ADOPTION OF AIMR SOFT DOLLAR STANDARDS

SUMMARY: On December 22, 1997, the Association for Investment Management and Research (AIMR) released for public comment the Report of its Blue Ribbon Task Force for Soft Dollar Standards. The Report—entitled “AIMR Soft Dollar Standards (Guidance for Ethical Practices Involving Client Brokerage)”—proposed voluntary ethical Standards for AIMR members involved in “soft dollar” arrangements. In response to industry comments received during the 60-day comment period, the Task Force revised the proposed Standards, which were then submitted to the AIMR Board of Governors. On May 17, 1998, the Board of Governors formally approved the Soft Dollar Standards as voluntary standards for AIMR members.

Provided below is a summary of the Standards, as adopted, as well as a discussion of the treatment of comments received during the public comment period.

ADDITIONAL INFORMATION: You can obtain a copy of the Adopted Soft Dollar Standards by visiting AIMR’s website at www.aimr.org to retrieve them electronically or by calling 804-980-3668 to request a copy of the Standards.

Provided as attachments to this Release are analyses of the comments received on the proposed Standards. To view a PDF version of the actual Soft Dollar Standards, click here.

For further information, contact Linda L. Rittenhouse, Vice President, Advocacy, Legislative & Regulatory Affairs, at 804-980-3668 or Michael S. Caccese, Senior Vice President, General Counsel & Secretary, at 804-980-3668, Association for Investment Management and Research, 5 Boar’s Head Lane, P.O. Box 3668, Charlottesville, VA 22903-0668.

I. HIGHLIGHTS OF THE ADOPTED STANDARDS

Significant provisions of the AIMR Soft Dollar Standards, including changes made in response to comments received, are as follows:

• “Research” which may be purchased with client brokerage has been defined as those services and/or products provided by a broker, the primary use of which must directly assist the investment manager in its investment decision-making process and not in the management of the investment firm. This reflects a change from the proposed definition which required the “primary content” of the services and/or products, if used, to directly assist the investment manager in its investment decision-making process.

• In light of the revised definition of “research,” the Standards now suggest a simplified three-step analysis for determining the research that may be paid for through soft dollar arrangements.
• The Standards seek to treat proprietary research and third-party research the same in evaluating soft dollar arrangements in recognition of the fact that both are paid for with client brokerage.

• For purposes of the Standards, soft dollar arrangements include transactions conducted on an agency or principal basis. Clarifying language has been added to address the fact that under certain fiduciary statutes, an investment manager may have to show that brokerage derived from principal trades directly benefits the client account generating the brokerage.

• Language in the “Disclosure” section of the Standards has been revised to clarify the information that an investment manager should provide upon client request. This section also clarifies that the disclosure and recordkeeping requirements under the Standards are intended to be met without an “unbundling” of research or a “tracing” of products or services.

• Language in the Standards has been revised to clarify that in client-directed brokerage arrangements, the investment manager is not required to seek to obtain best execution, but should disclose to its client the duty to continue to do so. Recommended Practices in Appendix A of the Standards clarifies the investment manager’s role in the client-directed Brokerage area.

II. SUMMARY OF COMMENTS RECEIVED ON PROPOSED STANDARDS

Approximately 60 comment letters were received in response to the proposed AIMR Soft Dollar Standards that were issued for public comment on December 22, 1997. The names of parties submitting comments listed by individual and by company, are provided in Attachments 1 and 2, respectively. Attachment 3 to this Release provides a summary of the prevalent “themes” addressed.

Five areas, in particular, generated the largest number of comments. These areas are discussed below.

A. Departure From Section 28(e) Safe Harbor Guidelines

Numerous commenters raised concerns about the Standards on the basis that they do not track the Section 28(e) “safe harbor” protections recognized by the Securities and Exchange Commission and, in some respects, present more stringent requirements. These commenters, who urged against adoption of the Standards, expressed a lack of comfort with what they perceived to be the creation of multiple standards in the soft dollar area.
As noted in the Report accompanying the Standards, AIMR believes that guidelines under existing law do not adequately clarify the issues raised by the complexity of current brokerage practices. Thus, the Standards depart from certain well-established practices in the soft dollar area, and address practices beyond what typically is afforded safe harbor protection under Section 28(e). The Report cautions, however, that the Standards are not to be read as in way changing the scope of activities determined by the SEC to fall within the safe harbor. Instead, they are separate, voluntary ethical Standards applicable to a variety of situations that arise in the context of obtaining products and services with client brokerage. As is often the case with ethical guidelines, the AIMR Soft Dollar Standards espouse principles and require adherence to behavior that may, in certain respects, be more stringent than what currently is simply required by law.

B. Definition of Research

The definition of “research” in the proposed Standards referred to services and/or products provided by a broker, “the primary content of which must, if used by the Investment Manager, directly assist the Manager in its Investment Decision-Making Process, and not in the management of the investment firm.” Commenters primarily objected to this definition on three grounds:

- the difficulty of applying the “primary content” standard, resulting in the loss which could lead to situations of legitimate research, simply because it was capable of a broader purpose;

- confusion about how to apply the definition in the context of identifying “separate components:” and

- a perceived disconnect between the “primary content” standard to determine the product or service and the mixed-use allocation that is based on “actual use.”

In light of the comments raised and with the intent to simplify its application, the definition of “research” has been changed to a “use” standard. In the Adopted Standards, “research” refers to services and/or products provided by a broker, “the primary use of which is to assist the Investment Manager in its Decision-Making Process and not in the management of the investment firm.”

