I-1.13 Soft-Dollar Arrangements: Do they present Conflicts of Interest?

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Summary: In a letter to the U.S. Senate Banking Committee Chairman Christopher Dodd, Mr. Cox said that "soft-dollar arrangements create a conflict between a money manager and its clients, compromise a money manager's fiduciary responsibility by inducing the manager to direct trades to broker-dealers that offer research the manager wants, instead of to the broker-dealer that could best execute the client's transactions, and encourage overtrading of client portfolios in an effort to generate soft-dollar credits."[i] These "troubling"[ii] practices as the former SEC Chairman referred to them, known as soft-dollar arrangements or soft commission arrangements, generally arise when an asset manager receives goods and services (*e.g.*, research) from a broker-dealer in exchange for placing securities transactions with that broker-dealer. U.S. and E.U. securities regulators have been concerned about, and have debated, these controversial practices and the potential, some would say "inherent", conflicts of interest for years. To prevent this type of conflicts of interest, we have seeing that securities regulators in the United States and the European Union have established standards so clients are able to asses whether their asset managers comply with their duties, and to ensure best execution requirements. Regulators are challenged to articulate the benchmark for determining the appropriateness of the research and brokerage services received and whether such services enhance the investment decision making process or order execution quality for the benefit of investors.

In the United States, Section 28(e) of the Securities Exchange Act of 1934 provides a "safe harbor" to protect fund advisers and other asset managers from criminal actions and civil suits for breach of fiduciary duty when they use soft-dollar commissions. The Commission has provided interpretative guidance to clarify the scope of application of Section 28(e). E.U. regulators, with a view to harmonize soft-dollar practices[iii] across its Member States, included soft-dollar arrangements in the directive 2004/39/EC in Markets in Financial Instruments Directive ("MiFID").

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I. INTRODUCTION

In May 2007, the former Chairman of the Securities and Exchange Commission ("SEC" or the "Commission"), Christopher Cox, urged the U.S. Senate and House of Representatives to consider legislation to repeal or at least revise soft-dollar regulation.[iv] In a letter to the U.S. Senate Banking Committee Chairman Christopher Dodd, Mr. Cox said that "soft-dollar arrangements create a conflict between a money manager and its clients, compromise a money manager's fiduciary responsibility by inducing the manager to direct trades to broker-dealers that offer research the manager wants, instead of to the broker-dealer that could best execute the client's transactions, and encourage overtrading of client portfolios in an effort to generate soft-dollar credits."[v] These "troubling"[vi] practices as the former SEC Chairman referred to them, known as soft-dollar arrangements or soft commission arrangements, generally arise when an asset manager receives goods and services (*e.g.*, research) from a broker-dealer in exchange for placing securities transactions with that broker-dealer. "The "soft" label is used because the asset manager does not pay for the goods and services separately with cash, but obtains them with what have been termed 'inflated brokerage commissions'".[vii] The soft-dollar arrangements can present a conflict of interest for the asset manager which obtains benefits for itself through the use of its clients' assets. By doing that, the manager could be viewed as breaching its fiduciary duty or best execution obligations. The use of these arrangements to pay for goods and services other than execution lacks transparency. This makes it difficult for clients to establish whether the asset manager is acting in their best interests or obtaining sufficient value for money on their behalf, or just engaging in excessive trading of clients' portfolios to obtain soft-dollar benefits, as Mr. Cox emphasized.

U.S. and E.U. securities regulators have been concerned about, and have debated, these controversial practices and the potential, some would say “inherent”, conflicts of interest for years. How have they reacted to the potential conflicts of interest create by soft-dollar arrangements? In the United States, Section 28(e) of the Securities Exchange Act of 1934 (the “Exchange Act”) provides a “safe harbor” to protect fund advisers and other asset managers from criminal actions and civil suits for breach of fiduciary duty when they use soft-dollar commissions. To adapt to market developments and respond to market participants’ concerns, the Commission has provided interpretative guidance to clarify the scope of application of Section 28(e).

Facing similar challenges, E.U. regulators, with a view to harmonize soft-dollar practices[viii] across its Member States, included soft-dollar arrangements in the directive 2004/39/EC in Markets in Financial Instruments Directive (“MiFID”). The U.K. securities regulator, the U.K. Financial Services Authority (“U.K. FSA”), inspired the work of E.U regulators in connection with soft-dollar arrangements.

The problem with soft-dollar arrangements is that they mix the cost of research with the costs of trading and then eclipse the transparency that is desirable to have in the markets and an accurate analysis of transaction costs. The potential conflicts of interest presented by soft-dollar arrangements require a permanent monitoring and reaction from regulators to advances in technology and evolution in market structure. As financial markets become more global, many U.S. market participants have a significant presence abroad and the soft-dollar regulations constitute also a challenge for market participants to comply with multiple regulatory regimes.

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II. U.S. Approach: Section 28(e) of the Securities Exchange Act of 1934 and Interpretative Guidance

1. Origins of Section 28(e) "Use of Client Commission Dollar": Safe-Harbor

In late the 1960s and early 1970s, after several brokerage firms collapsed and went out of business, pressure grew at the SEC and the U.S. Congress to examine the then current practices of stock exchanges and brokerage firms. This led to an examination and subsequent abolition of fixed minimum commission rates, a form of public price fixing.[ix] "In the era of fixed rates, when broker-dealers could not compete on the basis of services including non-execution services that they could charge for executing orders, they competed on the basis of services including non-execution services that they could offer."[x] These non-execution services included research.

In 1975, the SEC adopted Rule 19b-3 under the Exchange Act and the U.S. Congress passed legislation, both abolishing fixed commission rates. The intention behind this regulatory change was to allow stock markets and brokerage firms to adapt to changing events. However, the elimination of fixed commission rates raised concerns on the asset managers and broker-dealers sides on how asset managers will allocate research services without breaching their fiduciary duty *vis-à-vis* their clients, and how broker-dealers providing brokerage and research services will compete with broker-dealers providing execution-only services. To address these concerns the U.S. Congress decided to allow asset managers to continue paying for research through commission dollars in a bundled manner and included a safe harbor in the Securities Acts Amendments of 1975, codified as Section 28(e) of the Exchange Act ("Section 28(e)").

Section 28(e) provides a "safe harbor" for asset managers who use a client's commission dollars to obtain investment research and brokerage services from broker-dealers if certain conditions are met. "The safe harbor provides generally that a money manager does not breach his fiduciary duties under state or federal law solely on the basis that the money manager has paid brokerage commissions to a broker-dealer for effecting securities transactions in excess of the amount another broker-dealer would have charged, if the money manager determines in good faith that the amount of the commissions paid is reasonable in relation to the value of the brokerage and research services provided by such broker-dealer."[xi] The safe harbor allows asset managers to pay higher commissions on behalf of a client than otherwise are available to obtain brokerage and research services, if asset managers make their good faith determination regarding the reasonableness of commissions paid.[xii] "In making this good faith determination, an adviser may consider not only the benefit to be derived by the account paying the commissions, but also the benefits derived by other accounts. Moreover, the SEC believes that an adviser's burden of substantiating its good faith determination is greater where the adviser enters into a soft-dollar arrangement with an *affiliated* broker-dealer as opposed to an independent broker-dealer."[xiii] Conduct that is not protected by Section 28(e) may constitute a breach of fiduciary duty as well as a violation of the federal securities laws and the Employee Retirement Income Security Act of 1974. Since the passage of Section 28(e), to react to market developments and market participants' concerns, such as what type of goods and services are within the protection of Section 28(e), the SEC has issued interpretative releases.

