## OVERSEAS MARKET PRACTICES AND REGULATION

### United Kingdom (U.K.)

37. In the U.K., cash commission rebates are generally prohibited and soft dollar practices regulated under the Financial Services Act. Regulations on soft dollar practices were first put in place in 1989 when soft dollars were estimated to account for approximately 5% of total commission business. It is estimated that today soft dollars account for 10% to over 20% of commission business in the U.K..
38. A typical soft dollar arrangement in the U.K. involves a portfolio manager entering into an agreement with a broker whereby the manager agrees to direct a certain level of portfolio transaction business through the broker in return for the receipt of certain goods and services. The agreement generally contains a "multiple" or "conversion ratio" to govern the value of goods or services received in relation to commission paid. For example, a multiple of 1.5 means that for each \$1.5 dollars of commission paid, \$1 in goods or services will be provided. Multiples in the U.K. have ranged from 2.0 to as low as 1.2 during a price war among integrated market-makers.
39. The primary regulatory provision in the U.K. is Rule 3 of the Securities and Investment Board (SIB) Core Conduct of Business Rules (see Exhibit 1). Rule 3 in summary provides that : soft dollar benefits are restricted to goods and services that are used to assist in the provision of investment services to clients; the broker must agree to provide best execution; broking services supplied must not involve price disadvantages to clients; and adequate prior and periodic disclosure must be made. SIB has interpreted the Rule to prohibit cash commission rebates.
40. The core Rule described above is supplemented by further rules of the U.K. self-regulatory organizations. For example, IMRO Rules specify acceptable and unacceptable soft dollar benefits. As reflected in Exhibit 1, these Rules allow, among other things, research and portfolio-related services, certain computer hardware and software, dedicated telephone lines, seminar fees, and publications. The Rules prohibit benefits such as travel, accommodation, office equipment, salaries and direct money payments. The Rules also require prior disclosure of the manager's soft dollar policy and periodic disclosure of the nature and value of goods and services received in relation to total commissions paid. The disclosure is based on the managers' overall activity and is not specific to individual accounts.

### United States (U.S.)

41. Soft dollar arrangements in the U.S. are similar to those in the U.K. and other markets. The portfolio manager will receive a specified value of soft dollar benefits in relation to total commission paid to the broker. The multiples in the U.S. typically range from 2 to 1.5 (i.e. at a multiple of 2 the manager receives \$1 in soft benefits for every \$2 in commission paid). Managers divide their brokerage business among both full-service and soft dollar brokers to obtain traditional research and soft dollar goods and services. In addition, many full-service brokers also act as soft dollar brokers to compete in this area.
42. The U.S. federal securities laws allow a portfolio manager to pay higher brokerage commission than that generally available for simple execution services provided the amount of commission charged is reasonable in relation to brokerage and research provided by the broker [see Exhibit 1, Section 28(e)]. Best execution is required; the manager must determine in effect that the execution service and the soft dollar benefits received could not have been obtained separately at a lower cost. The benefits received must assist the manager in the discharge of his responsibilities to his clients generally. Written disclosure must be made to clients including the manager's soft dollar practices, the types of soft dollar benefits received, and the conflicts of interest that may arise. The general rule does not require disclosure of the value of soft dollar benefits received, the ratio of soft dollars received to total commissions received, nor soft dollar activity in relation to specific individual accounts. Cash rebates are not allowed as they would violate the best execution rule.

### Australia

43. The Australian Investment Managers' Group recently issued a practice note on soft dollar dealing. The note, at Exhibit 1, provides as follows in relation to soft dollar arrangements: goods or services acquired are of demonstrable benefit to the client; the cost of dealing will not disadvantage the client; if the broker acts as principal the notional brokerage rate should be the same as it would be on an agency basis; there are no cash rebates which could amount to a secret commission; the overall level of soft dollar arrangements should not be excessive; disclosure should be made; and specific information should be supplied to clients on request.

### Other Markets

44. In many markets where cash rebates and soft dollar practices are not specifically regulated, these practices are usually governed by common law or statutorily imposed principles of fiduciary duty similar to those discussed above. Interpretation and application of principles of fiduciary duty in various markets is complex and beyond the scope of this Paper.
45. The SFC has, however, reviewed information compiled by the International Organization of Securities Commissions concerning portfolio managers and conflicts of interests. Summary information indicates that regulatory authorities in a number of markets interpret their local rules to prohibit managers from receiving compensation other than from the portfolio (Spain, France, and Japan) or to prohibit soft dollar arrangements (Italy, Switzerland, and Germany). In addition, rules in these markets impose various restrictions on transactions involving a portfolio and persons connected with the portfolio manager.

## **DISCUSSION**

### Cash Commission Rebates

46. The SFC believes that current cash rebate practices raise significant concerns that must be addressed in Hong Kong. The SFC's main concerns with cash rebates are that at present inadequate disclosure is made to clients, the best execution requirement is often not met, conflicts of interest may be created, and that there is a need to ensure that rebate practices comply with Hong Kong common law and legislation.

### **Authorized Funds**

47. For authorized unit trusts, the level of cash rebates received by a manager is generally not disclosed to unit holders. Disclosure that rebates may be retained by the manager is usually cursory and often contained in a complex trust deed that is not seen or read by most investors. A unit holder or prospective unit holder is led to believe that the manager's compensation is provided by an initial charge and an annual management fee and that "normal" brokerage commission is an expense payable out of the fund. In comparing several unit trusts each advertising a management fee of say 1.5%, it is not clear that one manager may receive only a 1.5% payment out of fund assets while the other manager receives 1.5% plus

significant additional revenues flowing from cash rebates. In many cases, the investor is also completely unaware that brokerage commission payments from both funds are being used to pay for a wide range of soft dollar goods and services for the portfolio manager.