C. Inclusion of Proprietary Research

Commenters argued that it is impractical, if not impossible, to provide the degree of detailed disclosure thought to be required by the proposed Standards, without having to “unbundle” proprietary research. While the Standards seek to treat third-party and proprietary research the same, they do not intend to require research obtained through either proprietary or third-party sources to be attributed on an account-by-account basis or to otherwise require a “tracing” of products or services. However, given the number of commenters who read the proposed Standards to require this treatment, necessary clarifying language has been added to the Adopted Standards.
In particular, language in the Disclosure section of the Standards (VI. C.) has been streamlined to provide that when specifically requested by its client, an investment manager should be able to provide the following information on at least an annual basis:

(1) *On a firm-wide basis,* a description of the products and services that were received from Brokers pursuant to a soft dollar arrangement, detailed by broker;

(2) *For a specific client account,*
   a. the total amount of commissions generated for that client through soft dollar arrangements, detailed by broker; and
   b. the total amount of brokerage directed by that client through directed brokerage arrangements; and

(3) The aggregate percentage of the investment manager’s brokerage derived from all client-directed brokerage arrangements, as well as the percentage of the manager’s aggregate directed brokerage that is comprised by the client’s directed brokerage. (If the client’s directed brokerage constitutes less than 10 percent of the investment manager’s aggregate amount of brokerage, it does not need to be reported.)

No longer required, but recommended, is that when requested by its client, the investment manager should provide (1) a description of the product or service obtained with client brokerage and (2) the aggregate dollar amount of brokerage paid from all accounts over which the investment manager has investment discretion.

**D. Calculation Of Amounts From Principal Trades**

The proposed Standards required the investment manager to report the “capital value of all principal trades on all equity securities and bonds.” Several commenters objected to this requirement on the basis that it is impossible to determine the amount on a principal trade attributable to soft dollar research. AIMR agrees. This language has been deleted from the Adopted Standards.

**E. Disclosure and Recordkeeping Requirements**

Numerous commenters objected to the proposed Standards’ disclosure and recordkeeping requirements as burdensome. However, our analysis indicates that in order to meet federal disclosure requirements, an investment manager is already required, under current law, to disclose, or to maintain the majority of the information the manager is required to disclose under the Standards. *Attachment 4,* including *Tables I* and *II,* provides an analysis of federal recordkeeping and disclosure requirements, compared to the AIMR Soft Dollar Standards.

June 15, 1998
SOFT DOLLAR REPORT RESPONSES BY INDIVIDUAL

1. Maye Albanez and five other individuals*
   Clifford Associates

2. Theodore Aronson
   Aronson+Partners

3. Vicki L. Bailey
   Advantus Capital Management, Inc.

4. Richard C. Barrett, CFA
   Stonebridge Capital Management, Inc.

5. James E. Bayne*
   Committee on Investment of Employee Benefit Assets (CIEBA)

6. Christopher C. Berberet, CFA
   Madison Investment Advisors, Inc.

7. Gregory H. Bokach, CFA
   American Century Mutual Funds

8. Karin B. Bonding, CFA
   Capital Markets Institute, Inc.

9. Dewitt F. Bowman, CFA

10. Robert W. Bridges
    Sterling Capital

11. Kathryn Brown
    Capital Technology, Inc.

12. John J. Burchenal
    Lehman Brothers

13. Gary D. Campbell, CFA
    Commerce Bank

*Received after deadline
14. Richard M. Charlton
   New England Pension Consultants

15. Carole H. Cox
   City Capital Counseling, Inc.

16. John G. Danz, Jr. *
   Oxford Capital Management, Inc.

17. Christopher S. Dechairio

18. Martin Gerber
   Connor, Clark & Lunn

19. Geofrey J. Greenleaf *
   Greenleaf Capital Management

20. Hilton Jervey
   Summit Bank

21. Samuel P. Jones, Jr., CFA
   Franklin Research & Development

22. Paul Haaga *
   Capital Research

23. Margaret D. Hadzima*
   Scudder Kemper Investments, Inc.

24. Brent R. Harris, CFA *
   Pacific Investment Management Co.

25. Ronald S. Hartwick *
   Cramblit & Carney, Inc.

26. John C. Helmer, CFA
   Caldwell Securities, Inc.

27. Roger Hertog
   Sanford C. Bernstein & Co., Inc.

28. Stephen P. Holmes, CFA
   Summit Strategies Group

*Received after deadline
29. Henry H. Hopkins and 22 CFA charterholders
   T. Rowe Price Associates, Inc.

30. Jules A. Huot

31. Thomas P. Lemke *
   Strong Capital Management

32. William O. Leszinske
   Harris Investment Management

33. Darcy S. MacLaren, CFA
   SAFECO Asset Management Company

34. Wayne B. McAlpine
   Commission Direct Inc.

35. Gerald T. Lins *
   Bankers Trust

36. Karen S. McQue, CFA and two other CFA charterholders
   NWQ Investment Management

37. Lisa A. Menelly
   Fidelity Investments

38. David J. Merkel, CFA
   Provident Mutual

39. E. Blake Moore, Jr. and six AIMR members
   Nicholas Applegate

40. George W. Noyes *
   Standish, Ayer & Wood, Inc.

41. Lee A. Pickard, Esq.
   Alliance in Support of Independent Research

42. Lee N. Price, CFA
   Dresdner RCM Global Investors

43. Thomas O. Putnam *
   Fenimore Asset Management, Inc.

*Received after deadline
44. Page T. Reece *
   Lowe, Brockenbrough & Tattersall, Inc.

45. Kevin P. Riley, CFA and five other CFA charterholders
   Roxbury Capital Management

46. Peter A. Rudolph
    Jacobs Levy

47. Frederic P. Sapirstein *
    Hoenig Group, Inc.

48. James K. Schmidt, CFA and four other CFA charterholders
    John Hancock Funds

49. Paul Secord *
    Farmers Insurance Group of Companies

50. Patrice M. Singleton *
    Harding, Loevner Management, L.P.

51. David R. Steffie
    Coros Technologies

52. Roger C. Stone
    Stone Investment Advisory, Inc.

53. David G. Tittsworth
    Investment Counsel Association of America, Inc.

54. Matthew G. Thompson, CFA *
    Thompson, Siegel & Walmsley, Inc.

55. Craig S. Tyle, Esq.
    Investment Company Institute

56. Gene Tremblay, CFA and two other CFA charterholders
    Wellington Management Company, LLP

57. James R. Vertin, CFA
    Alpine Counselors

*Received after deadline
58. Sam R. Wakefield
   Allied Research Services, Inc.