2. Market Developments and Controversies: How the SEC Has Reacted to them? SEC SEC's Interpretative Guidance

- ***1976 Release: no protection for "products and services which are readily and customarily available and offered to the general public on a commercial basis"***[xiv]

In March 1976, soon after the enactment of Section 28(e), the SEC issued a release to provide guidance on what type of products and services were within the safe harbor provided by Section

28(e). The 1976 Release provided that "products and services which are readily and customarily available and offered to the general public on a commercial basis", such as newspapers, government publications and office equipment, were not within the safe harbor. The Commission also admonished asset managers not to direct broker-dealers to make "give-up"[xv] payments and stated that to be within the definition of brokerage and research services under Section 28(e), "it was intended [...] that a research paid for in commissions by accounts under management be provided by the particular broker who executed the transactions for those accounts."[xvi]

- ***1980 Report and 1986 Release: extensive interpretative guidance***[xvii]

In the 1980s, after an examination of commission practices conducted by the Commission, the Commission concluded that the standard set up by the 1976 Release was "difficult to apply and unduly restrictive in some circumstances",[xviii] "particularly as the types of research products and their method of delivery had proliferated and become more complex."[xix] The Commission withdrew the 1976 Release's standard and interpreted the safe harbor to be available to research services that satisfy the definition of "brokerage and research services" under Section 28(e)(3) and provide "lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities."[xx] In the 1986 Release, the Commission also concluded that a product or service that was "readily and customarily available and offered to the general public on a commercial basis" nevertheless could constitute research. The 1986 Release also re-affirmed that, under appropriate circumstances, asset managers may use client commissions to obtain third-party research (*i.e.*, research produced by someone other than the executing broker).[xxi] The Commission also emphasized the importance of disclosure requirements (written disclosure of client commission arrangements) and asset managers' best execution duty.[xxii] The 1986 Release introduced the concept of "mixed use" and the Commission indicated that where a product has a mixed use, an investment manager should make a reasonable allocation of the cost of the product according its use, and should keep adequate books and records concerning the allocations.[xxiii] The Commission, to control the inherent conflicts of interest of this allocation, noted that an asset manager may use client commissions pursuant to Section 28(e) to pay for the portion of a service or specific component that assist him/her in the investment decision-making process only and not for the portion of a service that provides him/her administrative assistance.

- ***2001 Release: agents v. principals***

The 2001 Release ended with the Commission's interpretation that Section 28(e) was available only for research and brokerage services obtained in relation to commissions paid to a broker-dealer acting in an "agency capacity".[xxiv] In practice, that meant that asset managers could not rely on the Section 28(e) safe harbor for research and brokerage services obtained in relation to fees charged by market makers when they executed transactions in a "principal" capacity. The analysis behind that interpretation was that the fees on principal transactions were not quantifiable and fully disclosed in a way that would allow asset managers to determine that the fees were reasonable in relation to the value of the research and brokerage services received.[xxv]

Between 2001 and 2005, critics to the interpretation of the safe harbor rose and the Commission was urged to provide further clarification,[xxvi] and also take into account the developments in the United Kingdom. Many U.S. market participants have a significant presence abroad, in particular in the United Kingdom, and they were concerned about costs of compliance with multiple regulatory regimes and incompatibilities among them. On July 22, 2005, the U.K. FSA adopted final client commission rules. The U.K. FSA final rules describe "execution" and "research" services and products eligible to be paid for by commissions, and specify a number of "non-permitted" services that must be paid in hard dollars, such as custody not incidental to execution, computer hardware, telephone lines, and portfolio performance measurement and valuation services.[xxvii] This was the context of the Commission's proposed interpretative release that led to the issuance of the 2006 Release.

- ***2005 Interpretative Release and 2006 Release: contours of the Section 28(e) safe harbor***

On October 19, 2005, the Commission issued a proposed interpretative release ("2005 Proposal") providing guidance and requesting comments on the scope of the brokerage-allocation safe harbor in Section 28(e). The 2005 Proposal focused on the scope of the Section 28(e) safe harbor and it did not address soft-dollar arrangements that do not fall within the safe harbor.[xxviii] On July 18, 2006, despite the expressed antipathy for Section 28(e), the SEC published an interpretation clarifying the range of products and services that are eligible for safe harbor protection under Section 28(e), with a goal of providing "maximum flexibility" for asset managers to use client commissions to seek best execution of trades while obtaining valuable research.[xxix] The 2006 Release significantly expands upon the 2005 Proposal, and contains important interpretive statements on research, brokerage, third-party services, and other aspects of the Section 28(e) safe harbor. The Commission substantially altered the approach to "commission sharing arrangements"[xxx] for providing third-party research as described in the 2005 Proposal. The new interpretation calls them "client commission arrangements" and permits them to operate in a more flexible manner than the 2005 Proposal would have allowed.[xxxi]

An asset manager's role as a fiduciary includes the duty to use reasonable efforts to obtain best execution in connection with clients' transactions. Best execution requires the manager to seek to "execute securities transactions for clients in such manner that the client's total cost or proceeds in each transaction are the most favorable under the circumstances."[xxxii] Section 28(e) provides a safe harbor from liability under any federal or state law that existed at the time the 1975 Amendments were enacted when the manager causes a client to pay more than the lowest available commission for effecting a securities transaction. In connection with third-party research, the Commission reiterated its long-standing position that independent research providers are accorded equal treatment with proprietary research providers, and that the Section 28(e) safe harbor encompasses third-party research and proprietary research on equal terms. While the Commission reiterated that Section 28(e) provides that a broker-dealer in a client commission arrangement must be involved in the process of "effecting" trades for the asset manager and must "provide" the research products and services, the 2006 Release broadens the scope of what would be permitted under the 2005 Proposal in order to provide greater flexibility in using client commissions to seek best execution for trades and obtain research. In part in response to comments on the 2005 Proposal that introducing brokers, who do not execute trades, would perhaps be precluded from providing valuable third-party research, the 2006 Release provides that a broker will be deemed to have effected a trade, and thus be eligible to share in commissions protected under Section 28(e), if it performs at least one of seven functions and has taken steps to see that the other functions have been reasonably allocated to one or another broker-dealer in the arrangement in a manner that is fully consistent with the obligations under self-regulatory organization (SRO) and SEC rules.[xxxiii]

In issuing the 2006 Release, the Commission intended to clarify the scope of "brokerage and research services" for purposes of Section 28(e), in light of evolving technologies and industry practices. The 2006 Release sets out a three-step analysis that an asset manager should employ when determining whether a product or service falls within the statutory scope of Section 28(e) safe harbor.[xxxiv] The Commission also concluded that "research services" are restricted to advice, analyses, and reports relating to the subject matter areas in Section 28(e)(3). The Commission attempted to draw a line between products and services that have substantive content (*i.e.*, the expression of reasoning or knowledge), which are eligible as research (*e.g.*, pre-trade and post-trade analytics available through an order management system, conferences and seminars (but not meals or transportation)) and those that have "inherently tangible" characteristics, which are not eligible (*e.g.*, operational overhead, computer hardware). A research service or product is covered by the Section 28(e) safe harbor only to the extent that the service or product constitutes advice, an analysis or a report and provides lawful and appropriate assistance in the investment decision-making process (as opposed to, for example, the use of account performance analyses for marketing purposes). The 2006 Release provides that the form of the research (*e.g.*, electronic, paper or oral) does not affect the availability of the safe harbor. The Commission determined that the non-eligible products and services do not reflect the expression of reasoning or knowledge relating to the subject matter identified in Section 28(e).