48. In the case of institutional accounts, many but not all clients are aware of cash rebate practices and are free to negotiate an IMA to prohibit cash rebate payments or require related disclosure. However, in the SFC's experience, most institutional clients are subject to an existing IMA that does not provide adequate disclosure of the value of rebates involved. The SFC believes that clients will not receive adequate disclosure unless a disclosure requirement is put in place.
49. The SFC is especially concerned with the effect of cash rebates on the best execution requirement. The SFC understands that full-service brokerage commission rates are available in Hong Kong at between .25% to .35% for institutional-size transactions. Managers that do not accept cash rebates are able to negotiate commissions in this range while managers that do accept rebates often pay higher rates, for example .50%, and receive and retain from .15% to .25% in cash for their own accounts. This practice is not consistent with the best execution requirement and is not adequately disclosed to clients.
50. As noted, fiduciary duties and the PBO are relevant to any discussion of cash rebate practices. Both would indicate that portfolio managers must obtain the informed consent of clients to cash rebates and must make full disclosure of such practices to clients.
51. Another factor relevant to cash rebates relates to the potential for conflict of interest, and for overtrading or "churning" of portfolios. For a manager who takes cash rebates, each portfolio transaction generates additional revenue for the manager regardless of the merits of the transactions or the performance of the portfolio. Market participants have suggested that cash rebates involve an inherent conflict of interest that creates the temptation to overtrade.
52. **The SFC believes that at a minimum the Hong Kong regulatory system must specifically require the consent of clients to cash rebates and full disclosure of such practices by portfolio managers to clients. In relation to authorized unit trusts, the SFC believes the appropriate regulatory response is a prohibition of cash commission rebates. The SFC's proposals in this regard are contained in paragraphs 76 to 80 of this Paper.**

53. Under current market practices, unit trust holders are not aware of the value of rebates involved nor of how rebates affect best execution. They are also unable to make informed comparisons between unit trust managers who do and do not accept rebates. Furthermore, if they do become aware, the cost of switching from one fund to another can be quite high. Current practices therefore contribute to a lack of transparency in relation to fees and charges.
54. The SFC believes that its concerns in relation to cash rebates and authorized unit trusts would not be addressed through increased disclosure. Even if substantial and complete information were available, the potential for conflicts of interest in the SFC's view outweighs any benefits flowing from cash rebate practices in relation to authorized unit trusts.
55. It has been suggested that a prohibition of cash rebates in relation to unit trusts could damage the fund management industry and Hong Kong in general. For example, some managers may decide to move their operations to other jurisdictions to avoid Hong Kong regulations and thereby detract from overall economic activity in Hong Kong. The SFC does not believe that this would occur to any material extent merely as a result of such a prohibition nor that the potential for this to occur justifies a continuation of current cash rebate practices in relation to authorized unit trusts.
56. From discussions with market participants, the SFC understands that the likely effect of a prohibition of cash rebates in relation to authorized unit trusts is that managers who currently rely on rebates will consider increasing management fees. The SFC considers that such a move would be in line with the need for greater transparency in relation to fees and charges. There have been suggestions that managers may consider implementing a "transaction fee" to cover costs that are now covered through rebates. Due to the potential conflicts of interest inherent in most transaction based charges, the SFC would not look favourably on such arrangements. Managers may also consider increasing their level of soft dollar activity, which is discussed further below.
57. It has also been suggested that a prohibition of cash rebates would unfairly benefit integrated firms with both fund management and brokerage arms, as commissions would simply be retained within the brokerage division. However, the SFC notes that limitations are placed on the use of connected brokers by the Code. The principle of best execution should be the overriding consideration and adherence to this will be monitored through the SFC's regular compliance visits. It is also noted that retention of rebates is by no means a uniform practice among fund managers in Hong Kong, even among those without brokerage affiliates.

### **Discretionary Accounts and Unauthorized Unit Trusts**

58. The practice of retaining cash rebates by a manager of institutional and other private discretionary accounts, as it is with the manager of a unit trust, conflicts with the best execution standard and creates other conflicts of interest between the manager and his clients. However, the operation of institutional and other discretionary accounts differs from the operation of unit trusts, in that a discretionary account client typically executes an IMA with the manager which sets out the terms upon which the manager is to handle the account. Many clients, particularly institutional clients, employ professional consultants to negotiate their IMAs and often knowingly consent to their manager accepting cash rebates in exchange for lower account management fees.
59. As a result of this difference, the SFC, while of the view that the practice of cash rebates should be eliminated altogether, believes that a prohibition of cash rebates at this time for institutional and other discretionary accounts would be overly disruptive to the portfolio management industry, as all IMAs authorizing managers to retain rebates would need to be renegotiated. The IMA renegotiation process would require a substantial work effort by the industry and would add extra expenses to the industry and its clients.
60. **The SFC believes that the initial step to deal with its cash rebates concerns relative to discretionary accounts is to impose new standards of increased disclosure.** The proposed standards would require managers to obtain prior written consent from their clients allowing the manager to retain cash rebates and, thereafter, to disclose to each client on a periodic basis the amount of cash rebates the manager has received in handling the account. The SFC believes that the disclosure standard could be implemented relatively quickly, would not be overly disruptive to the portfolio management industry, and would greatly increase the transparency of management fees. The increased disclosure would enable institutional and less sophisticated clients to effectively compare compensation levels among managers that retain cash rebates and those who do not.
61. The SFC's decision to propose increased disclosure to address its concerns about cash rebate practices associated with the management of discretionary accounts is an interim measure to allow the portfolio management industry a limited time to prepare for the elimination of the practice. **The SFC has concluded that the longer term solution to address its cash rebate concerns is to eliminate the practice. This is likely to take several years.**

