

# CFA Institute Soft Dollar Standards

---

Guidance for  
Ethical Practices  
Involving  
Client Brokerage



Centre for  
Financial  
Market  
Integrity

Corrected content posted November 2011.

©November 2004 [reprint], August 1999 [reprint], 1998 by Association for Investment Management and Research

All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or any information storage and retrieval system, without permission of the copyright holder. Requests for permission to make copies of any part of the work should be mailed to: CFA Institute, Permissions Department, P.O. Box 3668, Charlottesville, VA 22903.

Printed in the United States of America  
November 2004

# Contents

Introduction.....	1
Background.....	1
Overview.....	2
Comparison with Current Practices .....	2
Definitions .....	3
CFA Institute Soft Dollar Standards	
I.    General .....	6
II.   Relationships with Clients .....	6
III.  Selection of Brokers .....	6
IV.  Evaluation of Research.....	7
V.   Client-Directed Brokerage .....	7
VI.  Disclosure.....	7
VII. Record Keeping .....	9
Appendix A: Recommended Practices for Client-Directed Brokerage Arrangements .....	10
Appendix B: Permissible Research Guidance .....	11
Appendix C: Case Study under the CFA Institute Soft Dollar Standards .....	13
Appendix D: Analysis of Proposed Transactions under Applicable U.S. Law .....	19
Appendix E: Analysis of Proposed Transactions under Applicable Canadian Law.....	21
Sample Reports.....	24

---

## Soft Dollar Standards

### (Guidance for Ethical Practices Involving Client Brokerage)

The AIMR Soft Dollar Standards were approved by the AIMR Board of Governors for use by AIMR members worldwide who are involved in “soft dollar” issues. Soft dollar practices involve the use of client brokerage by an investment manager to obtain certain products and services to aid the manager in its investment decision-making process. The practice of using client brokerage to purchase research has become extremely complex, exceeding in large part the usefulness of the existing guidance as currently set forth in the AIMR Standards of Professional Conduct. The AIMR Soft Dollar Standards endeavor to provide additional guidance through the articulation of fundamental ethical principles applicable to investment managers who serve as fiduciaries for client assets.

AIMR recognizes that guidance in this area is not static and will require future refinements to respond to ongoing developments in technology, the law, and the investment management industry. The Standards will be revised and interpreted as necessary to remain current, but will continue to honor the overriding fiduciary principles that form the cornerstone of the Soft Dollar Standards.

The AIMR Soft Dollar Standards would not exist in this form were it not for the tremendous efforts of the AIMR Task Force for Soft Dollar Standards, created in late 1997 to address this area. Through the dedicated work of the individuals noted below, the Task Force has made a valuable contribution in raising the ethical awareness in the soft dollar area. It is with much appreciation that AIMR acknowledges the following Task Force members. Special appreciation goes to R. Charles Tschampion, CFA-Task Force Chair, who through his diligence, patience, and tremendous moderating skills, was able to have this diverse group of extremely talented professionals reach a consensus on such a controversial topic. AIMR would like to thank additional Task Force members: Raymond L. Aronson; Eugene K. Bolton; Geoffrey I. Edelstein, CFA; David I. Fisher; John W. Gomez; Thomas J. Healey, CFA; John E. Hull; Michael L. McCowin, CFA; John J. Nagorniak, CFA; John H. Pieper, CFA; Howard J. Schwartz; Jan Twardowski; Deborah W. Veverka, CFA; Wayne H. Wagner; and Arthur Zeikel.

Thomas A. Bowman, CFA  
President and Chief Executive Officer  
AIMR

September 1998

## Introduction

CFA Institute Soft Dollar Standards provide guidance to investment professionals worldwide through the articulation of high ethical standards for CFA Institute Members dealing with “soft dollar” issues. CFA Institute Soft Dollar Standards are consistent with and complement the existing CFA Institute Standards of Professional Conduct that all CFA Institute Members and Candidates in the CFA Program are required to follow.

The purposes of the Standards are to define “soft dollars,” identify what is “allowable” research, establish standards for soft dollar use, create model disclosure guidelines, and provide guidance for client-directed brokerage arrangements.