The 2006 Release reiterated the Commission's guidance on mixed-use items provided in the 1986 Release and emphasizes that an adviser should keep adequate records to support allocation determinations.[xxxv] The 2006 Release highlights certain areas in which an asset manager must make reasonable mixed-use allocations —such as trade analytical software, account performance analyses, proxy voting services, and order management systems— to the extent that the manager uses those items for purposes other than investment decision-making.

Regarding market participants' concerns about compliance with multiple regulatory regimes, the Commission indicated that the guidance provided by the 2006 Release was intended to be generally consistent with the guidance provided by the U.K. FSA. The 2006 Release, however, highlights certain differences between the Commission's and the U.K. FSA's guidance, such as the eligibility under the 2006 Release (but not under the U.K. FSA's guidance) of seminars, publications targeted to a narrow audience, and raw data provided for research purposes.

Through these interpretive releases, the Commission has reiterated its intention to avoid conflicts of interest and improve transparency of soft-dollar arrangements.[xxxvi] Indeed, in the SEC Open Meeting on July 12, 2006, the Commissioner Roel C. Campos said "I am glad to see that some industry participants have taken a piece of the puzzle into their own hands with the unbundling of commissions (such as Fidelity's and Lehman Brothers' $7 million October 2005 unbundling deal), which requires the sell side to affix a value to each of its research products. The likely outcome of this conduct is to reduce the types of goods and services managers considered legitimate under the safe harbor. Again, the power of transparency and disclosure can be enormous."[xxxvii] A concern is still the misuse that market participants give to soft dollars -some firms will use soft dollars to buy office equipment or to pay other expenses not eligible for the Section 28(e) safe harbor and will fail to make appropriate allocations of mixed-use items, between soft dollars and their own expenses. "The Commission has warned asset managers in the past about 'extending the outer boundaries' of the safe harbor, and cautioned broker-dealer that they need to be alert to situations where an asset manager may be breaching its fiduciary duties and the securities laws."[xxxviii] As presented in this part, the Commission has debated these issues for several years and has released guidance for managers and advisers and even appealed to Congress directly for help.

II. U.K. AND E.U. APPROACHES: UK FSA's Guidance and MiFID

1. U.K. FSA's Guidance: Origins of Soft Commission Arrangements and Current Rules

Soft commission arrangements grew up in the United Kingdom in the 1970s, in response to the minimum commission regime operated by the London Stock Exchange. Brokers competed by offering additional services to asset managers, to discount the cost to them of having to pay hard commission at a fixed minimum rate. The United Kingdom was following the example of the U.S. market, where soft-dollar arrangements had also arisen in response to a fixed commission regime. By the time fixed commissions were abolished in 1986, "softing" had become a common practice in the market place. Under the soft commission arrangements that were typical in the United Kingdom, a broker agreed to pay for certain goods and services that were supplied directly to the asset manager – usually by a third-party rather than the broker or one of its associated companies. The total amount the broker will pay was agreed between the parties, and was dependent on the asset manager sending a specific volume of business to the broker.[xxxix] Soft commission arrangements therefore imply a commitment on the part of the asset manager to direct a certain level of business to the broker.[xl]

In 2000, the Chancellor of the Exchequer appointed Paul Myners, then chairman of Gartmore Investment Management, to carry out a review of institutional investment in the United Kingdom. Mr. Myners published his final report in March 2001 ("Myners Report").[xli] This centered on the efficiency of investment decision making and the responsibilities of those involved, particularly pension fund trustees and their investment managers. The Myners Report also examined the way in which dealing commission were charged to a fund, when the fund manager buys and sells securities for the fund's portfolio. Here, the report focused on the disparity in the way that the main costs of managing a pension fund – management fees and dealing commissions – were treated.[xlii] Mr. Myners noted that management fees were transparent to the customer; and indeed pension scheme trustees and their advisers subject them to considerable scrutiny and negotiation when appointing a fund manager. Dealing commissions, on the other hand, were not transparent, since they are invariably charged directly to the fund itself on a transaction by transaction basis. As a result, customers were less likely to know how much commission was charged to their funds in total, or how much of that commission was being used to buy services in addition to trade execution. Mr. Myners was concerned that the lack of customer focus on commission costs provided an "artificial bias" for fund managers to acquire additional services paid for through commission. This enabled a fund manager to reduce his own operating expenses even after the management fee was been negotiated and agreed, and so increase the profit element of the management fee.[xliii] Mr. Myners concluded that there was an incentive for fund managers to direct business to brokers to obtain additional services, rather than the most favorable trade execution terms for their customers, and that this represented an unacceptable market distortion. Concerned by the issues raised in the Myners Reports, and the consequences of the lack of transparency and the potential conflicts of interest of dealing commissions on consumer protection and market confidence, in July 2001, the U.K. FSA and the HM Treasury agreed to review the U.K. regulatory regime. They started analyzing how well the U.K. regulatory regime addressed the conflicts of interest and market distortions arising from bundled brokerage and soft commission arrangements. The U.K. FSA and the HM Treasury carried out this work in parallel with their work on best execution and investment research, as they thought the subjects were interrelated. In April 2003, the U.K. FSA issued a Consultation Paper identifying four areas of concern. Similarly to the SEC's concerns, the U.K. regulators were worried about the opacity in the transaction costs, the potential conflicts of interests[xliv] and the disclosure of the managers' soft commission arrangements to their clients.[xlv] The U.K. FSA and the HM Treasury concluded that the U.K. regulatory regime[xlvi] did not address the issues mentioned below satisfactorily, and that further action was necessary. The U.K. FSA proposed two main amendments to the existing regulatory regime which it believed would realign the interests of asset managers and their clients and create greater transparency for clients. The U.K. FSA proposed to limit the range of services which a broker may offer under a soft or bundled arrangement. They believed that will reduce incentives for asset managers to deal with brokers against the interests of their clients. Accordingly, the first proposal was that certain goods and services should be excluded from those that can be provided under soft or bundled arrangements. After extensive consultation and studies,[xlvii] on July 22, 2005, the U.K. FSA adopted final client commission rules, which came into effect on July 1, 2006.[xlviii]

The U.K. FSA introduced a new section into the U.K. FSA's Conduct of Business Sourcebook ("COB") and deleted the section formerly entitled "Inducements and Soft Commissions," which dealt with the requirements of, and allowable benefits under, soft commission agreements, as well as prior and periodic disclosure requirements, in relation to soft commission agreements. The new title reads "Inducements."[xlix] In the July 2005 Policy Statement, the U.K. FSA summarized the effect of its rules, together with the introduction of "an enhanced industry disclosure regime to tackle the identified lack of transparency and accountability." The intended result was to:

- "Limit investment managers' use of dealing commissions to the purchase of execution and research services;
- Require investment managers to disclose to their customers details of how commission payments have been spent and what services have been acquired with them;

- Embed in the commercial relationship between investment managers and brokers incentives to secure value for clients for execution and research spend; and

- Promote competition between those who produce investment research by removing the regulatory distinction between research services provided by brokers along with execution (*i.e.*, bundled services) and research services provided by third parties (*i.e.*, softed services)."