59. Jason J. Wallach, CFA
   Systematic Financial Management Inc.

60. Randall T. Zipfel *
   National Asset Management

*Received after deadline
SOFT DOLLAR REPORT RESPONSES BY COMPANY

1. Advantus Capital Management, Inc.
   (Vicki L. Bailey)

2. Alliance in Support of Independent Research
   (Lee A. Pickard, Esq.)

3. Allied Research Services, Inc.
   (Sam R. Wakefield)

4. Alpine Counselors
   (James R. Vertin, CFA)

5. American Century Mutual Funds
   (Gregory H. Bokach, CFA)

6. Aronson+Partners
   (Theodore Aronson)

7. Bankers Trust*
   (Gerald T. Lins)

8. Dewitt F. Bowman, CFA

9. Caldwell Securities, Inc.
   (John C. Helmer, CFA)

10. Coros Technologies
    (David R. Steffie)

11. Capital Research *
    (Paul Haaga)

12. Capital Markets Institute, Inc.
    (Karin B. Bonding, CFA)

13. Capital Technology, Inc.
    (Kathryn Brown)

*Received after deadline
14. Clifford Associates*  
   (Five Individuals)

15. City Capital Counseling, Inc.  
   (Carole H. Cox)

16. Commerce Bank  
   (Gary D. Campbell, CFA)

17. Commission Direct Inc.  
   (Wayne B. McAlpine)

18. Committee on Investment of Employee Benefit Assets (CIEBA)*  
   (James E. Bayne)

19. Connor, Clark & Lunn  
   (Martin Gerber)

20. Cramblit & Carney, Inc. *  
   (Ronald S. Hartwick)

21. Christopher S. Dechairio

22. Dresdner RCM Global Investors  
   (Lee N. Price, CFA)

23. Farmers Insurance Group of Companies *  
   (Paul Secord)

24. Fenimore Asset Management, Inc. *  
   (Thomas O. Putnam)

25. Fidelity Investments  
   (Lisa Menelly)

26. Franklin Research & Development  
   (Samuel P. Jones, Jr., CFA)

27. Greenleaf Capital Management *  
   (Geofrey J. Greenleaf)

*Received after deadline
28. Harding, Loevner Management, L.P. *
   (Patrice M. Singleton)

29. Harris Investment Management
   (William O. Leszinske)

30. Hoenig Group, Inc. *
   (Frederic P. Sapirstein)

31. Jules A. Huot

32. Investment Company Institute *
   (Craig S. Tyle, Esq.)

33. Investment Counsel Association of America, Inc.
   (David G. Tittsworth)

34. Jacobs Levy
   (Peter A. Rudolph)

35. John Hancock Funds
   (Six CFA Charterholders)

36. Lehman Brothers
   (John J. Burchenal)

37. Lowe, Brockenbrough & Tattersall, Inc. *
   (Page T. Reece)

38. Madison Investment Advisors, Inc.
   (Christopher C. Berberet, CFA)

39. National Asset Management *
   (Randall T. Zipfel)

40. New England Pension Consultants
   (Richard M. Charlton)

41. Nicholas Applegate
   (E. Blake Moore, Jr.
   and six AIMR members)

*Received after deadline
42. NWQ Investment Management  
   (Karen S. McQue, CFA and two other CFA charterholders)

43. Oxford Capital Management, Inc. *  
   (John G. Danz, Jr.)

44. Pacific Investment Management Co. *  
   (Brent R. Harris, CFA)

45. Provident Mutual  
   (David J. Merkel, CFA)

46. Roxbury Capital Management  
   (Six CFA Charterholders)

47. SAFECO Asset Management Company  
   (Darcy S. MacLaren, CFA)

48. Sanford C. Bernstein & Co., Inc.  
   (Roger Hertog)

49. Scudder Kemper Investments, Inc.*  
   (Margaret D. Hadzima)

50. Standish, Ayer & Wood, Inc. *  
   (George W. Noyes)

51. Sterling Capital  
   (Robert W. Bridges)

52. Stone Investment Advisory, Inc.  
   (Roger C. Stone)

53. Stonebridge Capital Management, Inc.  
   (Richard C. Barrett, CFA)

54. Strong Capital Management *  
   (Thomas P. Lemke)

55. Summit Bank  
   (Hilton Jervey)

*Received after deadline
56. Summit Strategies Group  
   (Stephen P. Holmes, CFA)

57. Systematic Financial Management Inc.  
   (Jason J. Wallach, CFA)

58. Thompson, Siegel & Walmsley, Inc. *  
   (Matthew G. Thompson, CFA)

   (Henry H. Hopkins and 22  
   CFA charterholders)

60. Wellington Management Company, LLP  
   (Three CFA charterholders)

*Received after deadline
SOFT DOLLAR COMMENT LETTERS—MAJOR THEMES

The comment letters received on the proposed AIMR Soft Dollar Standards reflect several recurring themes or concerns. Many letters expressed a great appreciation of the Standards as an important effort to provide ethical guidance in this complex area. Others resist the effort in the proposed Standards to go beyond the SEC’s “safe harbor” language and definition of “research”. Groups of commenters have questioned the propriety of a group other than the SEC to even create standards, as well as raised issues with respect to certain aspects of the Standards themselves.

For example, a large group of commenters (through the submission of “form” letters) has objected to the proposed Standards on the basis that they are premature and potentially in conflict with future SEC standards. This group argues that the possibility of multiple sets of standards (AIMR, SEC, DOL) will create confusion within the industry and among investors. This group wants either the SEC to be the source of a uniform set of soft dollar standards or for AIMR to wait until the SEC “speaks” before issuing its Standards in final.

