Today, in the wake of the scandals in the mutual fund industry, the conflicts of interest between money managers and their clients have come under heightened scrutiny. It is therefore not surprising that a broad review of soft dollars is now on the SEC agenda. The SEC has formed a task force that is "actively reviewing the use of soft dollars, the impact of soft dollars on our nation's securities markets and whether allocations of soft dollar payments further the interests of investors." Against this backdrop, let us revisit the nature and scope of permissible soft dollar arrangements.

What Are Soft Dollars and Who Uses Them

The term "soft dollars" is generally used to describe arrangements in which a money manager pays for research or other products or services from a broker-dealer with client commissions. In contrast to soft dollars, when an adviser uses its own money to purchase these products or services, it is said to be paying with "hard dollars." In its Market 2000 study, the SEC offered the following definition of soft dollars: "Soft dollars refer to the use of customer commissions by investment advisers or money managers to pay for research and other services that benefit the investment adviser." Against this backdrop, let us revisit the nature and scope of permissible soft dollar arrangements.

A Hard Look at Soft Dollars

by Alan C. Porter and Andras P. Teleki

Soft dollar arrangements have been a lawful and accepted practice of money managers for many years. Indeed, Section 28(e) of the Securities Exchange Act of 1934 has shielded these arrangements against claims of breach of fiduciary duty since 1975. An investment adviser's duty of full and frank disclosure of all material facts has served to expose the conflicts of interest inherent in these arrangements to advisory clients.

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Soft Dollars, Best Execution and the Section 28(e) Safe Harbor

Soft dollar arrangements can be a factor in a money manager’s “best execution” determinations. The SEC has asserted that investment advisers have a duty to “execute securities transactions for clients in such a manner that the client’s total cost or proceeds in each transaction is the most favorable under the circumstances” or, in other words, the duty to obtain “best execution” of portfolio trades for its clients.3 In making this determination, the adviser should consider the full range and quality of a broker’s service 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 adviser.4

Section 28(e) of the Securities Exchange Act of 1934 provides a safe harbor against violations of federal and state law, or breach of common law fiduciary duty, for a money manager that directs a client’s brokerage in return for research, even if the adviser uses the research to benefit its other accounts. Because Section 28(e) is a safe harbor, failure to adhere to each of its elements does not itself result in a violation of law or breach of fiduciary duty. Rather, it means that the soft dollar arrangement will be subject to regulation under laws that would otherwise apply but for the safe harbor. Section 28(e)(1) provides:

This provision is intended to protect money managers that pay more than the lowest available commission rate based on the brokerage services provided, so long as they comply with the requirements of the safe harbor. In order to claim the protection of Section 28(e), the following seven elements must be satisfied:

1. The investment adviser must be supplied with “brokerage and research services”;
2. The services must be “provided” by the broker-dealer. (This element is relevant in third-party research arrangements, where a person other than the adviser’s broker-dealer provides a research or brokerage service);
3. A “broker-dealer” must be the “provider” of the service;
4. The adviser must have “investment discretion” in placing the brokerage;
5. The commissions paid must be “reasonable” in relation to the services provided;
6. “Commissions” must be used to purchase the services; and
7. The brokerage placed must be for “securities transactions.”

Adviser must be supplied with brokerage and research services. Section 28(e) only applies to the provision of “brokerage and research services.” The provision of other services is not protected. The test for determining whether something is research is “whether it provides lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities.”5

The current definition of “research and brokerage services,” although broad, is not so expansive as to include any expense of an investment adviser. For example, overhead or administrative expenses, such as rent, furniture and secretarial support, do not constitute “research.”6 Nor does the correction of trading errors constitute “brokerage services.”7 Likewise, consulting services in marketing aimed at soliciting new clients do not constitute “research.”8

Sometimes, a service may have more than one use, with only a portion of the use related to brokerage and research services. If a broker-dealer provides products to a money manager encompassing both “research and brokerage services” and other services, the “money manager must make a reasonable allocation of the cost of the product according to its use. The percentage of the service or specific component that provides assistance to a money manager in the investment decision-making process may be paid in commission dollars, while those services that provide
administrative or other non-research assistance to the money manager are outside the Section 28(e) safe harbor and must be paid for by the money manager using his own funds.14

Some mutual fund groups direct portfolio trades to a broker-dealer for payment of fund expenses. Such fund expenses may include, among others, investment advisory fees, custodian fees, transfer agent fees and administrative or service fees. Such arrangements are outside the scope of the safe harbor because the broker-dealer is not supplying research services.