The U.K. FSA established a set of principles governing soft commissions. Principle 1 (Integrity) requires a firm to conduct its business with integrity. Principle 6 (Customers' Interests) requires a firm to pay due regard to the interests of its customers and treat them fairly. Principle 8 (Conflicts of Interest) requires a firm to manage conflicts of interest fairly, both between itself and its customers and between one customer and another.

The U.K. FSA allows the use of dealing commissions to purchase good or services only where the investment manager (an investment manager that executes customer orders through a broker and passes on the broker's charges (whether commission or otherwise) to its customers; and in return for those charges receives goods or services in addition to the execution of its customer orders) "(a) has reasonable grounds to be satisfied that the goods or services […] (i) are related to the execution of trades on behalf of the investment manager's customers; or (ii) comprise the provision of research; and (b) will reasonably assist the investment manager in the provision of its services to its customers on whose behalf the orders are being executed and do not, and are not likely to, impair compliance with the duty of the investment manager to act in the best interests of its customers." The COB explains the circumstances in which an investment manager will have such reasonable grounds to be satisfied in relation respectively to execution and research. The execution requirement will be met (COB 7.18.4(1)E) "if the goods or services are: (a) linked to the arranging and conclusion of a specific investment transaction (or series of related transactions); and (b) provided between the point at which the investment manager makes an investment or trading decision and the point at which the investment transaction (or series of related transactions) is concluded." In relation to research, the requirement will be met if the research (COB 7.18.5(1)E): "(a) is capable of adding value to the investment or trading decisions by providing new insights that inform the investment manager when making such decisions about its customers' portfolios; (b) whatever form its output takes, represents original thought, in the critical and careful consideration and assessment of new and existing facts, and does not merely repeat or repackage what has been presented before; (c) has intellectual rigour and does not merely state what is commonplace or self-evident; and (d) involves analysis or manipulation of data to reach meaningful conclusions." The COB also listed the goods and services which the U.K. FSA states will not meet the above requirements and which, therefore, a manager cannot purchase with commission (*e.g.*, computer hardware, seminar fees, portfolio valuation services).[1]

Recognizing the importance of monitoring the effects of the new rules, the U.K. FSA developed performance indicators (the U.K. FSA charged OXERA with developing these indicators) to determine whether its proposals are achieving the desire outcome, among others intended results, provide greater transparency regarding the use of dealing commissions. On April 7, 2009, the U.K. FSA published its post-implementation review of the use of dealing commission regime. The U.K. FSA concludes that the evidence it has gathered indicates that as a result of the new regime, the market appears to be delivering the outcomes it sought; in particular: overall, the performance indicators found that the expected changes were occurring and that the market was moving towards delivering the intended outcomes. The report also found that the new regime has clearly delivered benefits to the market. Commission rates have fallen and the new regime has limited the use of dealing commission to the purchase of "execution and research", encouraged greater separation in the purchase of execution and research and improved the provision of information. On the retail side, the evidence indicates that the benefits accruing on the wholesale side are being delivered to retail consumers since retail funds are treated in the same way as wholesale funds. When the U.K. FSA implemented the rules, it anticipated some adverse effects, such as the risk that the new regime might lead to lower liquidity. While disclosures were being provided, there was limited evidence that they were being used. However, if the use of disclosures were to increase, this might deliver further benefits, stated the U.K. FSA.[li]

2. MiFID[lii] and CESR's work: an Intent to Harmonize E.U. Soft Commission Practices

MiFID was enacted on April 21, 2004 and came into effect in November 1, 2007. This directive gave investment firms (this term includes broker-dealers and asset managers) an effective "single passport", allowing them to operate throughout the European Union on the basis of authorization in their home Member State. It is a very far-reaching piece of legislation. It sets out a comprehensive regulatory regime covering investment services and financial markets in Europe. It contains measures which changed and improved the organization and functioning of investment firms, facilitate cross-border trading and thereby encourage the integration of E.U. capital markets. MiFID was also intended to ensure strong investor protection, inter alia with a comprehensive set of rules governing the relationship which investment firms have with their clients. This directive provides the framework legislation, voted on by the European Council and Parliament, also known as Level 1.[liii]

A successful application of MiFID depends upon an intensification of supervisory convergence through its Members States. Following the implementation of MiFID Level 1, the emphasis at European Level was shifted to Level 3. The DG Competition of the European Commission published an issues paper on May 24, 2006 entitled "Competition in EU securities trading and post-trading". Section 4.2.2 of the paper focused on inducements. In its discussion of the appropriate regulation of soft commissions, DG Competition singles out the U.K. FSA soft commission regime as a model approach. Since then, the Committee of European Securities Regulators ("CESR"), in charge of implementing Level 3 to facilitate the convergence of regulatory outcomes, has issued recommendations further tightening the regulations around inducements. MiFID Level 1 extends best execution to all traded products and prohibited inducements-note that a safe harbor is provided under certain conditions.

The purpose of the provisions on inducements under MiFID and its implementing regulations (referred hereinto as "MiFID") is to ensure that firms comply with its "duties" to act honestly, fairly and professionally in accordance with the best interests of their clients.[liv] Under MiFID, fees, commissions or non-monetary benefits paid or provided to or by the client or a person acting on behalf of the client are authorized inducements. Proper fees are defined as fees which enable or are necessary for the provision of investment services, and which, by their nature, cannot give rise to conflicts with the firms' "duties". Fees, commissions or non-monetary benefits paid or provided to or by a third-party or a person acting on behalf of a third party are prohibited, except if, the inducements are disclosed to the client before the provision of the services, are designed to enhance the quality of the relevant service or the inducements do not impair the firm's "duty" to act in the best interest of the client.[lv] CESR has provided guidance in how to assess if the inducement enhances the quality of the service and comply with the firm's duty and has stresses that both criteria should be met.[lvi] Note that these criteria have been qualified as vague and ambiguous by market participants.[lvii]

E.U. regulators and CESR have emphasized the importance of disclosure. One of the questions raised by market participants was how to disclose. Pre-MiFID a mere reference to the fact that an inducement was paid by a third-party was sufficient and post-MiFID, that is no longer sufficient, the inducement must be clearly disclosed to the client-the disclosure must include its existence, nature and amount of the inducement received or paid, prior to the provision of the relevant service. The disclosure must include the "essential terms" to allow the investor to relate the information to the service render and the firm must be able to provide further details ate the request of the client. Through MiFID and CESR's recommendations, E.U. regulators propose to enhance fee transparency, obliging investment firms to give their clients, as pre-contractual information, an itemized breakdown of the fees charged for each trade executed. It is hoped that this additional transparency will help asset managers to become more cost sensitive, and further competition would hereby be encouraged in the brokerage market.

Despite the meritorious effort to reach a common approach across the European Union to supervise soft commissions, they are still a subject where Member States have the power to impose further or different standards. In its paper entitled CESR's Level 3 Feedback Statement (para. 27-28),[lviii] CESR noted that softing and bundling arrangements were regulated differently by different Member States. Many respondents mentioned the U.K. arrangements as a precedent for the European Union and recommended that they continue. The majority of respondents suggested that regulation on softing and bundling reflects the particularities of specific markets and that national regulators may be best placed to effect appropriate supervision. In addition, it was suggested that softing and bundling arrangements should be led by an industry driven approach and that any common approach be developed only after full consultation and research to discover the exact nature of practices in the various Member States.