Another group of commenters focuses on the proposed recordkeeping and disclosure requirements as imposing a substantial compliance burden on the investment manager without commensurate benefits accruing to the investor. This argument is addressed in a separate attachment, which provides charts comparing the proposed Standards’ requirements with those currently required under federal law.

A group has also raised questions about the inclusion of proprietary research in the Standards’ definition of Soft Dollar Arrangements. This group argues that such research is almost impossible to value or even to correlate with particular trades.

Following is a list of many of the issues repeatedly raised in the comment letters received on the proposed Standards. In addition, the definition of “research” is the subject of many specific comments.

Summary of Themes

1. AIMR’S Role

The SEC, not AIMR, should do the regulating, so that there is one consistent standard for soft dollar practices for use throughout the entire investment advisory industry. As a corollary, AIMR’s definition of “research,” which differs from the SEC’s, will lead to industry and investor confusion.

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1 For purposes of this document, commenters have been listed by company, even if the commenters appear to be signing in their individual capacities. Please refer to the chart in Tab 2 for an analysis of whether comments received reflect the position of the company or individual.
Investment Counsel Association of America, Inc.
Strong Capital Management
Nicholas Applegate
T. Rowe Price
Standish, Ayer & Wood, Inc.
Greenleaf Capital Management
Pacific Investment Management Company
Cramblit & Carney, Inc.
Thompson, Siegel & Walmsley, Inc.
Harding, Loevner Management, L.P.
Lowe, Brockenbrough & Tattersall, Inc.
Oxford Capital Management
Fenimore Asset Management
Clifford Associates
Bankers Trust
Scudder Kemper Investments, Inc.

2. Recordkeeping

(i) The recordkeeping requirements are burdensome (and not of commensurate benefit to the client).

T. Rowe Price
Madison Investment Advisors (e.g., Advent software doesn’t have capability to track brokerage firms acting as principal vs. agent.)
Harris Investment Management
Sanford C. Bernstein & Co.
American Century (instead proposes that investment advisors simply record annually all soft dollar and third-party brokerage expenditures and make records available to clients.)
Alliance in Support of Independent Research
John Hancock Funds
Fidelity Investments
Bankers Trust

(ii) What do recordkeeping requirements entail (e.g., what constitutes an “obligation” to generate a specific amount of brokerage; how to document that each service/product assists in the decision-making process; would this require documentation of all conversations with analysts)?

Hoenig Group
Fidelity Investments

3. Disclosure
(i) The disclosure requirements are unclear and/or onerous. How should disclosure be provided—through Form ADV or otherwise? A substantial amount of the disclosure is not required under current practices and will be a hardship on smaller investment firms. A common sentiment was that some required disclosure would not provide the client with meaningful information and may burden/confuse the investor with too much information.

- Investment Counsel Association of America, Inc.
- Investment Company Institute (limits flexibility)
- Standish, Ayer & Wood, Inc.
- NWQ Investment Management
- Wellington Management Company, LLP
- Stonebridge Capital Management, Inc. (how provided)
- Roxbury Capital Management Capital Management (how provided)
- City Capital (how provided)
- Commerce Bank (can’t provide VI.C.3. information)
- Alliance in Support of Independent Research
- John Hancock Funds

(ii) Disclosure of competitive information to the “Street” (e.g., the ratio of client’s brokerage cost to total brokerage paid by all discretionary accounts) is considered confidential or not necessarily in the client’s best interests (reveals the “size of the commission pie”, which may affect the level of service provided by the brokerage firm).

- Madison Investment Advisors
- Wellington Management Company, LLP (firmwide aggregated brokerage placement considered confidential)
- Sterling Capital
- Allied Research Services, Inc.
- Alliance in Support of Independent Research

(iii) Disclosure requirements do not go far enough. (Standards require keeping a complete accounting of soft dollar uses, but do not require full disclosure to client.) The manager should disclose not only the list of services, but also the cost of services in hard dollars and equivalent costs in commissions spent.

- American Century

(iv) The Standards should require that documentation be prepared on an annual basis for the past year.

- NWQ Investment Management Company

(v) Disclosure of proprietary research should be documented based on type of research, not on each item of research.

- NWQ Investment Management Company
4. **Enforcement by SEC**

The Standards leave the actual decision-making to the judgment of the investment manager; however, it is feared that the SEC will reach a different decision about the permissibility of a certain research product and bring an enforcement action. To remedy this potential problem, include a stronger statement in the Standards that they are subject to the manager’s interpretation.

NWQ Investment Management Company  
Stonebridge Capital Management, Inc.

5. **Proprietary Research**

(i) There is an inability to define the value of proprietary research: much is meaningless and thus thrown out; while the research may be sent in relation to a particular transaction, it is often used for both agency and principal transactions; and it is highly impractical to require advisers to determine whether the research was used and, if so, how much, and the accounts for which the research was (often indirectly) used. Proprietary research is often intertwined with other services connected with trade execution.

T. Rowe Price  
Madison Investment Advisors  
NWQ Investment Management Company (if manager determines research has no value, does it have to include such research in complying with the Standards?)  
Farmers Insurance Group of Companies  
John Hancock Funds

(ii) Inclusion of proprietary research will be resisted by municipal bond issuers. New issue syndicate rules forbid use of commission dollars for soft dollar purposes. These Standards would require the buy side to find the means to pay “the new soft dollar requirements” (which will increase underwriting expenses by 10%-20%).

Standish, Ayer & Wood, Inc.
6. **Best Execution**

(i) The definition of “best execution” reflects a misplaced emphasis on total cost and is not reflective of SEC positions.²

- Investment Counsel Association of America, Inc.
- T. Rowe Price
- Standish, Ayer & Wood, Inc.
- Sanford C. Bernstein & Co.
- Provident Mutual
- John Hancock Funds
- Fidelity Investments

(ii) It is inappropriate to put the investment manager in the untenable position of having to seek to obtain best execution in client-directed arrangements, given that it is the client’s decision to direct the trade and the adviser is often cut out of the process. Under the Standards, what is the adviser’s obligation in the situation where it cannot obtain best execution? Must it refuse to place the order?