The services must be provided by the broker-dealer. In general, this element depends on the manner in which a third-party research arrangement is structured. If the broker-dealer contracts with the third-party research provider and pays that provider for the research service, then the arrangement is within the Section 28(e) safe harbor. However, if the money manager contracts with the third-party research provider, and the broker-dealer either pays the third-party provider or provides the money manager with the funds to pay the third-party provider, then the arrangement is not protected. A useful test to verify that this element of Section 28(e) is satisfied is to ask whether the money manager would have any obligation to pay the third-party research provider if the broker-dealer was unwilling or unable to do so. If the money manager would have such an obligation, the arrangement generally is not within the safe harbor.

A broker-dealer must be the provider of the service. An entity acting as a broker dealer must generate the soft dollar credits. A money manager does not lose the protection of Section 28(e) merely because it pays commissions to an introducing broker and places its orders directly with the executing or clearing broker.10 Such “correspondent relationships,” however, fall outside the scope of Section 28(e) when the introducing broker is merely a “file cabinet” broker, that is, a broker that only forwards the money manager’s orders to another broker-dealer and has no execution involvement or capabilities.11

The adviser must have investment discretion in placing the brokerage. Section 28(e) only affords protection to money managers that have “investment discretion.”12 For this reason, a directed brokerage arrangement where, for example, a retirement plan client, and not the adviser, selects the executing broker does not fall within the safe harbor and, accordingly, neither the plan sponsor, the adviser, nor the broker-dealer participating in the transaction can rely on Section 28(e).13 Thus, plan sponsors that delegate investment discretion to money managers are not protected by Section 28(e).14

The commissions paid must be reasonable in relation to the services provided. Under Section 28(e), a money manager must determine “in good faith” that any higher commissions are reasonable in relation to the services provided. “The legislative history of Section 28(e) makes clear that the burden of proof in demonstrating this determination rests on the money manager.”15 “[A] money manager that obligated itself normally to generate a specified amount of commissions would be faced with a heavy burden of demonstrating that he was consistently obtaining best execution.”16 Soft dollar arrangements between a money manager and an affiliated broker-dealer are subject to even greater scrutiny. A money manager who, in return for research services, pays an affiliated broker-dealer for execution of brokerage transactions, is under a heavy burden to show that the payments were appropriate.

Commissions must be used to purchase the services. In December 2001, the SEC extended its interpretation of the term “commission” in Section 28(e) to include transaction costs in certain principal trades, even if they are not denominated as “commissions.” The SEC interpreted this term 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.18

The SEC concluded that the information provided to money managers on a qualifying riskless principal trade, and the regulatory safeguards ensuring the accuracy of that information, are adequate to determine the reasonableness of the fees charged, as required by Section 28(e). The SEC distinguishes those qualifying Nasdaq riskless principal trades from a dealer’s traditional principal trades from inventory and a market maker’s net trades.19 The SEC explains that, in each of the latter trades, a dealer can receive an undisclosed “fee” (i.e., compensation in the form of its profit on the difference in prices (the spread) between its purchase and sale of the security).20 In addition, the SEC explains that the price at which the trade is reported “is to some degree within the control of the dealer.” The SEC thus indicates that, because the dealer in these contexts is not required to report
and confirm its trade price and compensation in a particular way, the money manager cannot be certain of the facts it needs to make the determination required by Section 28(e)—that the fee is reasonable in relation to the brokerage and research services provided.

The SEC clearly holds out the possibility that other categories of trades will be deemed in the future to qualify under its new interpretive position.

**The brokerage placed must be for securities transactions.** Section 28(e) only applies to “securities transactions.” Thus, commissions on transactions in other types of investments, such as real estate, are not protected by the safe harbor.

### Disclosure Obligations Related to Soft Dollars

The Investment Advisers Act of 1940 as well as common law fiduciary principles require investment advisers to make full and frank disclosure of all conflicts of interest that “might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.” This disclosure must be clear enough so that the client is fully apprised of the facts and is in a position to evaluate the adviser’s overlapping motivations and give informed consent. Moreover, if it is to be meaningful and effective, the disclosure must also be timely.22

Section 28(e) does not relieve a money manager of its disclosure obligations under the securities laws. Disclosure is required even if a soft dollar arrangement is within the safe harbor. Places where disclosure regarding soft dollar arrangements can be found include, among others, the following:

1. **Form ADV.** Form ADV, the basic registration and disclosure document for investment advisers, requires an adviser to disclose certain information regarding its brokerage practices and soft dollar arrangements. In particular, Item 12 of Part II requires an adviser to describe . . . the factors considered in selecting brokers and determining the reasonableness of their commissions. If the value of products, research and services given to the adviser or a related person is a factor, describe: [a] the products, research and services; [b] whether clients may pay commissions higher than those obtainable from other brokers in return for those products and services; [c] whether research is used to service all of adviser accounts or just those paying for it; and [d] 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 addition, Item 13 of Part II requires an adviser to describe any arrangement in which the adviser “is paid cash by or receives some economic benefit (including commissions, equipment or non-research services) from a non-client in connection with giving advice to clients.”