The Soft Dollar Standards are *voluntary* standards for Members. If a CFA Institute Member claims compliance with the Standards, then certain of these Standards are mandatory (i.e., they *must* be followed to claim compliance) and others are recommended (i.e., they *should* be followed). CFA Institute strongly encourages Members to adopt the required and recommended Standards. If the Soft Dollar Standards are adopted, compliance will not supplant the responsibility to comply with applicable law.<sup>1</sup> CFA Institute Members should comply at all times with the relevant laws of the countries in which they do business. In situations in which these Standards impose a higher degree of responsibility or disclosure than, but do not conflict with, local law, the Member is held to the mandatory provisions of these Standards.

## Background

In 1975, the U.S. Congress created a “safe harbor” under Section 28(e) of the Securities and Exchange Act of 1934 to protect investment managers from claims that they had breached their fiduciary duties by using their client commissions to pay a higher commission to acquire investment research than they might have paid for “execution” services. According to Securities and Exchange Commission (SEC) Staff,

<sup>1</sup>For example, in the United States, the Securities Exchange Act of 1934, Investment Company Act of 1940, and Investment Advisers Act of 1940 all address the use of client commissions in soft dollar arrangements. The U.S. Department of Labor also provides regulations regarding directed brokerage practices concerning ERISA-covered pension plans.

the protection of Section 28(e) is available only for securities transactions conducted on an agency basis.<sup>2</sup> Since that time, the soft dollar area has undergone considerable expansion, both in terms of actual usage and the types of products and services for which safe harbor protection is claimed. The complexity of these practices, including technologically sophisticated research tools and the existence of “mixed-use” products, has resulted in a fair amount of legitimate confusion surrounding the appropriate use of soft dollars.

CFA Institute seeks to provide ethical standards for CFA Institute Members and those in the industry that engage in soft dollar practices and also emphasizes the paramount duty of the investment manager, as a fiduciary, to place the interests of clients before those of the investment manager. In particular, the Soft Dollar Standards focus on six key areas:

- Definitions—to enable all parties dealing with soft dollar practices to have a common understanding of all of the different aspects of soft dollars.
- Research—to give clear guidance to investment managers on what products and services are appropriate for a manager to purchase with client brokerage.
- Mixed-Use Products—to clarify the manager’s duty to clearly justify the use of client brokerage to pay a portion of a mixed-use product.
- Disclosure—to obligate investment managers to clearly disclose their soft dollar practices and give detailed information to each client when requested.
- Record keeping—to ensure that the client can (1) receive assurances that what the investment manager is doing with the client’s brokerage can be supported in an “audit,” and (2) receive important information on request.
- Client-Directed Brokerage—to clarify the manager’s role and fiduciary responsibilities with respect to clients.

<sup>2</sup>According to the SEC staff, securities transactions conducted on a principal basis cannot claim Section 28(e) “safe harbor” protection. Both principal transactions and those agency transactions unable to qualify for “safe harbor” protection are not necessarily illegal but are evaluated based on the existence of full disclosure, informed client consent, and other fundamental fiduciary principles, including placing the client’s interests first.

## Overview

CFA Institute Soft Dollar Standards focus on the Member's obligations to its clients. Although the Standards primarily focus on the obligations of the Member as investment manager, they may be applicable to other parties involved in soft dollar practices, including brokers, plan sponsors, and trustees. Each of these parties, however, has its own set of obligations that should be considered prior to participating in any soft dollar arrangement.

CFA Institute Soft Dollar Standards are ethical principles intended to ensure

- full and fair disclosure of an investment manager's use of a client's brokerage<sup>3</sup>;
- consistent presentation of information so that the client, broker, and other applicable parties can clearly understand an investment manager's brokerage practices;
- uniform disclosure and record keeping to enable an investment manager's client to have a clear understanding of how the investment manager is using the client's brokerage; and
- high standards of ethical practices within the investment industry.

No finite set of standards can cover all potential situations or anticipated future developments concerning the types of investment research available to investment managers. However, meeting the objective of full and fair disclosure and ensuring that the "client comes first" obligates an investment manager to disclose fully and clearly to its client the investment manager's practice when addressing any potential conflict concerning the payment methods for investment research.