The European Commission has accepted in principle the U.K. FSA's Article 4 notification[lix] of the U.K.'s use of dealing commissions regime, *i.e.*, that the U.K. soft dealing commissions regime can remain intact under MiFID. This suggests a jurisdictional approach may be allowed in this area going forward. The U.K. FSA has taken a more restrictive approach to soft commissions requiring evidence that the service(s) provided constitute research and/or execution in order to be exempt from regulation; whereas, CESR (and regulators in the European Union outside of the United Kingdom) do not have this requirement. Under the U.K. FSA use of dealing commission rules, services that are related to the execution of orders and investment research are considered as enhancing the quality of investment management services to a client.

The European Union is still struggling with the notion of soft commissions. The jurisdictional approach and the vagueness and ambiguity contouring soft commissions under MiFID and CESR's recommendations make it difficult for firms to comply with a variety of standards and for regulators to monitor firms' practices.

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IV. Concluding Remarks

Bundling and softing enable asset managers to finance some of their management expenses by charging their clients in a way that lacks transparency. This makes it difficult for clients to identify which additional services are being bought with their money, or how much they are paying for them. Consequently, clients do not have enough information to judge whether they are getting good value for their money and to assess how well their asset manager has performed its "good faith" or best execution obligation.[lx] The former SEC Chairman, Mr. Cox claimed the elimination of soft-dollars complaining that some soft-dollar arrangements were being used to pay for membership dues, office rent, carpeting, “and even entertainment and travel expenses.”[lxi] In my opinion, there is little doubt soft-dollar arrangements engender conflicts of interest, and that most asset managers’ clients lack actual knowledge of these conflicts or the wherewithal to directly monitor their managers and brokers. To prevent this type of conflicts of interest, we have seeing that securities regulators in the United States and the European Union have established standards so clients are able to asses whether their asset managers comply with their duties, and to ensure best execution requirements. Regulators are challenged to articulate the benchmark for determining the appropriateness of the research and brokerage services received and whether such services enhance the investment decision making process or order execution quality for the benefit of investors. An enforceable and thereby effective best execution regime is the best safeguard against conflicts of interest. Disclosure of transaction costs (as pre-contractual information) is the keystone of client protection. This should result in an environment in which the costs of managing and dealing of assets are more visible and clients are better placed to understand and assess them, and asset managers are more costs sensitive.[lxii] Clients should receive reports explaining how much of their commissions were spent on what services, with assessments of the value asset managers place on the research they purchase. This would in turn place downward pressure on the over-consumption of services, as clients include this among other issues they would consider in the selection of asset managers.

Two main economic benefits have been claimed for softing. It can:

- ease market entry by smaller fund managers and brokers, increasing competition and choice; and

- facilitate market entry for third-party research providers, enabling them to compete with broker research (mitigating some of the negative effects of bundling).[1] The availability of third-party research made it possible for smaller asset managers to compete with the large investment managers since they could cover considerable portions of what would otherwise have been their overheads by paying for research from all sources—not just traditional in-house, Street research—through their clients' commissions.

It has been said that research would be undersupplied if soft-dollar commissions were abolished entirely. It would be a mistake to prohibit innovative business practices in the interest of investor protection simply because they give rise to conflicts of interest. Regulators are confronted to create an environment in which technologies can flourish and investors are protected. In the soft-dollars world, a balance can be established in restricting the range of services and products for which soft-dollars could be used and increasing transparency through disclosure of transaction costs.

Properly balancing conflicts of interest is a task best left to regulators with the participation of market participants-professional associations and self-regulatory organizations should be key players.

Maria-Leticia Ossa Daza

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[i] "Cox's soft-dollar fight becomes a lonely battle" in InvestmentNews (www.investmentnews.com), February 25, 2008.

[ii] *Supra* note 1.

[iii] Note that the term used in the European Union to refer to soft-dollar arrangements may vary. This paper uses soft-dollar arrangements and soft commission arrangements as interchangeable terms. The U.K. Financial Services Authority has established a distinction between "soft commission arrangements" and "bundled brokerage". Under a soft commission arrangement, the fund manager receives goods and services (usually from third parties) which are paid for by the broker. There is an explicit prior agreement that links the value of the softed goods and services to a specified volume of commission from dealing orders. "Bundled brokerage" is an arrangement in which a broker provides a client (*e.g.*, a fund manager) with a combination of trade execution services and other services,

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[1] Stephen M. Horan and D. Bruce Johnsen, "The Welfare Effects of Soft-Dollar Brokerage: Law and Economics", Research Foundation of the Association for Investment Manage, January 2001.

such as investment research, paid for through commission. The components of the "bundle" are not usually offered or priced as separate services. There is an expectation, but no obligation, that the fund manager will deal through the broker. See Financial Services Authority, "Bundled Brokerage and Soft Commission Arrangements", Feedback on CP176, May 2004.

[iv] In his speech to the National Italian-American Foundation, SEC Chairman said that "*[Soft-Dollars are] a witch's brew of hidden fees, conflicts of interest, and complexity . . . at odds with investors' best interests. . . . That's why I've asked Congress to consider legislation to repeal or at least substantially revise the 1975 law that provides a "safe harbor" for soft-dollars*." Speech by SEC Chairman: Address to the National Italian-American Foundation by former Chairman Christopher Cox, U.S. Securities and Exchange Commission, New York City, May 31, 2007.

[v] "Cox's soft-dollar fight becomes a lonely battle" in InvestmentNews (www.investmentnews.com), February 25, 2008.

[vi] *Supra* note 1.

[vii] Larry E. Bergmann, "Soft-Dollar Arrangements under Section 28(e) of the Securities Exchange Act", The Review of Securities & Commodities Regulation, Vol. 40 No. 8, April 18, 2007.

[viii] Note that the term used in the European Union to refer to soft-dollar arrangements may vary. This paper uses soft-dollar arrangements and soft commission arrangements as interchangeable terms. The U.K. Financial Services Authority has established a distinction between "soft commission arrangements" and "bundled brokerage". Under a soft commission arrangement, the fund manager receives goods and services (usually from third parties) which are paid for by the broker. There is an explicit prior agreement that links the value of the softed goods and services to a specified volume of commission from dealing orders. "Bundled brokerage" is an arrangement in which a broker provides a client (*e.g*., a fund manager) with a combination of trade execution services and other services, such as investment research, paid for through commission. The components of the "bundle" are not usually offered or priced as separate services. There is an expectation, but no obligation, that the fund manager will deal through the broker. See Financial Services Authority, "Bundled Brokerage and Soft Commission Arrangements", Feedback on CP176, May 2004.

[ix] There is price fixing when business competitors (in this case broker-dealers) agree to sell the same product or service (commission for execution) at the same price.

[x] Securities and Exchange Commission, 17 CFR Part 241, Release No. 34-54165; File No. S7-13-06, in Federal Register, Rules and Regulations, Vol. 71, No.141, July 24, 2006.

[xi] See *supra* note 7. Section 28(e), in pertinent part, provides: "No person [...] 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 the State or Federal law [...] 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 which he exercises investment discretion." See SEC-LAW, FSLR 1934 Securities Exchange Act Sec. 28.

[xii] See *supra* note 7.

[xiii] Securities Law Handbook of Investment Advisers, "Regulation of Investment Advisers", Thomas P. Lemke and Gerald T. Lins, 2008 Edition, Thomson West.