### Soft Dollar Arrangements

62. In recent years soft dollar arrangements have grown rapidly in overseas markets and in Hong Kong. Prior to the development of negotiated brokerage commission rates in markets such as the U.S. and U.K., brokers could not compete effectively on price and therefore competed on service. The primary service provided by brokers to portfolio managers was research. There was not much regulatory concern over the provision of research, because all brokers charged roughly the same rates. The research did not carry a higher cost and it benefited the manager and clients.
63. As brokerage rates became negotiable, a question arose as to whether a manager could pay more than the minimum available brokerage rate to a full-service broker who provided high-quality research. If he could not, he or his client would have to search out the lowest commission rate and pay separately for research, but brokers did not sell research separately. The regulatory response could either force an unbundling of brokerage rates (i.e. separate charges for execution, research, advice, etc) or allow "paying up" for research (i.e. allow paying more than the lowest available rates in exchange for the research). U.S. and U.K. regulators, for example, decided to allow such "paying up".
64. Over the years, "research" became more complicated than the traditional written reports concerning investments and began to include sophisticated analyses of portfolios, performance, market prices and market movements. The research became automated and therefore required computer hardware and software to access and analyze the research. At the same time, transaction execution and settlement services became cheaper due to new trading and settlement systems, and the overall automation of the industry. This explains the development of low soft dollar multiples as noted above (e.g. \$1.5 or even \$1.2 dollars paid in brokerage commission can be converted into \$1 of soft goods and services).
65. An accompanying development to "paying up" for research was the regulatory approach of allowing brokers to provide research generated by third parties. The manager could pay a commission higher than the lowest available to a broker who did not generate research himself, but purchased it from third parties and delivered it to the manager. This was justified as promoting competition among brokers and in the generation of research, including promotion of third-party research.

66. The concept of "research" became broader with technological advances. It was also broadened in regulations to eventually include any goods or services that assist the manager in servicing his clients. The rationale was one of product substitution; if a manager could "pay up" for traditional research, he ought to be able to "pay up" for other goods or services that provide similar assistance to him and are beneficial to his clients.
67. In allowing the receipt of soft dollar goods and services, regulators have insisted that clients receive best execution on their transactions. Best execution is now interpreted by regulators to mean not necessarily the lowest execution price, but that the quality and price of execution services plus the value of soft dollar goods and services received could not have been obtained separately at a lower price. Also, established soft dollar regulations require disclosure to clients of soft dollar practices.
68. Although soft dollar arrangements have gained general acceptance, they are subject to criticisms and concern. From the client's perspective, soft dollars represent hard cash paid out of the client's assets. Critics argue that managers have less incentive to negotiate lower commission rates or seek the best execution services, but have an incentive to negotiate to receive goods and services for themselves that they would otherwise have to pay for out of their own resources. Others argue that the same potential problem has always existed in relation to "paying up" for traditional research.
69. Soft dollar arrangements are also criticized as creating conflicts of interest. Most soft dollar arrangements are based on the manager directing a certain level of business to the broker in exchange for soft dollar benefits, which may be received in advance. Critics argue that this ties the manager into using the soft dollar broker, even if the broker's execution services prove to be inferior. The manager may also be tempted to overtrade a portfolio to reach the required level of commission business. Respondents argue again that these conflicts exist with full-service brokers and the receipt of traditional research.
70. Another criticism of soft dollar arrangements is that they are creating fundamental and detrimental changes to the securities industry. Full-service brokers argue that they lose market share to soft dollar brokers, because the aggregate level of commission business in any market is not increased by the introduction of soft dollar brokers. In response, full-service brokers must reluctantly join in softing or cut costs which could adversely affect the quality

of their research. Full-service brokers also argue that managers direct "easy" and lucrative executions to soft dollar brokers and direct less profitable and more difficult executions to full-service brokers.

71. Soft dollar arrangements have become a common practice in Hong Kong. However, industry practices indicate that unit trust and institutional investors are not adequately informed of soft dollar practices. In addition, there are no guidelines covering acceptable soft dollar goods and services. The SFC therefore believes standards should be introduced in Hong Kong in relation to soft dollar arrangements.
72. An initial question is whether soft dollar arrangements should be prohibited in Hong Kong. The SFC does not endorse soft dollar arrangements and believes they may create conflicts of interest between managers and clients. As a practical matter, however, soft dollar practices are now entrenched in major international markets, including Hong Kong and the markets in which Hong Kong managers are active. In addition, a prohibition of soft dollar practices could call into question the provision of research as a soft dollar benefit, even though this result would not be intended. Finally, soft dollar practices can be controlled to guard against conflicts of interest. The SFC therefore believes a prohibition of soft dollar activity would be unduly disruptive and is not the appropriate regulatory response in Hong Kong.
73. **The SFC is, however, proposing standards which are broadly in line with international standards in this area. The proposed standards in summary would (1) allow soft dollar arrangements, subject to restrictions on acceptable goods and services, (2) continue to require best execution, and (3) require prior and periodic disclosure to be made to clients.** The proposed standards would apply to authorized unit trusts and to other discretionary accounts and incorporate a transition period.
74. **In relation to discretionary accounts other than authorized unit trusts, the proposals would also require arm's length dealings in relation to persons connected with the manager.** This is similar to the requirements of the Code on Unit Trusts and Mutual Funds and is viewed as necessary to prevent evasion of the SFC's proposals through use of connected parties. It is also consistent with international standards and principles of fiduciary duty.

75. The SFC expects that the introduction of the proposed standards covering soft dollar practices should not have a significant or disruptive impact in Hong Kong, as many managers already follow overseas regulations in relation to these practices. For those managers who do not follow overseas regulations, the SFC believes the proposed standards will not be unduly burdensome and should contribute significantly to clients' understanding of soft dollar practices. The standards should also operate to guard against abuse of soft dollars. The proposed standards are relatively simple and are in the SFC's view the appropriate starting point for conduct standards in Hong Kong. As experience is gained with the proposed standards and as market practices develop, modifications or additional standards may be necessary.