CFA Institute Soft Dollar Standards are based on the following set of fundamental principles that an investment manager should consider when attempting to comply:

- An investment manager is a fiduciary and, as such, must disclose all relevant aspects concerning any benefit the manager receives through a client's brokerage;
- Proprietary research and third-party research are to be treated the same in evaluating soft dollar arrangements, because the research that an investment manager receives from each is paid for with client brokerage;

---

<sup>3</sup>The term "Brokerage" is described in the definitions section of the Standards.

- Research should be purchased with client brokerage only if the primary use of the research, whether a product or a service, directly assists the investment manager in its investment decision-making process and not in the management of the investment firm; and
- When in doubt, the research should be paid for with investment manager assets, not client brokerage.

## Comparison with Current Practices

CFA Institute Soft Dollar Standards seek to clarify certain areas of brokerage practices that have been a source of confusion for CFA Institute Members. By emphasizing the basic fiduciary responsibilities of CFA Institute Members with respect to their client's assets, the Soft Dollar Standards are intended to illuminate the line between permissible and impermissible uses of client brokerage. In this respect, the Standards do not create "new law" but address well-established principles applicable to the investment manager–client relationship.

In other respects, a reiteration of the current "soft dollar" practices would fail to adequately address the issues raised by the complexity of current brokerage practices faced by CFA Institute Members. The Soft Dollar Standards, therefore, depart from certain well-established practices in the soft dollar area and address practices beyond those that currently claim Section 28(e) safe harbor protection.

The Soft Dollar Standards are not to be read as in any way changing the scope of activities that the SEC determines to fall within the safe harbor. Instead they are separate, ethical standards applicable to a variety of practices implicated in Soft Dollar Arrangements. Thus, these Standards will impose higher standards of conduct in certain areas on CFA Institute Members that voluntarily elect to comply with the Standards, as follows:

### 1. Definition of Soft Dollar Arrangements

- a. *Proprietary, in addition to third-party, research.*

Traditionally, soft dollar arrangements are understood to address those products or services provided to the investment manager by someone other than the executing broker, products or services that are commonly known as "third-party" research. Such an approach is deficient in light of the range of products and services provided by

both third-party research providers and “in-house” research departments of brokerage firms. Thus, any meaningful Standards must also recognize the importance of research provided by the executing broker, commonly known as “proprietary” or “in-house” research.

For purposes of the Soft Dollar Standards, “soft dollar arrangements” include proprietary, as well as third-party, research arrangements and seek to treat both categories the same. Although these Standards do *not* suggest an “unbundling” of proprietary research, they do require the investment manager to provide certain basic information regarding the types of research obtained with client brokerage through proprietary research arrangements. Moreover, these Standards should not be read to require research obtained either through third-party or proprietary arrangements to be attributed on an account-by-account basis or otherwise to require a “tracing” of products or services.

b. *Principal, in addition to agency, trades.*

Traditionally, the term “soft dollars” refers to commissions generated by trades conducted on an agency basis.<sup>4</sup> However, such an approach fails to recognize that research may be obtained through the use of “spreads” or “discounts” generated by trades conducted on a principal basis. For the purposes of the Soft Dollar Standards, soft dollar arrangements include transactions conducted on an agency *or* principal basis.

## 2. Definition of Research

Traditionally, “allowable” research in the soft dollar context is evaluated by whether it provides lawful and appropriate assistance to an investment manager in the investment decision-making process. This approach, however, leaves CFA Institute Members with inadequate guidance. Consequently, the Soft Dollar Standards embrace a definition of research that requires the primary use of the soft dollar product or service to directly assist the investment manager in its investment decision-making process and not in the management of the investment firm.

<sup>4</sup>As noted above, the “safe harbor” provided by Section 28(e) of the Securities Exchange Act of 1934, as interpreted by the SEC staff, applies only to those transactions conducted on an agency, not principal, basis.