- T. Rowe Price
- Standish, Ayer & Wood, Inc. (one exception is the allocation of new issue credits in a fixed income trade, where the credits themselves may be client designated.)
- Stonebridge Capital Management, Inc.
- Advantus Capital Management
- Alliance in Support of Independent Research
- Hoenig Group
- Fidelity Investments (there also is conflict between the requirement to obtain best execution and the requirement to notify the client of inability to obtain best execution.)
- Bankers Trust

(iii) The duty to seek to obtain “best execution” should be replaced with “obtaining best price.”

- American Century

(iv) The best execution definition conflicts with the criteria for selecting brokers.

- Fidelity Investments
- John Hancock Funds

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² The SEC staff has indicated that the definition, as drafted, comports with their position.
(v) The Standards should require a statement from traders that they do not knowingly execute trades at less than best price in order to satisfy a sponsor’s requirement to pay bills, direct payments or recapture commissions.

American Century

7. “Actual Use”

(i) It is impractical and overly burdensome to have the “actual” use as the focal point for determining whether (and the amount of) research that can be purchased with soft dollars. (The current SEC standard is read to focus on “expected” use for evaluating research.)

Harris Investment Management
Sanford C. Bernstein & Co.
Investment Company Institute
Fidelity Investments (conflict within Standards with respect to expected/actual use)
Hoenig Group (“intended” use standard is proper if product/service is canceled in a timely manner if “actual” use falls short.)

(ii) Mixed-use analysis that requires a determination of the part of research “actually” used to assist the investment manager (vs. demonstration of good faith allocation, as required by the SEC) is impossible/impractical to apply.

T. Rowe Price
Sanford C. Bernstein & Co.
Investment Company Institute (unclear what is meant by “directly” assists)

9. Separate Components

There is confusion as to how to treat/interpret “separate components” for purposes of applying the four-step analysis.

T. Rowe Price
Madison Investment Advisors
Sanford C. Bernstein & Co.
NWQ Investment Management Company
Stonebridge Capital Management, Inc.
Roxbury Capital Management
Alliance in Support of Independent Research
10. **Primary Content**

(i) What is meant by “primary content”? The case study appears to confuse content with use. Also, the case study implies that a service or product with a “broader purpose” cannot qualify as “research” under the Standards.

Sanford C. Bernstein & Co.
Hoenig Group

(ii) The “primary content” test focuses on the wrong issue, which instead should be how the product or service is *used*.

Hoenig Group

11. **Principal Trades**

(i) There is much confusion about the need for, and ability to obtain, prior consent from a client in connection with principal trades (if research does not directly benefit the client account generating the trade). If a manager receives unsolicited research which it discards, does it still need prior consent from all clients for whom the manager does principal trades? What are the manager’s obligations where it does not obtain prior consent and thus cannot obtain best execution because the broker with best price/execution is the one that provides the manager with substantial research, much of which is unrelated to the client’s principal transactions?

NWQ Investment
Stonebridge Capital Management, Inc.
Roxbury Capital Management
Advantus Capital Management, Inc. (where is consent needed?)
John Hancock Funds

(ii) To meet the requirement that brokerage from principal trades directly benefit the client would require brokers to unbundle the research, which requires a concerted effort by the industry to force brokers to provide more detailed accounting.

Standish, Ayer & Wood, Inc.

(iii) Several commenters read the recordkeeping requirements to require a showing of markups on principal trades, which information often is not reported by brokers, or captured by advisers. In the fixed income market, the broker’s “take” on a trade is not known/divulged/entered on trade confirmations. Thus, reporting of aggregate brokerage paid from a client’s account, let alone for the entire firm, is impossible, without making arbitrary assumptions.

Madison Investment Advisors
Sanford C. Bernstein & Co.
(iv) There is no way of knowing the amounts retained by brokers on principal trades and thus managers cannot provide an “accounting” of those trades placed for research recognition vs. trade execution.

Wellington Management Company, LLP

(v) Including principal trades is not appropriate.

Commission Direct Inc.
Bankers Trust

12. Capital Value

(i) There is a need for clarification of the term “capital value.”

NWQ Investment Management Company
Stonebridge Capital Management, Inc.
Roxbury Capital Management

(ii) Calculating the capital value of all principal trades is burdensome to the manager and of no value to the client.

Alliance in Support of Independent Research

13. Directly Assists

(i) How “direct” must “directly benefits the investment manager” be? (Cumulative knowledge? Can’t attribute each investment decision to each piece of research.)

Sanford C. Bernstein & Co.

(ii) Standard seems at odds with SEC’s “lawful and appropriate” standard. The need to analyze multiple arrangements under both SEC and AIMR Standards is overly burdensome.

Bankers Trust

14. Miscellaneous

(i) What is the application of the Standards to wrap fee programs?

NWQ Investment Management Company
Stonebridge Capital Management, Inc.
Roxbury Capital Management
(ii) If the Standards become effective, when is compliance determined (e.g., at time of effectiveness as to all accounts, existing and future, or on a going-forward basis with respect to new clients)?

NWQ Investment Management Company
Stonebridge Capital Management, Inc.
Roxbury Capital Management

(iii) The manager should not be responsible for evaluating the client-directed brokerage arrangement or for structuring the arrangement in a particular way.

City Capital Counseling, Inc.
Sterling Capital
Commerce Bank
Hoenig Group

(iv) The client authorization requirement is onerous (requiring amendment of all contracts).

Commerce Bank

(v) One commenter was disappointed that no bank investment management firms or anyone from the OCC were represented on the Task Force.

Commerce Bank

(vi) There is an issue with respect to prohibiting the allocation of client brokerage based on the amount of client referrals.

Investment Counsel Association of America, Inc.
Nicholas Applegate

(vii) It is inappropriate to define a rigid set of criteria the manager must consider when choosing a broker.

Wellington Management Company, LLP

(viii) The four-step analysis for determining mixed-use allocation is too subject to manipulation. Managers using identical products for identical purposes could identify different percentages attributable to soft dollar arrangements.