It is important to note that Form ADV is an “evergreen” document. This means that most of the important items of the form, including Items 12 and 13 of Part II, must be amended periodically to reflect current practices. Thus, an investment adviser should adopt procedures to ensure that its Form ADV is amended to reflect any changes in its soft dollar practices.23 In addition, in certain instances, disclosure of soft dollar arrangements in Form ADV alone may be insufficient to satisfy an adviser’s disclosure obligation to its clients. For example, currently Part II of Form ADV must be delivered only at the commencement of the advisory relationship, and offered to be delivered only annually thereafter. Thus, an adviser may have to provide existing clients with updated Part II disclosure whenever material changes occur in its soft dollar practices.24

2. **Form N-SAR.** Registered investment companies are required to disclose information concerning brokerage practices in semi-annual reports on Form N-SAR. Item 26 of Form N-SAR requires a yes or no response to a series of questions as to the “[c]onsiderations which affected the participation of brokers and dealers or other entities in commissions or other compensation paid on portfolio transactions of registrant.” Investment companies are also required to disclose detailed information regarding soft dollar arrangements in their registration statements.

3. **Form N-1A.** Item 16 of Part B (the Statement of Additional Information) requires disclosure of how transactions in portfolio securities are effected, including a general statement about brokerage commissions paid by the fund during its most recent fiscal years. In addition, the fund must disclose how the fund will select brokers to effect securities transactions for the fund and how the fund will evaluate the overall reasonableness of brokerage commissions paid, including the factors that the fund will consider in making these determinations. Item 16 also requires the fund to explain that research services provided by brokers through which the fund effects securities transactions may be used by the fund’s adviser in servicing all of its accounts and that not all
of these services may be used by the adviser in connection with the fund. Other policies or practices applicable to the fund with respect to the allocation of research services provided by brokers must be disclosed as well. Finally, if the fund or its adviser, through an agreement or understanding with a broker, directed the fund’s brokerage transactions to a broker because of research services provided, the amount of the transactions and the related commissions must be disclosed.

Beyond the disclosure obligations in these SEC filings, a fund’s board must be informed of any soft dollar arrangements by the fund’s adviser as part of the annual approval of the investment advisory contract. Specifically, Section 15(a)(1) of the Investment Company Act of 1940 requires advisory contracts to “precisely [describe] all compensation to be paid thereunder.” As a form of compensation, soft dollar arrangements must be addressed by the contract and disclosed to the fund’s board in connection with the annual review.25

To address their responsibilities, fund boards should consider obtaining the following information in connection with their review of an adviser’s soft dollar practices:

- Portfolio turnover, brokers used and commissions paid, including average commissions;
- A listing of all soft dollar services, the brokers that pay for these services, and the estimated annual cost of each soft dollar arrangement;
- Written attestation from the fund adviser that best execution is being obtained on all trades; and
- Any additional information concerning any directed brokerage arrangements.

Pitfalls of Soft Dollar Arrangements

A soft dollar arrangement outside of the Section 28(e) safe harbor could be found to violate an adviser’s fiduciary obligation to seek best execution of client securities transactions. Soft dollar arrangements also tend to raise disclosure related issues and historically have been the source of some abuse. The following are examples of compliance issues that have arisen in the context of soft dollar arrangements.

Mind the Disclosure. An investment adviser must adequately disclose to clients any soft dollar arrangements, whether or not they fall within the Section 28(e) safe harbor. In particular, advisers should remember the following concerning this disclosure obligation:

- The SEC has taken the position in enforcement actions that soft dollar arrangements are material, and must be disclosed in Form ADV, regardless of their dollar amount in relation to the adviser’s total business. Thus, Form ADV disclosure should reflect all soft dollar arrangements.
- Many investment advisers use full service brokers who provide research to all of their clients. Although some advisers do not consider use of a full service broker to constitute a soft dollar arrangement, this practice arguably does, in fact, constitute a soft dollar arrangement and should be disclosed in Form ADV. In other words, an adviser that uses full service brokers and receives research from them probably should not disclose that it has no soft dollar arrangements.