[xiv] See Securities Exchange Act Release No. 12251 (Mar. 24, 1976).

[xv] "The 'give-up' of concern was a payment by the broker-dealer executing a trade to another broker-dealer of a portion of the commission charged by the executing broker, where the broker-dealer receiving the give-up had no role in the trade generating the commissions. The give-up was made to pay for products and services that benefited the asset manager but often had no benefit for its clients that had paid the commissions. The broker-dealer paying the give-up may not have known what services the other broker-dealer provided to the asset manager. The bottom

line was that the client paid excessive commissions for the benefit that it received. The SEC found that such arrangements violated securities laws." Larry E. Bergmann, "Soft-Dollar Arrangements under Section 28(e) of the Securities Exchange Act", The Review of Securities & Commodities Regulation, Vol. 40 No. 8, April 18, 2007.

[xvi] Securities and Exchange Commission, 17 CFR Part 241, Release No. 34-54165; File No. S7-13-06, in Federal Register, Rules and Regulations, Vol. 71, No. 141, July 24, 2006.

[xvii] See Securities Exchange Act Release No. 23170 (April 23, 1986).

[xviii] *Supra* note 14 (1986 Release, 51 FR at 16005).

[xix] *Supra* note 13.

[xx] *Supra* note 14 (1986 Release, 51 FR at 16006).

[xxi] *Supra* note 13 (1986 Release, 51 FR at 16007). The 1986 Release cited the Investment Information, Inc.'s Report stating that "while a broker may under appropriate circumstances arrange to have research materials or services produced by a third-party, it is not 'providing' such research services when it pays obligations incurred by the money manager to the third party."

[xxii] An asset manager, as a fiduciary, has an obligation to "execute transactions for clients in such manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances." 1986 Release, 51 FR at 16011. A duty of best execution also "requires a broker-dealer to seek the most favorable terms reasonably available under the circumstances for a customer's transaction." Rel. No. 34-37619A (1996), 61 FR 48290, 48322 (1996). The SEC states that the provisions of Section 28(e) do not alter best execution obligations. Release, 71 FR at 41978 n.6.

[xxiii] "In many cases, a product or service obtained using client commissions may serve functions that are not related to the investment decision-making process, such as accounting or marketing. Management information services, which may integrate trading, execution, accounting, record-keeping, and other administrative matters such as measuring the performance of accounts, were noted as and example of a product that may have mixed-use. *Supra* note 13 (1986 Release, 51 FR at 16006).

[xxiv] See 2001 Release, 67 FR at 6; 1995 Rule Proposal, 60 FR at 9751 n.10; Investment Company Act release No. 20472 (Aug. 11, 1994), 59 FR 42187, 42188 n.3 (Aug. 17, 1994).

[xxv] 2001 Release, 67 FR at 7.

[xxvi] The Commission was urged to update and clarify prior releases and to address some results in the 1998 Office of Compliance Inspection and Examination staff's report on soft-dollar practices (http://sec.gov/news/studies/softdolr.htm. See SEC Release No. 34-52635 (Oct. 19, 2005) at 31-32, where the staff concluded that some investment managers were taking an expansive view of the safe harbor under Section 28(e).

[xxvii] See U.K. Financial Services Authority, Policy Statement 05/9, Bundled Brokerage and Soft Commission Arrangements: Feedback on CP 05/5 and Final Rules (July 2005) ("FSA Final Rules"), available at http://www.fsa.gov.uk/pages/library/policy/policy/2005/05_09.shtml. The rules apply only to equity trades and not to fixed income trades. FSA Final Rules, at Annex, p. 6 (Conduct of Business Sourcebook Rule 7.18.1). The FSA proposed the rules in March 2005. See Consultation Paper 05/5, "Bundled Brokerage and Soft Commission Arrangements: Proposed Rules" (Mar. 2005) ("FSA Rule Proposal"), available at http://www.fsa.gov.uk/pubs/cp/cp05_05.pdf. See also FSA Final Rules, at Annex, pp. 8-9 (Conduct of Business Sourcebook Rules 7.18.4 to 7.18.8). See also FSA Rule Proposal, at 63-64.

[xxviii] Section 28(e) provides that the safe harbor "is exclusive and plenary [...] unless otherwise expressly provided by contract [...]" The 2005 Proposal notes that investment managers "may provide more detailed disclosure when they receive products and services that fall outside the scope of the safe harbor." SEC Release No. 34-52635 (Oct. 19, 2005), available at: http://www.sec.gov/rules/interp/34-52635.pdf. at n.73. The Commission further observed, however, that, regardless of any disclosures made to investors, arrangements by advisers to investment companies registered under the Investment Company Act of 1940 or employee benefit plans subject to the Employee Retirement Income Security Act of 1974 may violate those statutes if they fall outside the safe harbor. See *id*. in text accompanying nn. 21-24.

[xxix] See Securities Exchange Act Release No. 54165 (July 18, 2006) and Interpretation of Client Commission Practices Under Section 28(e), Exchange Act Release No. 54165 (July 18, 2006), *available at* http://www.sec.gov/rules/interp/2006/34-54165.pdf.

[xxx] The 2006 Release says that the SEC prefers "client commission arrangements" to "soft-dollars" to avoid confusion associated with the latter term, and to distinguish it from "the phrase 'commission-sharing arrangements' used in the United Kingdom to refer to unique arrangements in that market place." 71 FR at 41978 n.4.

[xxxi] On January 17, 2007, the Office of chief counsel of the Division of Market Regulation of the SEC issued a "no-action" letter clarifying the operation of a new type of client commission arrangement permitted by the SEC's 2006 Release concerning Section 28(e). See SEC Staff No-Action Letter re: Status of service Providers in Goldman Sachs & Co.'s research XPRESS Program (January 17, 2007), available at www.sec.gov/divisions/marketreg/mr-noaction/2007/goldmansavchs011707-15a.pdf.

[xxxii] See Securities Exchange Act Release No. 54165 (July 18, 2006) at 16011.

[xxxiii] Under the 2006 Release, a broker-dealer is involved in effecting a trade for purposes of Section 28(e) if it performs one of the following three functions -- executes, clears, or settles the trade -- *or* performs one of the following four specified functions and allocates the other functions to another broker-dealer: (1) taking financial responsibility for client trades; (2) maintaining records relating to client trades; (3) monitoring and responding to client comments concerning the trading process; or (4) monitoring trades and settlements. Three additional functions qualify as "effecting," bringing the total to seven: (5) executing trades; (6) clearing trades; and (7) settling trades.

[xxxiv] In making a determination, the asset manager should: (1) determine whether the product or service falls within the specific statutory limits of Section 28(e)(3) (*i.e.*, whether it involves an eligible product or service); (2) determine whether the product or service provides lawful and appropriate assistance in the performance of the investment adviser's investment decision-making responsibilities; and (3) make a good-faith determination that the amount of client commissions paid is reasonable in light of the value of the products or services provided by the broker-dealer. The burden of proof rests on the asset manager to prove that the manager made a good-faith determination in selecting a broker-dealer. See, "Soft Dollars: The SEC changes the Rules of the Road", Securities Markets, Insights, Volume 20, number 8, August 2006.

[xxxv] See 2006 Release at 41979 and 41991 (noting that "[l]ack of documentation makes it difficult for the manager to make the required good faith showing of reasonableness . . . and also makes it difficult for compliance personnel to ascertain the basis for the [mixed-use] allocation.")