In many cases, this determination may not lend itself to absolute precision, but an investment manager must use its best judgment as a fiduciary to justify the use of client brokerage to pay for a product or service. The Standards suggest the use of a three-tiered analysis to aid CFA Institute Members in determining whether a product or service is research. Such an approach is intended to provide needed guidance for CFA Institute Members in determining when it is appropriate to use client brokerage to purchase a product or service.

## 3. Enhanced Disclosure

Disclosure of a CFA Institute Member’s brokerage practices will provide the Member’s client with a means of evaluating the Member’s soft dollar practices and how client brokerage is used. Under the Soft Dollar Standards, the CFA Institute Member must disclose to its clients certain information, the majority of which the Member is already required under current law to disclose, or to maintain, in order to meet federal disclosure requirements. Moreover, although the Soft Dollar Standards require the CFA Institute Member to disclose the *availability* of additional information, this information does not actually have to be provided, unless it is specifically requested by the client.

## 4. Compliance Statement

Finally, the Soft Dollar Standards contemplate the use of a voluntary statement of compliance. Only a claim of compliance with these Standards requires an investment manager to comply with all of the mandatory provisions of these Standards and only as to the client brokerage that its compliance statement relates. Thus, an investment manager that claims compliance with the Soft Dollar Standards must provide the client with a statement that any brokerage arrangement with respect to *that* client’s account comports with the mandatory provisions of these Standards. Such a compliance statement will help to ensure the continued integrity of the Standards and provide clients with additional assurance with respect to how their brokerage is used by their investment manager.

## Definitions

*For purposes of the CFA Institute Soft Dollar Standards, the following terms apply:*

**Agency Trade** refers to a transaction involving the payment of a commission.

**Best Execution** refers to executing Client transactions so that the Client's *total cost* is the most favorable under the particular circumstances at that time.

**Broker** refers to any person or entity that provides securities execution services.

**Brokerage** refers to the amount on any trade retained by a Broker to be used directly or indirectly as payment for execution services and, when applicable, Research supplied to the Investment Manager or its Client in connection with Soft Dollar Arrangements or for benefits provided to the Client in Client-Directed Brokerage Arrangements. For these purposes, trades may be conducted on an agency or principal basis.

**Brokerage Arrangement** refers to an arrangement whereby a Broker provides services or products that are in addition to execution. Brokerage Arrangements include Investment Manager-Directed and Client-Directed Brokerage Arrangements.

**Brokerage and Research Services** refers to services and/or products provided by a Broker to an Investment Manager through a Brokerage Arrangement.

**Client** refers to the entity, including a natural person, investment fund, or separate account, designated to receive the benefits, including income, from the Brokerage generated through Securities Transactions. A Client may be represented by a trustee or other Fiduciary, who may or may not have Investment Discretion.

**Client-Directed Brokerage Arrangement** refers to an arrangement whereby a Client directs that trades for its account be executed through a specific Broker in exchange for which the Client receives a benefit in addition to execution services. Client-Directed Brokerage Arrangements include rebates, commission banking, and commission recapture programs through which the Broker provides the Client with cash or services or pays certain obligations of the Client. A Client may also direct the use of limited lists of brokers—not for the purpose of reducing Brokerage costs but to effect various other goals (e.g., increased diversity by using minority-owned brokers) or geographical concentration.

**Commission** refers to the amount paid to the Broker in addition to the price of the security and applicable regulatory fees on an Agency Trade.

**Fiduciary** refers to any entity, or a natural person, including a CFA Institute Member, that has discretionary authority or responsibility for the management of a Client's assets or other relationships of special trust.

**Investment Decision-Making Process** refers to the quantitative and qualitative processes and related tools used by the Investment Manager in rendering investment advice to its Clients, including financial analysis, trading and risk analysis, securities selection, broker selection, asset allocation, and suitability analysis.

**Investment Discretion** refers to the sole or shared authority (whether or not exercised) to determine what securities or other assets to purchase or sell on behalf of a Client.

**Investment Manager** refers to any entity, or a natural person, including a CFA Institute Member, that serves in the capacity of asset manager to a Client. The Investment Manager may have sole, shared, or no Investment Discretion over an account.