American Century

(ix) It is difficult to meet the requirement that over a reasonable time a client will receive the benefit of research purchased with soft dollars (e.g., what is a “reasonable time”). This approach contrasts with the 28(e) safe harbor that permits the fiduciary to avoid account-by-account allocations.
The Standards need to address “brokerage services” (e.g., the manager’s responsibility when brokers provide trade order delivery systems to clients that route orders through particular brokers and no charge is made for the system placed at the manager’s trading room).

Clarify that “step out trades” are excluded when calculating the aggregate percentages of manager’s brokerage related to client-directed brokerage.

NWQ Investment Management Company
Stonebridge Capital Management, Inc.
Roxbury Capital Management
An aspect of the proposed Standards which has been the subject of the most significant criticism, even from those who generally support the Standards, are the record-keeping requirements. (Particularly because of the record-keeping requirements, the disclosure requirements also have received substantial comment, although few, if any commentators disagree with the principle of disclosure.) The principal bases for the criticism are that the proposed Standards require the investment manager to

- Create and maintain records which are not required current by applicable law;
- Quantify the “cost” or “value” of certain types of “research”, or the allocation of the cost or value to specific client accounts, which is not even available (e.g., the “mark up” on principal transactions), or which can not, or can not easily, be quantified or allocated; and/or
- Incur significant costs upon the manager without producing corresponding benefits for the client.

New Recordkeeping Obligations

The commentators’ criticism that the proposed Standards create new record-keeping obligations is generally valid if the focus is solely on the “records” which are “mandated” by specific federal regulations. There are very few specific requirements to create or maintain such records.

However, the criticism is not generally valid if the focus is on the “records” (or, at least, the internal documents and written memorialization) which a manager should, if not must, have and maintain in some fashion (1) to support its decision to use various brokers, and (2) to develop and show the basis for disclosure which the manager must make, or be prepared to make, to the SEC and/or different types of clients (particularly, ERISA plan sponsors).

For example: There is no mandated regulation requiring an adviser to an investment company to maintain a list of all research products obtained with soft dollars, the costs of obtaining these products, or the benefits received by the adviser. However, there is a registration statement requirement to disclose the “nature of research services” received if research is a factor in selecting brokers. We do not see how the adviser could develop and make such disclosure (or support the disclosure in the context of an SEC inspection or in litigation) without having some “records” to turn to as the basis for formulating the disclosure.
To assist in the evaluation of these comments, we have prepared two tables:

<table>
<thead>
<tr>
<th>I</th>
<th>Summary comparison of records required by the proposed Standards with the records mandated by Federal law.</th>
</tr>
</thead>
<tbody>
<tr>
<td>II</td>
<td>Detailed comparison of the records we believe an adviser must maintain in some fashion to make and support required disclosure with the records required by the proposed Standards.</td>
</tr>
</tbody>
</table>

Quantification and Allocation

Many commentators assert that it is difficult, and perhaps impossible, to quantify the “cost” or “value” of much “Research”, particularly “Proprietary Research”. Although most Third-Party Research contemplates a specific (minimum) flow and amount of commissions to the broker providing the Third-Party Research and some Proprietary Research may also have clearly expected levels of commissions, much Proprietary Research comes to managers unsolicited, may or may not be used by the Manager, and is provided without any quantified expected level of commissions. Moreover, at least some of this research, which includes oral conversations with the brokers, traders and analysts, may have no clearly quantifiable value, particularly at the time it is received, although it is a part of the factual “information mix” available to a manager; and, as a practical matter, it would be impractical to the point of impossible to track and monitor usage.

Similarly, and particularly with respect to Proprietary Research, many commentators assert that managers have no basis to determine that any particular transaction for a particular Client transaction is specifically directed to a broker providing Proprietary Research to the manager. Rather, over time “enough” trades and commissions are directed to such a broker to leave the broker satisfied with continuing to provide the research (including oral advice), even though the manager may not be placing trades with the broker to get the Proprietary Research.

Costs vs. Benefits

Clearly the proposed Standards would require a manager (i) to create or format records which it is not currently required by law to maintain, and (ii) to formalize and/or be more precise with “records” it may now be creating in only a informal fashion. Whether the imposition of these additional costs produces adequate benefits is a matter of judgment.
TABLE I

COMPARATIVE ANALYSIS
SOFT DOLLAR RECORDKEEPING REQUIREMENTS

Specific Mandatory Record Keeping Requirements

The following chart compares the record keeping requirements of the proposed Standards to **specific mandatory** record keeping requirements of federal law that are implicated in soft dollar and directed brokerage arrangements.

<table>
<thead>
<tr>
<th>AIMR Soft Dollar Standards</th>
<th>Applicable Federal Law</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Recordkeeping (Required)</strong></td>
<td></td>
</tr>
<tr>
<td>A. Required by applicable law.</td>
<td>These requirements are identified below.</td>
</tr>
<tr>
<td>B. Necessary to supply Clients (upon request) on a timely basis with the information required by Standard VI.C. which requires:</td>
<td>--</td>
</tr>
</tbody>
</table>

**Section VI.C**

1. The description of the specific Research received by the Investment Manager, regardless of whether it derives from Proprietary or Third-Party Research Arrangements, including:

   a. describing the products and services, including their separate components, received from each Broker pursuant to a Soft Dollar Arrangement;

   To a registered investment company client, records to show what was done with *that* investment company’s brokerage [1940 Act, Rule 31a-1(b)(9)].
### AIMR Soft Dollar Standards

| b. | identifying the producer of the products and services received pursuant to a Soft Dollar Arrangement; |
| c. | reporting the aggregate Brokerage paid from a Client’s account at least annually by reporting the aggregate Commissions by Broker and the capital value of all principal trades on all equity securities and bonds; and |
| d. | reporting the amount of Brokerage directed by the Client to specific Brokers at least annually. |

2. Information segregated by the amount of Brokerage paid from all the accounts over which the Investment Manager has Investment Discretion.