## **THE SFC'S PROPOSED STANDARDS FOR CASH COMMISSION REBATES AND SOFT DOLLAR ARRANGEMENTS**

### **Authorized Unit Trusts and Mutual Funds**

76. The SFC proposes that its Code on Unit Trusts and Mutual Funds be amended to specifically prohibit the retention of cash rebates by management companies and investment advisers of authorized funds, and to regulate soft dollar practices.
77. The soft dollar principles would allow a management company or adviser for an authorized fund to receive goods or services from a broker in consideration of directing transactions in fund property to the broker only if :
- (a) the goods or services are of demonstrable benefit to the holders;
  - (b) the price and quality of transaction execution and the value of such goods or services are on the best available terms; and
  - (c) adequate prior and periodic disclosure is made in the fund's offering document and annual and interim reports.
78. The goods and services (i.e. soft dollars) contemplated within (a) above would typically include the following : research and advisory services, including economic and political analysis; portfolio analysis, including valuation and performance measurement; market analysis, data and quotation services; computer hardware and software incidental to the above goods and services; and

investment-related publications. Such goods and services would not include travel, accommodation, entertainment, general administrative goods or services, general office equipment or premises, membership fees, employee salaries, or direct money payments.

79. Compliance with the new requirements would be expected by 1 January 1995. However, managers of authorized funds would have a period of one year after the amendments become effective to amend their documentation in accordance with the new requirements.

### **Persons Registered with the SFC**

80. The SFC proposes to add the following provision to its Code of Conduct for Persons Registered with the SFC.

#### *C13. Rebates, Soft Dollars, and Connected Transactions*

*13.1 A registered person who acts for a client in the exercise of investment discretion may receive goods or services (i.e. soft dollars) from a broker in consideration of directing transaction business on behalf of such client to the broker only if:*

- (a) the goods or services are of demonstrable benefit to the client;*
- (b) the price and quality of transaction execution and the value of such goods or services are on the best available terms; and*
- (c) adequate prior and periodic disclosure is made to the client.*

*13.2 A registered person described in 13.1 who intends to receive and retain cash or money rebates in relation to client transactions may retain such rebates only if:*

- (a) the client has consented in writing to such retention of rebates, and*
- (b) full periodic disclosure of such rebates and their approximate value is made to the client.*

- 13.3 *A registered person described in 13.1 shall ensure and be able to demonstrate that any transactions undertaken or other services acquired in relation to a client's account that involve payments from client assets directly or indirectly to a person connected with the registered person are undertaken at arm's length terms and in the best interests of the client. Essentially, this requires that such terms not be less favourable than those generally available in the market.*
- 13.4 *A registered person acting as a broker or dealer who provides goods or services as described in 13.1(a) or rebates described in 13.2 shall not knowingly contribute to a violation of this section by another registered person and should endeavour to follow the requirements of this section, including in relation to portfolio managers who are not registered persons.*

*Guidance Notes.*

- 1. Goods and services falling within 13.1(a) above may include : research and advisory services, including economic and political analysis; portfolio analysis, including valuation and performance measurement; market analysis, data and quotation services; computer hardware and software incidental to the above goods and services; and investment-related publications. Such goods and services may not include travel, accommodation, entertainment, general administrative goods or services, general office equipment or premises, membership fees, employee salaries, or direct money payments. This Guidance note is not exhaustive and may be amended from time to time.*
- 2. Prior disclosure noted in 13.1(c) above should generally be made in the Client Agreement or other investment management agreement (or an addendum thereto). Such disclosure must include a statement in prominent print that the client may pay higher brokerage rates than those generally available for transaction execution in exchange for the manager receiving good and services falling within 13.1(a) above. Periodic disclosure must be made at least twice annually and include a statement describing the registered person's soft dollar practices, including a description of the goods and services received by the manager.*

*If cash rebates are retained under 13.2, prior consent should generally be obtained in the Client Agreement or other investment management agreement (or an addendum thereto). Specific disclosure in prominent print must be included containing a statement that the client may pay higher brokerage rates than those generally available; the difference constituting a cash payment to the registered person. Periodic disclosure must be made at least quarterly and must include a quantification of the value of rebates received in relation to the client's account. Disclosure may also be made in contract notes. Quantification of rebates may involve estimates taken from aggregate commission and rebate data provided such estimates are reasonably accurate in relation to the client's account.*

3. *Compliance with 13.1 above is expected by 1 January 1995. For periodic disclosure, a disclosure statement should be provided to clients by 1 July 1995.*

*Registered persons, as a matter of good business practice, should already be in compliance with 13.2 in relation to (a) client consent and (b) prior disclosure. Compliance by all registered persons is expected by 1 January 1995. For periodic disclosure, a disclosure statement should be provided to clients by 1 July 1995.*

*Registered persons should also already be in compliance with 13.3. Compliance by all registered persons is expected by 1 January 1995.*

Encl.

## SIB Rules

### Soft Commission

#### Core rule 3

A firm which deals for a customer on an advisory basis or in the exercise of discretion may not so deal through a broker pursuant to a soft commission agreement unless:

- a. the only benefits to be provided under the agreement are goods or services which can reasonably be expected to assist in the provision of investment services to the firm's customers and which are in fact so used;
- b. the broker has agreed to provide best execution to the customer;
- c. the firm is satisfied on reasonable grounds that the terms of business and methods by which the relevant broking services will be supplied do not involve any potential for comparative price disadvantage to the customer;
- d. in transactions in which the broker acts as principal, he is not remunerated by spread alone; and
- e. adequate prior and periodic disclosure is made.