**Investment Manager-Directed Brokerage Arrangement** refers to Proprietary and Third-Party Research Arrangements.

**Member** refers to any individual who is required to comply with the CFA Institute Code of Ethics and Standards of Professional Conduct in accordance with the CFA Institute Bylaws.

**Mixed-Use** refers to services and/or products, provided to an Investment Manager by a Broker through a Brokerage Arrangement, that have the capacity to be used for both the Investment Decision-Making Process *and* management of the investment firm.

**Principal Trade** refers to a transaction involving a “discount” or a “spread.”

**Proprietary Research Arrangement** refers to an arrangement whereby the Investment Manager directs a Broker to effect Securities Transactions for Client accounts in exchange for which the Investment Manager receives Research from, and/or access to, the “in-house” staffs of the brokerage firms.

**Provided by a Broker** refers to (1) in Proprietary Research Arrangements, Research developed by the Broker and (2) in Third-Party Research Arrangements, Research for which the obligation to pay is between the Broker and Third-Party Research Provider, not between the Investment Manager and Third-Party Research Provider.



**Research** refers to 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.

**Section 28(e) Safe Harbor** refers to the “safe harbor” set forth in Section 28(e) of the U.S. Securities Exchange Act of 1934, which provides that an Investment Manager that has Investment Discretion over a Client account is not in breach of its fiduciary duty when paying more than the lowest Commission rate available if it determines in good faith that the rate paid is commensurate with the value of Brokerage and Research Services provided by the Broker.

**Securities Transactions** refers to any transactions involving a Broker, whether conducted on an agency basis or principal basis.

**Soft Dollar Arrangement** refers to an arrangement whereby the Investment Manager directs transactions to a Broker, in exchange for which the Broker provides Brokerage and Research Services to the Investment Manager. Soft Dollar Arrangements include Proprietary and Third-Party Research Arrangements but do *not* include Client-Directed Brokerage Arrangements. Soft Dollar Arrangements are sometimes referred to herein as Investment Manager-Directed Brokerage Arrangements, where applicable.

**Third-Party Research Arrangement** refers to an arrangement whereby the Investment Manager directs a Broker to effect Securities Transactions for Client accounts in exchange for which the Investment Manager receives Research provided by the Broker, which has been generated by an entity *other than* the executing Broker.

## CFA Institute Soft Dollar Standards

### I. General

#### *Principles*

A. These Soft Dollar Standards apply to all CFA Institute Members' Proprietary and Third-Party Research Arrangements, with or without Commissions, and recognize two fundamental principles:

1. Brokerage is the property of the Client.
2. The Investment Manager has an ongoing duty to ensure the quality of transactions effected on behalf of its Client, including
  - a. seeking to obtain Best Execution,
  - b. minimizing transaction costs, and
  - c. using Client Brokerage to benefit Clients.

#### *Required*

- B. An Investment Manager in Soft Dollar Arrangements must always act for the benefit of its Clients and place Clients' interests before its own.
- C. An Investment Manager may not allocate a Client's Brokerage based on the amount of Client referrals the Investment Manager receives from a Broker.

*Clarification:* With respect to mutual funds, the Investment Manager's Client is the fund. However, in this context, the fund's board, not the fund, establishes the policies with respect to the use of certain brokers.

### II. Relationships with Clients

#### *Required*

- A. The Investment Manager must disclose to the Client that it may engage in Soft Dollar Arrangements prior to engaging in such Arrangements involving that Client's account.

#### *Recommended*

- B. The Investment Manager should assure that, over time, all Clients receive the benefits of Research purchased with Client Brokerage.
1. *Agency Trades.* While it is permissible for the Investment Manager to use a Client's Brokerage derived from

Agency Trades to obtain Research that may not directly benefit that particular Client at that particular time, the Investment Manager should endeavor to ensure that, over a reasonable period of time, the Client receives the benefit of Research purchased with other Clients' Brokerage.

2. *Principal Trades.* The Investment Manager should determine if the particular Principal Trade is subject to certain fiduciary requirements (e.g., ERISA, Investment Company Act of 1940) which require that Client Brokerage derived from Principal Trades must benefit the Client account generating the Brokerage. If such requirements do not apply, it is permissible to use Client Brokerage derived from Principal Trades to benefit Client accounts other than the account generating the Brokerage if the Investment Manager discloses this practice and obtains prior consent from the Client.