Deficiencies identified by the SEC staff relating to disclosure of soft dollar arrangements include:

- Failure to describe services obtained with soft dollars with sufficient specificity;
- Failure to disclose whether clients paid higher commissions in soft dollar arrangements;
- Failure to disclose that one client’s commissions are used to purchase a service that benefits other clients; and
- Limited and incomplete disclosure concerning the adviser’s practices of allocating costs in mixed use situations.

Aiding and Abetting an Adviser’s Violations. The SEC has stated that “[a] broker which causes or assists an institution to violate a duty to the investor may be aiding and abetting a fraudulent or deceptive act or practice.”26 Following this reasoning, in a widely publicized case, the SEC sued a registered broker-dealer and its president, alleging that they aided and abetted an adviser’s alleged soft dollar violations.27 According to the SEC, the adviser used soft dollar credits to pay for personal and business expenses unrelated to research without disclosure to its clients. The SEC’s order stated that the broker-dealer aided and abetted the adviser’s alleged soft dollar abuses by processing its trades and paying soft dollar benefits despite its awareness of significant red flags which should have alerted the broker-dealer that it may have been aiding and abetting the adviser’s misconduct. In a press release about the action, the Director of the SEC’s Division of Enforcement stated that the “case demonstrates that brokers can’t turn a blind eye to the fraudulent soft dollar practices of investment advisers.”
This case is important because it demonstrates that the SEC is prepared to institute proceedings against broker-dealers that allegedly aid and abet an adviser’s primary soft dollar violations. In such a proceeding, the SEC might assert secondary, aider and abettor liability against a broker-dealer based on its awareness of “significant red flags” or because the broker-dealer “knew that . . . [its] role was part of an overall activity that was improper and knowingly and substantially assisted the conduct that constituted the [primary] violation.” As a precaution against such liability, broker-dealers may implement measures designed to provide reasonable assurance that their soft dollar arrangements with investment advisers are in accordance with applicable legal and regulatory requirements. Such measures may include monitoring the soft dollar arrangement so that clear warnings of possible improper conduct by an adviser can be identified and reasonably addressed, as well as measures for establishing that the adviser is making appropriate disclosure of the soft dollar arrangement to its clients.

Recommended Compliance Procedures

Perhaps the most important recommendation in the SEC’s 1998 report on soft dollars is that broker-dealers and investment advisers adopt enhanced compliance procedures relating to their soft dollar practices. It is prudent to review these recommendations, given the current regulatory focus on this area and because not following them could support a failure to supervise case.

For investment advisers, the report recommends that:

- A person or committee be appointed to oversee all soft dollar arrangements;
- Responsibilities and controls over soft dollar arrangements be memorialized in written procedures;
- Brokerage allocation practices and the receipt of soft dollar services be periodically reviewed;
- Soft dollar arrangements be approved in advance by a senior official of the adviser;
- Form ADV disclosure be periodically reviewed for accuracy and completeness;
- The cost of mixed-use products be properly allocated and a record maintained of the bases for the allocations;
- Statements be obtained from brokers listing all soft dollar arrangements, with periodic comparison of these lists with the firm’s internal records; and
- Employees receive training on soft dollar rules and the firm’s soft dollar procedures.

For brokers, the report recommends that:

- A person or committee be created to oversee all soft dollar arrangements;
- The broker obtain evidence that the adviser has authority to enter into a soft dollar arrangement and, where applicable, that a client has authority to enter into a directed brokerage arrangement;
- Third-party arrangements should be structured so that the broker is obligated to pay the third-party provider; the broker should not pay invoices submitted by the adviser from a third-party provider;
- Brokers maintain lists of all soft dollar arrangements and periodically provide statements to their clients listing all soft dollar services and commissions; and
- Commissions generated and services provided be periodically reviewed and that advisers be periodically notified when there is an imbalance between the soft dollar “commitment” and actual brokerage.

With respect to the possible liability of a broker-dealer for soft dollar abuses, the report ominously warns that “broker-dealers may be found liable for aiding and abetting investment advisers’ violations of their fiduciary duties to advisory clients where the broker-dealer continues participation in a course of conduct that the broker-dealer either knows, or should reasonably be aware, is fraudulent.”