## IMRO Rules

### Soft commission

- 5-8 (1) A *firm* which deals for a *customer* on an advisory basis or in the exercise of discretion may not so deal through a *broker* pursuant to a *soft commission agreement* unless -
- (a) the only benefits to be provided under the agreement are goods or services which can reasonably be expected to assist in the provision of *investment services* to the *firm's customers* and which are in fact so used;
  - (b) the *broker* has agreed to provide best execution to the customer;
  - (c) the *firm* is satisfied on reasonable grounds that the terms of business and methods by which the relevant broking services will be supplied do not involve any potential for comparative price disadvantage to the *customer*;
  - (d) in transactions in which the *broker* acts as principal, he is not remunerated by spread alone; and
  - (e) adequate prior and periodic disclosure is made. [cr 3]

5-8 (1) Guidance

- 1 *Broker* includes a broker dealer and a *market maker*.
  - 2 Customer in (1)(b) above refers to the *firm* receiving goods or services under a *soft commission agreement*.
  - 3 Under (1)(c) above a *firm* may be satisfied that the relevant broking services will be supplied without involving the potential for comparative price disadvantage to the *customer* if -
    - (a) the *firm* is able to monitor the individual transaction prices obtained on its behalf by the *broker* and is satisfied that the *broker* has complied with its best execution obligation; or
    - (b) there is no need for the *firm* to disclose at the time of giving the *order* to the *broker* that the commission generated by the transaction is to be allocated to the *firm's* softing account.
  - 4 If neither of the provisions in paragraph 3 above can be satisfied, a *firm* should select a soft commission *broker* on the basis of the *broker's* ability to demonstrate independence of action within the market place. This is unlikely to be fulfilled in circumstances where the *broker* deals exclusively with one *market maker*.
  - 5 (1)(d) above is not complied with where the broker is only part remunerated by commission; unless the commission element (which must be disclosed) constitutes the greater proportion of the remuneration.
  - 6 A *broker* should set its multiple at a level which it can demonstrate would generate sufficient commission income from softing transactions to cover the costs of the soft goods or services provided, the cost of dealing and settling the associated transactions, together with the specialised softing administration.
- (2) Goods or services supplied under a *soft commission agreement* must reasonably be expected, and must be used, to -
- (a) assist in the provision of *investment services* to the *firm's* *customers* by means of -
    - (i) specific advice on dealing in, or on the value of, any *investment*;
    - (ii) research or analysis (about *investments* generally or other relevant matters); or
    - (iii) the use of computer or other information facilities;
  - (b) provide custodian services relating to *investments* of, or managed for, *customers*; or
  - (c) provide services relating to valuations of portfolios or the measurement of the performance of portfolios.

- 5-8 (3) A *firm* which receives goods or services under a *soft commission agreement* must provide, to any *customer* to whom it is relevant, a written statement detailing its policy in relation to *soft commission agreements*, either at the outset of the customer relationship or as soon as reasonably practicable after the relevant *soft commission agreement* is entered into.

Guidance

Policy statements should explain generally why the *firm* or its *associate* might find it necessary or desirable to pay soft commissions, bearing in mind the practices in the markets in which it does business on behalf of its *customers*.

- (4) (a) A *firm* which receives goods or services under a *soft commission agreement* must provide annually, to *customers* to whom it is relevant, the following information in relation to the period since the last report was made, or, if no previous report has been made, since the first transaction was effected under the agreement -
- (i) the percentage of the total commission paid by the *firm* under *soft commission agreements*;
  - (ii) the value (on a cost price basis) of goods or services received by the *firm* under *soft commission agreements* expressed as a percentage of the total commissions paid by the *firm*, including those not paid under *soft commission agreements*;
  - (iii) a summary of the goods or services received by the *firm* under *soft commission agreements*;
  - (iv) a list of the *brokers* who are parties to the *firm's soft commission agreements*; and
  - (v) a statement setting out the *firm's* policy in relation to *soft commission agreements*, or a statement that its policy has not changed since the last policy statement was given.
- (b) Where a *firm* directs any of its soft commission business through an *associate*, the information provided to *customers* in accordance with (4) (a) above must include any such business.

- 5-8 (4) (c) A *firm* is not required to provide an annual report in accordance with (4)(a) and (b) above to -
- (i) beneficiaries of funds under the *firm's* management; and
  - (ii) a *private customer*, unless it is a *small business investor*, provided that the *firm* includes in the written policy statement provided under (3) above -
    - (aa) an estimate of the percentage of its total commission that the *firm* reasonably expects to pay under *soft commission agreements*; and
    - (bb) a statement that details of the *firm's soft commission agreements*, in accordance with (4)(a) and (b) above, will be made available to the customer on request.
- (5) A *firm* must provide to any *customer* to whom it is relevant a written statement of its policy in relation to *soft commission agreements* promptly after any material change in that policy is made.
- (6) The disclosures under (4) above are not required in the case of a *customer* who is ordinarily resident outside the United Kingdom, provided the *firm* believes on reasonable grounds that he does not wish to receive such information.

Guidance

- 1 The disclosure requirement contained in (4) above applies to a *firm* which receives goods or services under a *soft commission agreement* in return for placing a minimum amount of business through, or in the way of, another party to the agreement. The disclosure can be made on a general basis to all *customers* to whom it is relevant, namely any *customer* for whom the *firm* enters into transactions where the commission generated has been or is to be used to pay for goods or services received under a *soft commission agreement*.
- 2 Where goods or services obtained through a *soft commission agreement* have a mixed use, partly falling outside the generic description of permitted goods and services contained in (2) above, the *firm* should make an appropriate allocation of the costs and disclose them in accordance with (4) above. Only the percentage of the specific component or service that meets the criteria set out in (2) above may be paid for from soft commission.
- 3 The goods and services in the table below fall within the generic description set out in (2) above and can be offered under a *soft commission agreement*.

Guidance (contd)

TABLE 5-8 A

Soft commission: permitted goods and services

research and advisory services, including economic factors and trends
portfolio valuation and analysis
performance measurement
market price services
custodian services
computer hardware associated with specialised computer software or research services
dedicated telephone lines
seminar fees (where the subject matter is of relevance to the provision of <i>investment services</i> )
publications (where the subject matter is of relevance to the provision of <i>investment services</i> )
_____
This list is not exhaustive and may be added to from time to time.