3. The aggregate percentage of the Investment Manager’s Brokerage derived from Client-Directed Brokerage, as a percentage of that aggregate.

(End of Section VI.C Requirements)

### Applicable Federal Law

<p>| b. | Same as above [1940 Act]. |
| c. | Same as above [1940 Act]. |
| d. | Same as above [1940 Act]. |
| 2. | To each advisory, client, records showing all (i) purchases and sales, (ii), price and (iii) executing broker [Advisers Act, Rule 204-2(a)(3)]. |
| 3. | To a registered investment company client with that investment company client’s brokerage only [1940 Act, Rule 31a-1(b)(9)]. |
| C. | No requirement to maintain records regarding aggregates. |
| D. | No requirement. |</p>
<table>
<thead>
<tr>
<th><strong>AIMR Soft Dollar Standards</strong></th>
<th><strong>Applicable Federal Law</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>E. Of any agreements with Brokers pertaining to Soft Dollar Arrangements.</td>
<td>No requirement.</td>
</tr>
<tr>
<td>F. That document transactions with Brokers involving Soft Dollar Arrangements including</td>
<td>--</td>
</tr>
<tr>
<td>1. A list of Proprietary, or Third-Party Research providers.</td>
<td>No requirement.</td>
</tr>
<tr>
<td>2. A description of the service or product obtained from the provider.</td>
<td>1940 Act, to a registered investment company client with <em>that</em> investment company client’s brokerage [Rule 31a-1(b)(9)].</td>
</tr>
<tr>
<td>G. That document the bases of allocation in determining to use Client Brokerage to pay for any portion of a Mixed-Use service or product.</td>
<td>Advisers Act, the SEC has stated that advisers must keep adequate records documenting good faith allocations.</td>
</tr>
<tr>
<td>H. That indicate how the services and products obtained through Soft Dollar Arrangements directly assist the Investment Manager in the Investment Decision-Making Process.</td>
<td>No requirement.</td>
</tr>
<tr>
<td>I. That show compliance with the AIMR Soft Dollar Standards, including the identity of the Investment Manager personnel responsible for determining such compliance.</td>
<td>No requirement.</td>
</tr>
<tr>
<td>J. Copies of all client disclosures and authorizations.</td>
<td>No requirement.</td>
</tr>
</tbody>
</table>
TABLE II
SUMMARY COMPARISONS: RECORDS IMPLICITLY NECESSARY TO MEET DISCLOSURE OBLIGATIONS TO RECORDS REQUIRED BY PROPOSED STANDARDS

Soft dollar and directed brokerage arrangements give rise to numerous disclosure obligations on the part of investment managers. In order to meet their disclosure obligations, investment managers must keep track of detailed information concerning their soft dollar and directed brokerage practices. These disclosure obligations necessarily require that investment managers maintain accurate records that provide a reliable basis for the disclosure made. The following chart compares the records requirements that are implicitly necessary to meet disclosure requirements to the record keeping requirements that are contained in the proposed Standards. Column 1 highlights the soft dollar and directed brokerage disclosures mandated under federal law. Column 2 highlights the record keeping which seems implicit in any good faith attempt to accurately provide and support the required disclosure. Column 3 highlights the record keeping requirements of the proposed Standards.

<table>
<thead>
<tr>
<th>Federal Law Disclosure Requirement</th>
<th>Implicit Record Keeping Obligation</th>
<th>AIMR Soft Dollar Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investment Company Act of 1940</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) <strong>Registration Statements:</strong> Investment companies are required to disclose detailed information concerning soft dollar arrangements in their registration statements(^4), including a general statement about brokerage commissions. Investment companies must describe how broker-dealers will be selected to effect securities transactions and how the overall</td>
<td>1. A list that identifies all broker-dealers through whom trades are executed.</td>
<td><em>Substantially the same as the Implicit Record Keeping Obligations</em></td>
</tr>
<tr>
<td></td>
<td>2. A list identifying all broker-dealers who provide or arrange for provision of products or services in addition to pure execution.</td>
<td>(\downarrow)</td>
</tr>
<tr>
<td></td>
<td>3. A list of all products and/or services that have been paid for with commission dollars.</td>
<td>(\downarrow)</td>
</tr>
</tbody>
</table>

\(^3\) In this regard, Section 42(b) of the Investment Company Act of 1940 and Section 209(b) of the Investment Advisers Act of 1940 provide that, "for the purpose of any investigation or any other proceeding under [the statutes], any member of the Commission, or any officer thereof designated by it, is empowered to . . . require the production of any books, papers, correspondence, memoranda, contracts, agreements, or other records which are relevant or material to the inquiry".