[xxxvi] The Commission issued a proposed new guidance on oversight of adviser trading practices by fund boards (see SEC release Nos. 34-58264, IC-28345, IA-2763 (July 30, 2008) and BLOOMBERG Law Report, Securities Law, Vol. 2, No. 32, August 11, 2008). The proposed guidance addressed the role of fund boards in monitoring conflict of interest faced by advisers when trading fund portfolio securities. The Commission noted that "there may be incentives for an investment adviser to compromise its fiduciary obligations to the fund in its trading activities in order to obtain certain benefits that serve its own interests or the interests of other clients." It is particularly the case when advisers use fund brokerage commissions to pay brokerage and research services. Under the proposed new guidance, fund boards should ask for specific information on how an adviser determines what its total research needs are and how research is actually obtained. See also Terrance J. O'Malley, "Investment Adviser's Legal and Compliance Guide", Wolters Kluwer Law & Business, Aspen publishers, 2007 and 2008 Supplements.

[xxxvii] Statement of Commissioner Roel C. Campos at the SEC Open Meeting of July 12, 2006 available at: http://www.sec.gov/news/speech/2006/spch071206rcc2.htm.

[xxxviii] Larry E. Bergmann, "Soft-Dollar Arrangements under Section 28(e) of the Securities Exchange Act", The Review of Securities & Commodities Regulation, Vol. 40 No. 8, April 18, 2007.

[xxxix] This was typically expressed as a fixed ratio between the amount of hard commission the asset manager will generate and the value of credits earned that can be set against the cost of the additional goods and services. This ratio was known as the "multiple" or "multiplier", although the figure is not necessarily stated explicitly in soft commission agreements. The Oxford Economic Research Associates (OXERA) report indicates that in 2000-2001 the average multiple was between 1.15 and 1.1715. So, for example, for every £115 of hard commission that a fund

manager paid to a broker, the broker paid for goods or services to the value of £100. See Consultation Paper 176, "Bundled Brokerage and Soft Commission Arrangements (April 2003) available at http://www.fsa.gov.uk.

[xl] As discussed in the first part of this paper, in the United States, the term "soft" covers any services unrelated to execution that are supplied to asset managers in exchange for commission, whether or not they have an individual market price, or there is an agreement to secure a specified level of business. By contrast, the term "hard dollars" is used in the United States for services that are explicitly priced and paid for separately by the asset manager.

[xli] "Institutional Investment in the United Kingdom: A Review" HM Treasury, March 6, 2001. See Consultation Paper 176, "Bundled Brokerage and Soft Commission Arrangements (April 2003) available at http://www.fsa.gov.uk.

[xlii] *Supra* note 36, paragraphs 5.102 -5.103.

[xliii] The U.K. FSA pointed out, to stress the relevance of dealing commissions, that in 2000, U.K. fund managers paid about £2.3billion in commissions from their customers' funds to U.K. brokers. However, commissions may pay for more than the cost of trade execution. Estimates varied but as much as 40% went on additional services such as investment research and market information technology, through "bundled" (or "full service") broking or "soft commission" arrangements. See Consultation Paper 176, "Bundled Brokerage and Soft Commission Arrangements (April 2003) available at http://www.fsa.gov.uk.

[xliv] The U.K. FSA noted in its Consultation Paper that bundling and softing create an incentive for the asset manager to undertake volumes of trading that may be motivated by a desire to obtain particular quantities of additional services, rather than to improve the performance of their customers' funds. Equally, brokers who were paid by commission have a clear interest in maximizing trading volumes. Since customers' control of transaction costs is imperfect, trading volumes and commission rates could be higher than they need be. See Consultation Paper 176, "Bundled Brokerage and Soft Commission Arrangements (April 2003) available at http://www.fsa.gov.uk.

[xlv] The four areas of concern identified in the FSA Consultation Paper are: (1) A system in which costs are opaque and accountability to fund management customers is deficient gives little comfort that the underlying conflicts of interest are being controlled effectively, or that dealing arrangements result in good value for money for investors; (2) Bundled and soft commission arrangements create powerful incentives that have a strong influence on fund managers' trading decisions and the routing of business to brokers. In some circumstances, buying additional services may be a stronger driver for trading decisions than execution quality. This is particularly the case with soft commission arrangements where the commission rate can be higher than normal, but where the proportion of the commission spent taken up by soft services typically exceeds 80%. Such an arrangement seems bound to have an impact on execution quality; (3) The control over these incentives exerted by normal market disciplines is weak and uneven. Competition between fund managers focuses on the mandate for the business and the size of the management fee, rather than commission costs. Although fund managers are judged on fund performance, isolating the effect on performance of bundling and soft commission arrangements from any other factor is well-nigh impossible. More disclosure can help, and we welcome the steps taken by the Investment Management Association and the National Association of Pension Funds to improve disclosure of transaction costs to pension funds. However, we are not convinced that more disclosure will be enough to address the issues. In the retail funds market we think it would have minimal impact; (4) Bundled and soft commission arrangements create similar incentives and have similar economic effects, so treating them differently in regulatory terms is unhelpful and creates its own distortions. See Consultation Paper 176, "Bundled Brokerage and Soft Commission Arrangements (April 2003) available at http://www.fsa.gov.uk.

[xlvi] The soft commission U.K. regime was originally constructed on the basis that the inducements to place business with particular brokers were felt to be so strong that additional safeguards were called for. The principal provisions were that: • a soft commission arrangement must be in writing; • soft commission can only be used to acquire certain goods and services that will enhance the provisions of a firm's investment services to its customers; • the broker must agree to provide best execution; and • the firm must obtain the customer's prior consent to soft trades for his portfolio, and provide periodic disclosure of commissions paid and the value of softed services received.

[xlvii] See CP171: “Conflicts of Interest: Investment Research and Issues of Securities”, FSA February 2003 and OXERA Report on “Cost–benefit analysis of the FSA’s policy propositions on soft commissions and bundling”, Oxford Economic Research Associates, March 2003. See also FSA Consultation Paper: “Bundled Brokerage and Soft Commission Arrangements: Proposed Rules”, March 2005, Policy Statement 04/13 “Bundled brokerage and soft commission arrangements: Feedback on CP176” (PS04/13) and “Bundled brokerage and soft commission arrangements: Update on issues arising from PS04/13” (PS04/23).

[xlviii] Their effective date was January 1, 2006 subject to a transitional period which ended on June 30, 2006.

[xlix] The term “inducements” includes soft commission arrangements.

[l] Note that “directed commissions” and “commission recapture arrangements”, which may be also considered as detrimental to the fair and efficient operation of the market because they tend to focus broker selection on factors other than execution quality, are not treated in this paper. “Directed commission” and “commission recapture” arrangements, as defined in the FSA Consultation Paper 176, “Bundled Brokerage and Soft Commission Arrangements (April 2003), are variants of bundled and soft commission arrangements. Directed commission is an arrangement under which the customer, for example a pension fund, instructs the fund manager to direct a certain proportion of the trades, and therefore commission, generated by the manager on the fund’s portfolio to a specific broker. In return, that broker supplies services or cash rebates that exclusively benefit that portfolio. “Commission recapture” is a similar concept. The customer (for example, the pension fund) appoints an intermediary (not the fund manager) to negotiate with one or more brokers, so that each broker pays to the intermediary a proportion of the commission they receive on the deals for that customer’s fund.