(4) The goods and services in the table below do not fall within the generic description set out in (2) above.

TABLE 5-8 B

Soft commission: non-permitted goods and services

travel, accommodation or entertainment costs, whether or not related to the provision of <i>investment services</i>
any seminar fees not falling within the permitted goods and services list
any subscription for publications not falling within the permitted goods and services list
office administrative computer software, for example word processing, accounting programmes
computer hardware not associated with specialist computer software
membership fees to professional associations
purchase or rental of office equipment or ancillary facilities
<i>employees' salaries</i>
direct money payments
_____
This list is not exhaustive and may be added to from time to time.



## U.S. Federal Securities Laws

1487 2-19-92

Fees for Services— § 28(e)

19,711

### Sec. 28(e)

(1) No person using the mails, or any means or instrumentality of interstate commerce, in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law unless expressly provided to the contrary by a law enacted by the Congress or any State subsequent to the date of enactment of the Securities Acts Amendments of 1975 solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or 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 member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion. This subsection is exclusive and plenary insofar as conduct is covered by the foregoing, unless otherwise expressly provided by contract: Provided, however, That nothing in this subsection shall be construed to impair or limit the power of the Commission under any other provision of this title or otherwise.

Law

## **IV. Disclosure and Other Obligations Under the Investment Advisers Act of 1940 and the Investment Company Act of 1940 Applicable to Money Managers Engaging in Soft Dollar Arrangements.**

Most money managers engaging in soft dollar arrangements must comply with all applicable disclosure requirements under the federal securities laws, and registered investment advisers and others should pay particular attention to the disclosure and books and records requirements under the Advisers Act and the Company Act. Disclosure is required even if an arrangement is within the safe harbor provided by Section 28(e). In addition, money managers must comply with any other laws imposing fiduciary or other obligations with respect to their participation in such agreements. Set forth below is a discussion of the principal provisions of the Advisers Act and Company Act and rules and forms thereunder which, depending on the facts and circumstances involved, impose disclosure and other obligations on money managers and related persons.

### **A. Advisers Act**

#### **1. Form ADV**

Fundamental to the Advisers Act is the concept that an investment adviser has a fiduciary obligation to act in the best interest of clients. As a fiduciary, an adviser has a duty to disclose to clients all material information which is intended "to eliminate, or at least expose", all potential or actual conflicts of interest "which might incline an investment adviser consciously or unconsciously—to render advice which was not disinterested". Due to the potential conflict of interest when an adviser receives research as a result of allocating brokerage on behalf of clients' accounts, the Commission has long maintained that an adviser must disclose soft dollar arrangements to clients. The Commission has adopted mandatory disclosure standards for advisers involved in such arrangements, as discussed below.

Pursuant to its authority in Section 28(e)(2) to adopt rules governing a money manager's disclosure of brokerage policies and practices, the Commission proposed disclosure rules in 1976, but later determined to "incorporate more comprehensive brokerage placement practice disclosure requirements" within the registration process for investment advisers under the Advisers Act. One of these provisions is the so-called "brochure rule", which was adopted in 1979 and is set forth in Rule 204-3 under the Advisers Act. This rule requires generally that an adviser furnish each advisory client and each prospective advisory client with a written disclosure statement containing certain information regarding the adviser's business background and practices. The disclosure statement may be either a copy of Part II of the adviser's Form ADV, the registration form for investment advisers, or a written document containing at least the information required by Part II of the Form ADV.

Item 12 of Part II of Form ADV requires disclosure to clients regarding investment or brokerage discretion. The purpose of this disclosure is to provide clients with material information about the adviser's brokerage allocation policies and practices which may be important to them in deciding to hire an adviser and which will permit them to evaluate any conflicts of interest inherent in the adviser's arrangements for allocating brokerage. Because brokerage policies and practices vary greatly, the disclosure made in response to Item 12 should provide sufficient information to enable a client or potential client to understand such policies and practices. This item requires disclosure regarding (1) whether the adviser or a related person has authority to determine, without specific client consent, the broker-dealer to be used in any securities transaction or the commission rate to be paid, or (2) whether the adviser or a related person suggests broker-dealers to clients. If the adviser engages in either of these practices, whether or not pursuant to a written agreement, it must describe the factors considered in selecting broker-dealers and in determining the reasonableness of commissions charged. If the value of products, research, and services given to the adviser or a related person is a factor in those decisions, the adviser must describe the following:

- the products, research and services;
- whether clients may pay commissions higher than those obtainable from other brokers in return for those products and services;
- whether research is used to service all of the adviser's accounts or just those accounts paying for it; and
- any procedures the adviser used during the last fiscal year to direct client transactions to a particular broker in return for products and research services received.

In its release discussing the current adoption of Form ADV disclosure requirements and the brochure rule, the Commission pointed out that:

the amended rule and forms represent mandatory disclosure standards. More detailed or additional information and explanatory material could and should be provided where necessary, because of circumstances in particular cases, to ensure that all material information regarding brokerage placement practices and policies will be disclosed to investors.

An investment adviser should be particularly aware of the fact that the Advisers Act disclosure requirements apply to all soft dollar arrangements, whether or not they are within the safe harbor of Section 28(e). Moreover, compliance with Advisers Act disclosure requirements does not relieve an adviser from other disclosure obligations under federal or state law.

## 2. Section 204

Section 204 of the Advisers Act authorizes the Commission to adopt rules prescribing the books and records a registered adviser must maintain. Pursuant to this authority, the Commission has adopted Rule 204-2, which requires an adviser to keep true, accurate, and current books and records relating to its advisory business. In the case of securities transactions, particularly those which may involve soft dollars, the adviser's books and records should contain sufficient details relating to each participant in a particular transaction.