\(^4\) Form N-1A for open-end companies; Form N-2 for closed-end companies; Form N-3 for separate accounts organized as management investment companies.
<table>
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<td>reasonableness of commissions paid will be evaluated, including the factors considered in connection with these determinations. The disclosure required includes:</td>
<td>4. A list or memoranda documenting the use of any product or service paid for with commission dollars and classifying such product as within or without the definition of “brokerage or research services” within the meaning of Section 28(e).</td>
<td>↓</td>
</tr>
<tr>
<td>(i) if the receipt of products or services other than brokerage or research is a factor in selecting brokers, the products and services should be described;</td>
<td>5. For “mixed-use” products or services, memoranda indicating the relative anticipated use of the product or service and the basis for allocating the amount of cost paid for with commission dollars.</td>
<td>↓</td>
</tr>
<tr>
<td>(ii) if the receipt of research services is a factor in selecting brokers, the nature of such research services should be described;</td>
<td>6. Written procedures detailing the standards for allocating commission dollars in return for the receipt of products or services in addition to pure execution.</td>
<td>↓</td>
</tr>
<tr>
<td>(iii) the investment company must state if persons acting on its behalf are authorized to pay a commission in excess of that in which another broker might have charged for the same transaction in recognition of brokerage or research services provided by the broker;</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(iv) the investment company should explain that research services</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Federal Law Disclosure Requirement</strong></td>
<td><strong>Implicit Record Keeping Obligation</strong></td>
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</tr>
<tr>
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</tr>
<tr>
<td>provided by brokers may be used by the adviser in servicing all of its accounts or should describe other practices applicable to the investment company regarding allocation of research services provided by brokers; and</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(v) the registrant must state the amount of transactions and related commissions paid as a result of directing the investment company’s brokerage transactions to a broker because of research services provided pursuant to an agreement or understanding or otherwise through an internal allocation procedure.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) <strong>Semi-Annual Reports</strong>: Investment companies are required to disclose information concerning soft dollars on their semi-annual report filed with the SEC (Form N-SAR), including whether any of the following were considered in the selection of brokers:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) Receipt of investment research and statistical information;</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(ii) receipt of quotations for portfolio valuations;</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(iii) receipt of telephone line and wire services; and</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Substantially the same as the Implicit Record-Keeping Obligations Noted Previously in Middle Column.*
<table>
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</tr>
</thead>
<tbody>
<tr>
<td>(iv) an arrangement to return or credit part or all of Commissions or profits thereon to the investment adviser, principal underwriter, affiliated person or the investment company.</td>
<td></td>
<td>Substantially the same as the Implicit Record-Keeping Obligations Noted Previously in Middle Column</td>
</tr>
<tr>
<td>(c) <strong>Proxy Statements</strong>: Investment companies are required to disclose information concerning their soft dollar practices in proxy statements containing proposals to approve investment advisory contracts (Schedule 14A under the Securities Exchange Act of 1934), including a discussion of any benefits derived or to be derived by the investment adviser from the relationship with the investment company such as soft dollar arrangements by which brokers provide research to the investment company or its investment adviser in return for allocating fund brokerage.</td>
<td><strong>1.</strong> A list that identifies all broker-dealers through whom trades are executed. <strong>2.</strong> A list identifying all broker-dealers who provide or arrange for provision of products or services in addition to pure execution. <strong>3.</strong> A list of all products and/or services that have been paid for with commission dollars.</td>
<td><strong>Substantially the same as the Implicit Record Keeping Obligations</strong> ↓ ↓</td>
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*Investment Advisers Act of 1940*
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</table>
| charged. If the value of products, research, and services given to the adviser or a related person is a factor in those decisions, the adviser must describe:  
(i) the products, research, and services;  
(ii) whether clients may pay commissions higher than those obtainable from other brokers in return for those products and services;  
(iii) whether research is used to service all of the advisers accounts or just those accounts paying for it; and  
(iv) 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.  
2. In addition, although not tied to a disclosure obligation, the Commission has stated that investment advisers must keep adequate books and records concerning mixed used allocations so as to be able to make a required good faith showing of a mixed use allocation. | 4. A list or memoranda documenting the use of any product or service paid for with commission dollars and classifying such product as within or without the definition of “brokerage or research services” within the meaning of Section 28(e).  
5. For “mixed-use” products or services, memoranda indicating the relative use of the product or service and the basis for allocating the amount of cost paid for with commission dollars.  
6. Written procedures detailing the standards for allocating commission dollars in return for the receipt of products or services in addition to pure execution. | ↓  ↓  ↓ |
<table>
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</tr>
</thead>
<tbody>
<tr>
<td>&quot;Employment Retirement Income Security Act of 1974&quot;</td>
<td>1. A list that identifies all broker-dealers through whom trades are executed.</td>
<td>Substantially the same as the Implicit Record Keeping Obligations ↓</td>
</tr>
<tr>
<td>1. Concerning soft dollar practices, a plan sponsor has an ongoing responsibility to monitor the investment manager of a plan to ensure that the investment manager has secured best execution of the plan’s brokerage transactions and that the commissions paid are reasonable in relation to the value of the brokerage and other services received by the plans. In addition, a plan fiduciary (for example, a plan investment manager) may only effect or execute a securities transaction as agent for the plan if certain conditions are met, including that the investment manager provides the authorizing fiduciary with an initial authorization request that describes the investment manager’s brokerage placement practices.⁵</td>
<td>2. A list identifying all broker-dealers who provide or arrange for provision of products or services in addition to pure execution. ↓</td>
<td></td>
</tr>
<tr>
<td></td>
<td>3. A list of all products and/or services that have been paid for with commission dollars. ↓</td>
<td>↓</td>
</tr>
<tr>
<td></td>
<td>4. A list or memoranda documenting the use of any product or service paid for with commission dollars and classifying such product as within or without the definition of “brokerage or research services” within the meaning of Section 28(e). ↓</td>
<td>↓</td>
</tr>
<tr>
<td></td>
<td>5. For “mixed-use” products or services, memoranda indicating the relative use of the product or service and the basis for allocating the amount of cost paid for with commission dollars. ↓</td>
<td>↓</td>
</tr>
<tr>
<td></td>
<td>6. Written procedures detailing the standards for allocating commission dollars in return for the receipt of products or services in addition to pure execution. ↓</td>
<td>↓</td>
</tr>
</tbody>
</table>

⁵ This requirement is often satisfied by providing the authorizing fiduciary with a copy of Part II of the investment manager’s Form ADV, which must contain the disclosures discussed above.
<table>
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</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>7. Written procedures detailing the investment manager's procedures for ensuring best execution on plan account trades.</td>
<td>←</td>
</tr>
<tr>
<td></td>
<td>8. For sponsor-directed arrangements, written procedures for ensuring that goods or services obtained with plan commission dollars solely benefit the plan.</td>
<td>↓</td>
</tr>
</tbody>
</table>

Arguably Go Beyond the Implicit Requirements

- Describing “separate components” of products and services (VII(B) and VI (C)(1)(a))
- All arrangements, particularly oral, obligating manager to generate specific amount (VII (C))
- That indicate how the services directly assist in the Investment Decision - Making Process
- That show compliance with AIMR Standards, including personnel responsible for determining compliance