*Clarification:* Certain fiduciary statutes require that brokerage derived from a Principal Trade must directly benefit the Client account generating the Trade. In such situations, even consent by the Client will not waive this legal requirement. Compliance with the Soft Dollar Standards should not be read to, in any way, absolve one's responsibilities to comply fully with the applicable law regarding Principal Trades.

### III. Selection of Brokers

#### *Principle*

- A. Selecting Brokers to execute Clients' Securities Transactions is a key component of the Investment Manager's ability to add value to its Client portfolios. The failure to obtain Best Execution may result in impaired performance for the Client.

#### *Required*

- B. In selecting Brokers, the Investment Manager must consider the capabilities of the Broker to provide Best Execution.

**Recommended**

- C. In evaluating the Broker's capability to provide Best Execution, the Investment Manager should consider the Broker's financial responsibility, the Broker's responsiveness to the Investment Manager, the Commission rate or spread involved, and the range of services offered by the Broker.

*Clarification:* These criteria are relevant components to the Broker's ability to obtain the most favorable total cost under the particular circumstances at that time.

**IV. Evaluation of Research****Required**

- A. In determining whether to use Client Brokerage to pay for Research, the Investment Manager must use the following criteria:
1. Whether the Research under consideration meets the definition of Research contained in these Standards.
  2. Whether the Research benefits the Investment Manager's Client(s).
  3. Whether the Investment Manager is able to document the basis for the determinations.
  4. Whether under certain fiduciary regulations (e.g., ERISA, the Investment Company Act of 1940) for Principal Trades, the Research directly benefits the Client account generating the trade. If the Principal Trades are not subject to such regulations, the Research may benefit Client accounts other than those generating the trade if the Investment Manager has made disclosure and obtained prior Client consent.
- B. The inability to decide and document that the Research meets the above criteria requires that the Investment Manager *not* pay for such Research with Client Brokerage.
- C. In determining the portion of Mixed-Use Research to be paid with Client Brokerage, the Investment Manager must:

1. Be able to make a reasonable, justifiable, and documentable allocation of the cost of the Research according to its expected usage.
2. Pay with Client Brokerage only the portion of the Research that is actually used by the Investment Manager in the Investment Decision-Making Process.
3. Reevaluate the Mixed-Use Research allocation at least annually.

**V. Client-Directed Brokerage****Principle**

- A. Because Brokerage is an asset of the Client, not the Investment Manager, the practice of Client-Directed Brokerage does not violate any investment manager duty per se.
- B. In a Client-Directed Brokerage Arrangement:

**Required**

1. The Investment Manager must not use Brokerage from another Client account to pay for a product or service purchased under the Client-Directed Brokerage Arrangement.

**Recommended**

2. The Investment Manager should disclose to the Client:
  - a. the Investment Manager's duty to continue to seek to obtain Best Execution, and
  - b. that arrangements that require the Investment Manager to commit a certain percentage of Brokerage may affect the Investment Manager's ability to (i) seek to obtain Best Execution and (ii) obtain adequate Research.
3. The Investment Manager should attempt to structure the Client-Directed Brokerage Arrangement in a manner that comports with Appendix A to the Soft Dollar Standards (Exhibit A to this Topical Study).

**VI. Disclosure**

In addition to disclosure required elsewhere in the Soft Dollar Standards:

**Required**

A. An Investment Manager must clearly disclose, with specificity and in “plain language,” its policies with respect to all Soft Dollar Arrangements, including:

1. *To Clients and potential Clients.* An Investment Manager must disclose whether it may use the Research to benefit Clients other than those whose trades generated the Brokerage. This disclosure must address whether the trades generating the Brokerage involved transactions conducted on a principal basis.
2. *To Clients.* An Investment Manager must disclose (i) the types of Research received through Proprietary or Third-Party Research Arrangements; (ii) the extent of use; and (iii) whether any affiliated Broker is involved.