Whether and under what restrictions soft dollar arrangements, even those protected by the Section 28(e) safe harbor, will be permitted to continue is now under review by the SEC. While regulators are pondering what to do about soft dollars, it is of paramount importance for investment advisers to make full and frank disclosure of these arrangements to their clients. In the past, such disclosure has served to address the conflicts of interest arising from soft dollar arrangements by alerting clients to the conflicts and allowing them to decide the basis on which to proceed. In re-examining these arrangements, regulators must weigh the benefits that soft dollars can generate for investors and decide whether, notwithstanding the current regulatory scheme, disclosure can sufficiently guard against the inclination of advisers, conscious or unconscious, presumed to arise from such arrangements, to render other than disinterested advice to their clients. Stay tuned.
Notes


3. In the Matter of Kidder, Peabody & Co., Inc., et al., Investment Advisers Act Release No. 232 (Oct. 16, 1968). Although the SEC often speaks of an investment adviser's duty to obtain best execution, this duty is not expressly stated in the federal securities laws. The SEC has asserted that a duty of best execution arises from an adviser's fiduciary duty obligation under common law to exercise reasonable care to obtain the most favorable terms for its clients.


5. Release 23170.


8. In the Matter of Goodrich Securities, Inc. et al., Securities Exchange Act Release No. 28141 (June 25, 1990); In the Matter of Patterson Capital Corp. et al., Investment Advisers Act Release No. 1235 (June 25, 1990); In the Matter of Robert Michael Lee, Investment Advisers Act Release No. 1249 (Sept. 17, 1990); In the Matter of Kingsley, Jennison, McNulty & Morse, Inc., et al., Initial Decision Release No. 24, 1991 SEC LEXIS 2587 (Nov. 14, 1991) (An adviser allegedly violated its fiduciary duty by using soft dollars to pay for services that were related to “marketing techniques” and outside the “safe harbor” of Section 28(e). This violation was based on the adviser's failure to disclose the arrangement even though the adviser was found not to have “paid up” for the services that is to have paid higher commissions to obtain the services.).


12. Section 3(a)(35) of the Securities Exchange Act of 1934 provides that “[a] person exercises ‘investment discretion’ with respect to an account if, directly or indirectly, such person (A) is authorized to determine what securities or other property shall be purchased or sold by or for the account, (B) makes decisions as to what securities or other property shall be purchased or sold by or for the account even though some other person may have the responsibility for such investment decisions, or (C) otherwise exercises such influence with respect to the purchase and sale of securities or other property by or for the account as the Commission, by rule, determines, in the public interest or for the protection of investors, should be subject to the operation of the provisions of this title and the rules and regulations thereunder.”


15. Release 23170.


17. Release 23170.

18. “Commission Guidance on the Scope of Section 28(e) of the Exchange Act,” Securities Exchange Act Release No. 45194 (Dec. 27, 2001). The interpretation cites only riskless principal trades under NASD Rules 4632 (applicable to Nasdaq National Market securities), 4642 (applicable to Nasdaq Small Cap Market securities) and 6420 (applicable to “eligible securities”) as examples of trades that would meet the requirements of the new interpretation. These rules require a riskless principal transaction in which “both legs are executed at the same price . . . to be reported once, in the same manner as an agency transaction, exclusive of any markup, markdown, commission equivalent, or other fee.” Thus, a money manager would pay the same price as the dealer paid in the offsetting trade; this price, along with the remuneration to the dealer for effecting the transaction, is required to be disclosed on the Rule 10b-10 confirmation.

19. Special NASD Notice to Members 01-85 (Dec. 2001), among other things, describes the differences between a traditional principal trade, a “riskless principal trade,” within the meaning of Nasdaq rules, and a “net trade.” A traditional principal trade is one in which the dealer buys or sells for an account in which the dealer has a beneficial interest (e.g., a proprietary account) and typically charges the customer a markup, markdown or commission equivalent. As the NASD notice explains, a net trade takes place when a market maker, at the request of a customer, while holding a customer order to buy (sell), executes a buy (sell) as principal at one price (from the street or another customer) and executes an offsetting sell to (buy from) the customer at a different price. The difference between the price of the market maker’s transaction and the price of the offsetting transaction to the customer is the market maker’s compensation. This amount generally is not separately disclosed on the customer confirmation. A net trade is thus executed on a “riskless” basis, but, under NASD trade reporting rules, because the two transactions are effected at different prices, the market maker must report both legs to the tape (but not to the customer).

20. A dealer’s profit on a principal trade is not commonly referred to as a “fee” in the industry. By using the term, the interpretive release at this point may be suggesting that an unknown and unknowable portion of the dealer’s profit is essentially the fee for executing the trade.


23. See Rule 206(4)-7 under the Investment Advisers Act of 1940 (requiring registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Investment Advisers Act of 1940).