[li] OXERA Report, “The impact of the new regime for use of dealing commissions: post-implementation review”, April 2009 available at http://www.oxera.com

[lii] See Directive 2004/39/EC of the European Parliament and of the Council of April 21, 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC. Note that a directive requires individual Member States to transpose its requirements into national law to implement it whereas a regulation applies throughout the European Union without more. November 1, 2007 was the deadline gave by the European Commission to transpose the directive into national law.

[liii] The Lamfalussy arrangements constitute a new approach to the development and adoption of the European Unions’ financial services legislation. The approach is based on the recommendations of the Committee of “Wise Men”, chaired by Baron Alexandre Lamfalussy. It comprises a four-level procedure that speeds up the legislative process. It divides the legislation into high-level framework provisions and implementing measures. The arrangements also make provision for legislation to be modified as required to keep pace with market and supervisory developments. Open consultation procedures and greater transparency are central to the new arrangements. The parts of the Lamfalussy framework which are of most direct relevance to regulators are the committees on which they are represented, notably the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR). These are sometimes called the “Level 3 committees”. Finance ministries are also represented on so called “Level 2” committees. These are the European Banking Committee (EBC), the European Insurance and Occupational Pensions Committee (EIOPC) and the European Securities Committee (ESC). The four levels are: Level 1 - framework legislation, voted on by the Council and Parliament; Level 2 - implementing measures for the Level 1 legislation, led by the Commission; Level 3 - supervisory committees facilitating the convergence of regulatory outcomes; Level 4 - enforcement of all EU measures, led by the Commission. Under the Lamfalussy arrangements, the European Commission proposes framework legislation and it is adopted under the “co-decision” procedure. This involves both the European Council and the European Parliament (Level 1). It is supplemented at Level 2 by more detailed implementation measures, adopted by the Commission and endorsed by a qualified majority of Member States. The detailed Level 2 legislation is prepared by the Commission on the basis of advice provided by representatives of national supervisory authorities, acting through the “Level 3” committees (CEBS, CEIOPS and CESR). In finalizing their advice, the Level 3 committees consult extensively with providers and users of financial services. The Level 3 committees also aim to foster

supervisory convergence and best practice, principally through the creation of (non legally binding) guidance. Finally, at Level 4, the European Commission ensures that Member States are complying with applicable legislation and it pursues enforcement action where required.

[liv] Article 19(1) of the Level 1 MiFID provides that when providing investment services and/or, where appropriate, ancillary services to clients an investment firm must act honestly, fairly and professionally in accordance with the best interests of its clients.

[lv] Article 26 of the MiFID implementing Directive 2006/73/EC ("Level 2 Directive"), entitled "Inducements", sets further requirements in relation to the receipt or payment by an investment firm of a fee, commission or non-monetary benefit that could, in certain circumstances, place the firm in a situation where it would not be acting in compliance with the principle stated in MiFID Article 19(1) that the firm act honestly, fairly and professionally in accordance with the best interest of its clients. See CESR Consultation Paper, "Inducements under MiFID: Second Consultation Paper", April 2007, available at www.cesr-eu.org/data/document/07_316.pdf. See also MiFID consultation papers, comments letters and recommendations available at http://www.cesr-eu.org/index.php?page=contenu_search_res&doconly=all&searchdatefromday=1&searchdatefrommonth=1&searchdatefromyear=1970&searchdatetoday=10&searchdatetomonth=4&searchdatetoyear=2008&searchkeyword=mifid

[lvi] On May 30, 2007, CESR adopted recommendations on inducements (Ref: CESR/07-228b) with the aim of fostering supervisory convergence and consistent implementation in the day-to-day application of Article 26 of the MiFID Level 2 Directive. The document contains six recommendations and a number of supporting examples which illustrate some of the variety of situations in which Article 26 of the MiFID Level 2 Directive is relevant. The recommendations themselves clarify the range of application of the regime, specifying a common approach to the understanding of the different categories of payments within Article 26. The paper also introduces some indicative factors aimed at helping supervisors establish whether specific third-party payments are likely to meet the regulatory tests within Article 26(b). T he paper further clarifies the effect of Recital 39 in interpreting the operative provisions Article 26. Finally, some direction is provided with regard to the possibility for firms to have recourse to summary disclosure in connection with third party payments. The content of these recommendations reflected comments received from industry and consumer groups during the course of two consultations. CESR has adjusted some of its views in response to significant issues raised by stakeholders both as a result of the two public consultations on inducements and the two open hearings. CESR also publishes a Feedback Statement (Ref: CESR/07- 316) which sets out how the issues raised during consultation have been considered and reflected in the final recommendations. Two of the examples raised by CESR in its Level 3 guidance are: - Example IV suggests that if there is an incentive to use only the broker offering the benefits, then the incentive is likely to impair the firm's duty to act in the best interest of its clients (*e.g.*, to provide best execution). - Example XII regarding provision of general office equipment such as computer equipment states "Where equipment provided is closely related to services provided to clients, then its provision to an investment firm is more likely to be permitted. Where it is general office equipment that can be used for a wide range of purposes within the firm assessment against the factors in Recommendation 4 is more likely to lead to a conclusion that the item should not be permitted."

[lvii] See comment letter from market participants to CESR's Consultation Papers on Inducements available at http://www.cesr-eu.org/index.php?page=contenu_search_res&doconly=all&searchdatefromday=1&searchdatefrommonth=1&searchdatefromyear=1970&searchdatetoday=10&searchdatetomonth=4&searchdatetoyear=2008&searchkeyword=mifid.

[lviii] CESR's level 3 Feedback Statement on Inducements (Ref. CESR/07-316), available at www.cesr-eu.org/data/document/07_316.pdf.

[lix] Article 4 of MiFID's Level 2 Directive limits the scope for Member States to apply additional requirements in certain of the areas covered by MiFID. It sets out the conditions for creating or retaining such national requirements that go beyond MiFID and requires that these be notified and justified to the European Commission.

[lx] As Dr. Benn Steil and Dr. Robert Schwartz have pointed out in their studies on the economics of soft commission trading, the costs (explicit and implicit) of soft commission trades are roughly three times those for electronic, non-intermediated execution-only trades. These excess costs lead to the under performance of the asset

managers' clients' funds, and may constitute a tangible and material harm to the fund holders. Steil, Benn "The Economics of Soft-Dollar Trading", May 2003, available at www.efficientfrontiers.com, and Schwartz, Robert A, and Benn Steil, "Controlling Institutional Trading Costs: We Have Met the Enemy, and It is Us" , Journal of Portfolio Management, Spring 2002. See AFEI-AFG Charter of Good Practice: "Framework for Broker Compensation by Investment Manager", published in July 2006. For a more complete discussion of these, and other factors impacting the broker selection and best execution processes, see CFA Institute Trade Management Guidelines, November 8, 2002, p.7-8.

[lxi] Speech by SEC Chairman: Address to the National Italian-American Foundation by former Chairman Christopher Cox, U.S. Securities and Exchange Commission, New York City, May 31, 2007.

[lxii] "According the U.K. FSA, a market failure arises because the fund manager is insufficiently sensitive to the commission rate because it is anyway charged on to the fund, and hence the final investors pay. Fund managers, it is argued, are able to derive private benefits from the use of some of these funds purposes which do not directly benefit the fund owners, *i.e.*, the investors." DG Competition of the European Commission published an issues paper on May 24, 2006 entitled "Competition in EU securities trading and post-trading", Section 4.2.2.