## 3. Best execution

The Commission's staff has stated that an adviser, as a fiduciary, owes its clients a duty of obtaining the best execution on securities transactions. For further discussion of best execution, see Section V of this release.

## **B. Company Act**

The Company Act and rules and forms thereunder impose various disclosure and other obligations on registered investment companies, investment advisers of registered investment companies, and related persons in connection with soft dollar arrangements.

### 1. Form N-1A

Form N-1A is the integrated registration form used by most open-end management investment companies to register under the Company Act and to register their securities under the Securities Act of 1933. Its disclosure requirements form the basis of the two-part prospectus used by these investment companies. Part B of the form, termed the "Statement of Additional Information", requires disclosure about the company's brokerage allocation practices. Specifically, Item 17 requires a description of how transactions in portfolio securities are effected, including a general statement about brokerage commissions. Investment companies also must describe how broker-dealers will be selected to effect securities transactions and how the overall reasonableness of commissions paid will be evaluated, including the factors considered in connection with these determinations. The instructions to its item further require that:

- if the receipt of products or services other than brokerage or research is a factor in selecting brokers, the products and services should be described;
- if the receipt of research services is a factor in selecting brokers, the nature of such research services should be described;
- the registrant must state if persons acting on its behalf are authorized to pay a commission in excess of that which another broker might have charged for the same transaction in recognition of brokerage or research services provided by the broker;

- if applicable, the registrant should explain that research services provided by brokers may be used by the adviser in servicing all of its accounts or describe other practices applicable to the registrant regarding allocation of research services provided by brokers; and
- the registrant must state the amount of transactions and related commissions paid as a result of directing the registrant's brokerage transactions to a broker because of research services provided pursuant to an agreement or understanding with a broker or otherwise through an internal allocation procedure.

## 2. Section 20(a)

Section 20(a) of the Company Act makes it unlawful for any person to solicit proxies regarding the securities of any registered investment company in contravention of Commission rules. Pursuant to this provision, the Commission has adopted two rules that may be relevant to soft dollar arrangements. First, where a proxy solicitation is made on behalf of the management of the investment company, Rule 20a-1(b) requires the adviser of the investment company to furnish promptly to management, upon request, all information necessary for management to comply with the proxy rules, including information about soft dollar arrangements.

In addition to this general obligation, Rule 20a-2 requires disclosure of specific information about the adviser and its investment advisory contract in certain proxy solicitations, including information about brokerage placement practices. Specifically, paragraph (b)(7) of the rule requires disclosure of, among other things, the following:

- a description of how brokers are selected to effect securities transactions for the company and how the reasonableness of overall brokerage commissions paid will be evaluated, including the factors considered in these determinations;
- if the receipt of products or services other than research or brokerage is a factor in selecting brokers, a description of these products or services;
- if the receipt of research services is a factor in selecting brokers, the nature of such services;
- whether persons acting on behalf of the company are authorized to pay a broker a commission in excess of that which another broker might have charged for the same transaction in recognition for brokerage or research services provided by the broker;
- if applicable, an explanation that research services furnished by the company's brokers may be used by the adviser in servicing all of its accounts and that not all such services may be used by the adviser in connection with the company, or an explanation of other policies or practices applicable to the company regarding the allocation of research services provided by brokers; and
- the amount of transactions and related commissions directed to a broker or brokers pursuant to an agreement or understanding or otherwise through an internal allocation procedure.

## 3. Section 15(c)

Section 15(c) makes it unlawful for any investment company to enter into or renew any investment advisory contract unless it is approved by a majority of the

company's disinterested directors. In approving such a contract, this provision imposes on directors a duty to request and evaluate such information as may reasonably be necessary for the directors to evaluate the terms of the contract. This provision also imposes on the company's adviser a duty to furnish such information to the directors.

The Supreme Court has defined the Congressional purpose in enacting Section 15(c) and related provisions of the Company Act as placing "the unaffiliated directors in the role of independent watchdogs" entrusted with "the primary responsibility for looking after the interest of the funds' shareholders". Disinterested directors are required to "exercise informed discretion, and the responsibility for keeping the independent directors informed lies with management, i.e., the investment adviser and interested directors". Depending on the facts involved, the responsibility of the disinterested directors may include monitoring of the adviser's soft dollar arrangements.

#### 4. Section 31

Section 31 of the Company Act authorizes the Commission to adopt rules prescribing the books and records to be maintained by a registered investment company or by others, on its behalf, including investment advisers. Pursuant to this authority, the Commission adopted Rule 31a-1. Paragraph (b)(9) of that rule requires an investment company to maintain a record for each fiscal quarter describing in detail the basis or bases upon which it allocated orders for the purchase or sale of portfolio securities and divided brokerage commissions or other compensation on such orders. The record also must indicate the consideration given to services or benefits supplied by broker-dealers to the investment company or adviser and show the nature of such services or benefits made available.

#### 5. Section 36(b)

Under Section 36(b) of the Company Act, an investment adviser to a registered investment company has a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, from the investment company or its shareholders. However, with respect to any such amount received by an adviser, no violation of Section 36(b) could occur for a soft dollar arrangement falling within the safe harbor of Section 28(e). Where an adviser received amounts outside of the safe harbor of Section 28(e) such amounts would have to be analyzed under Section 36(b) to determine if they were consistent with that provision.

#### 6. Section 17(e)(1)

As relevant here, Section 17(e) (1) of the Company Act makes it unlawful for an affiliated person of a registered investment company to receive any compensation for the purchase or sale of any property to or for the investment company when that person is acting as an agent for the company other than in the course of that person's business as a broker-dealer. The Court of Appeals for the Second Circuit has held that the objective of Section 17(e)(1) "is to prevent that affiliated persons [of investment companies] from having their judgement and fidelity impaired by conflicts of interest" in situations where the benefit of a reciprocal relationship between the affiliated person and another person is diverted to the affiliated person while the burden of that relationship is borne by the investment company.

It is important to emphasize that receipt by an investment adviser of any compensation pursuant to a soft dollar arrangement in connection with the purchase or sale of any property, including securities, to or for the investment company arguably would violate Section 17(e)(1). To the extent that compensation is received by an affiliated person of a fund pursuant to a soft dollar arrangement within the safe harbor of Section 28(e), however, the prohibition of Section 17(e)(1) would not apply.

Finally, it is not necessary to show that the person receiving compensation prohibited by Section 17(e)(1) influenced the actions of the investment company, nor must economic injury to the investment company be shown. Rather, the essence of a violation of Section 17(e)(1) is the mere receipt of compensation in connection with the purchase or sale of property to or from the investment company.

## **V. Best execution Obligations**

As a fiduciary, a money manager has an obligation to obtain "best execution" of clients' transactions under the circumstances of the particular transaction. The money manager must:

execute securities transactions for clients in such manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances.

A money manager should consider the full range and quality of a broker's services in placing brokerage including, among other things, the value of research provided as well as execution capability, commission rate, financial responsibility, and responsiveness to the money manager. The Commission wishes to remind money managers that the determinative factor is not the lowest possible commission cost but whether the transaction represents the best qualitative execution for the managed account. In this connection, money managers should periodically and systematically evaluate the execution performance of broker-dealers executing their transactions.

AUSTRALIAN INVESTMENT MANAGERS' GROUP  
PRACTICE NOTE\*  
SOFT DOLLAR DEALING

## INTRODUCTION

This paper seeks to expand on the subject of "soft dollar" commission which is mentioned under Dealing Guidelines on page 4 of the AIMG Code of Conduct and should be read in conjunction with the Commentary attached. This paper is not intended to be a set of rules, but rather a statement of principles which should be adhered to by the members of AIMG.

These principles provide a self-regulatory framework to give a greater degree of industry certainty with respect to soft dollar dealing and are consistent with the regulatory environment in force in the US and UK.

This Practice Note is not intended to offer any de facto endorsement or otherwise of the practice of soft dollar dealing, but is issued for the guidance of members. Each member should take into account their own circumstances, internal compliance standards and other relevant factors in determining their attitude to soft dollar arrangements. Members attention particularly is drawn to the disclosure aspects of the principles contained herein.

## PRINCIPLES

An Investment Manager may enter into a soft dollar arrangement on behalf of a client providing:

1. The goods or services acquired are of demonstrable benefit to the client (see Appendix attached).
2. The cost of dealing will not disadvantage the client compared with similar dealing otherwise than under the soft-dollar arrangement.
3. When a broker acting under soft dollar arrangements acts as principal, the notional brokerage charged should be at the same rate as a similar size transaction on an agent basis.
4. There are no cash or money rebates involved which could be constituted to be a secret commission.

*\*This Practice Note is issued to members of the Australian Investment Managers' Group for their general guidance in matters of investment management practice. No representation is made that members of AIMG are bound to act in accordance with it.*

5. The total commitment made on behalf of all clients of the Investment Manager for such arrangements does not jeopardise the Manager's ability to continue to maintain adequate financial resources. This brokerage limit should be prudent and reflect the nature of the Manager's business, its level of capital and reasonable changes in market circumstances which could be expected. The Manager's policy towards its limit should be expressed as a maximum percentage of the total brokerage generated on each of its client's funds and stated in submissions.
6. Details of the manager's policy regarding soft dollars should be contained in all submissions and management mandates. A statement of compliance with the stated policy should be contained in all reports to clients on an annual basis or as required by the clients.
7. On request any information relating to how the manager's soft dollar policy affects clients individually should be made available to the client.

Issued 10 March 1994

Background Commentary Accompanying Practice Note  
SOFT DOLLAR DEALING

1. Soft dollar dealing is the allocation of any brokerage dollar generated with a stockbroking firm to pay for the supply of products and services produced independently of that firm. It has become a common part of funds management in the major equity markets of the world.
2. The practice of soft dollar dealing grew, in the main, out of the changes brought about by deregulation of the world's financial markets. It is used by fund managers to improve the performance of their clients' portfolios within a constant cost frame.
3. Soft dollar dealing provides professional fund managers with the flexibility to choose which product and services they want. It is in fact nothing more than product substitution, that is, substitution of products chosen by the fund manager for traditional broker generated research.
4. Soft dollar dealing accounts for 20% of total US institutional commissions and 15% of UK institutional commissions. The applicable ratio in Australia, that is the level of brokerage to be generated to cover the cost of product payments made, is consistent with that in the US and UK.
5. The custom and practice of the Australian soft dollar market mirrors the regulated environment of the US and UK. Most Australian institutions receive reporting and position monitoring information that exceed the US and UK requirements.
6. The test of which products and services can be purchased with soft dollars in the US is whether they provide "...lawful and appropriate assistance to the money manager in the performance of his investment decision making responsibilities". In the UK soft dollars can be used to purchase products and services "...which can reasonably be expected to assist in the provision of investment services to the firm's customers".
7. Soft dollar dealing is not a replacement for full service broking but an adjunct to it. Consideration must be given to the level of commission allocated to traditional and soft dollar brokers given the needs of the fund being managed.
8. The information that clients might reasonably request in Item 7 could include: the products and services acquired under the policy, their hard dollar value, the brokerage commissions generated, the brokerage rate and the brokers to whom these commissions were paid, the allocation procedure of these commissions to all funds managed, the soft dollar commission paid by each fund, the proportion of soft dollar brokerage by fund and of the total brokerage.

10 March 1994

## APPENDIX

### Typical Products and Services Purchased with Soft Dollars:

- \* Performance Measurement
- \* Third Party Research
- \* Fundamental Data-Bases
- \* Technical Analysis Software
- \* Portfolio Modelling Software
- \* Stock Quotation Systems
- \* Political or Economic Analysis

10 March 1994