*Clarification:* Description of the types and use of Research should be appropriate to the type of Research Arrangement involved. The disclosures required or recommended in the Soft Dollar Standards do not contemplate an “unbundling” of Proprietary Research Arrangements. Instead, the description of Research should, in the judgment of the Investment Manager, provide Clients with the ability to understand the type of Research involved *in the degree of detail* appropriate to the source of the Research.

B. To claim compliance with these Standards for any Client account, an Investment Manager must provide the Client with a statement that any Soft Dollar Arrangements with respect to the particular Client account comport with the CFA Institute Soft Dollar Standards. This statement must be provided at least annually.

*Clarification:* This statement is required only if the Investment Manager is claiming compliance with the Soft Dollar Standards. If applicable, the statement is to be provided to the individual Client to which the claim is being made.

C. An Investment Manager must prominently disclose in writing to its Client that additional information in accordance with the CFA

Institute Soft Dollar Standards concerning the Investment Manager’s Soft Dollar Arrangements is available on request. Such additional information should include the following on at least an annual basis:

*Clarification:* Although certain additional information is suggested, the Soft Dollar Standards are intended to preserve the ability of the Client and Investment Manager to determine what other information may be relevant in light of particular Client needs or types of accounts.

1. *On a firmwide basis.* A description of the products and services that were received from Brokers pursuant to a Soft Dollar Arrangement, regardless of whether the product or service derives from Proprietary or Third-Party Research Arrangements, detailed by Broker.
2. *For a specific Client account:*
  - a. the total amount of Commissions generated for that Client through a Soft Dollar Arrangement, detailed by Broker; and
  - b. the total amount of Brokerage directed by that Client through Directed Brokerage Arrangements.

*Clarification:* The disclosure required in this section is intended to provide the requesting Client with certain basic items of information: a description of what the entire firm obtained through Soft Dollar Arrangements, the identity of brokers providing those products and services, the total amount of Directed Brokerage attributable to the Client, and the total amount of Commissions generated for the requesting Client’s account.

3. The aggregate percentage of the Investment Manager’s Brokerage derived from Client-Directed Brokerage Arrangements and the amount of that Client’s Directed Brokerage, as a percentage of that aggregate.
  - a. The Investment Manager is not obligated to report amounts of Client-Directed Brokerage that constitute less than 10 percent of the Manager’s aggregate amount of Client-Directed Brokerage.

**Recommended**

When requested by a Client:

- D. The Investment Manager should provide a description of the product or service obtained through Brokerage generated from the Client's account.
- E. The Investment Manager should provide the aggregate dollar amount of Brokerage paid from all accounts over which the Manager has Investment Discretion.

**VII. Record Keeping****Required**

The Investment Manager must maintain, when applicable, all records that

- A. are required by applicable law;
- B. are necessary to supply Clients on a timely basis with the information required by Soft Dollar Standard VI;
- C. document arrangements, oral or written, obligating the Investment Manager to generate a specific amount of Brokerage;

- D. document arrangements with Clients pertaining to Soft Dollar or Client-Directed Brokerage Arrangements;
- E. document any agreements with Brokers pertaining to Soft Dollar Arrangements;
- F. document transactions with Brokers involving Soft Dollar Arrangements, including (1) a list of Proprietary or Third-Party Research providers and (2) a description of the service or product obtained from the provider;
- G. document the bases of allocation in determining to use Client Brokerage to pay for any portion of a Mixed-Use service or product;
- H. indicate how the services and products obtained through Soft Dollar Arrangements directly assist the Investment Manager in the Investment Decision-Making Process;
- I. show compliance with the CFA Institute Soft Dollar Standards, including the identity of the Investment Manager personnel responsible for determining such compliance.
- J. copies of all Client disclosures and authorizations.

## Appendix A

### Recommended Practices for Client-Directed Brokerage Arrangements

In Client-Directed Brokerage Arrangements:

- A. When directed by a Fiduciary, the Investment Manager should receive written assurance from the Fiduciary that the Client-Directed Brokerage Arrangement will solely benefit the Client's account.
- B. The Investment Manager should attempt to structure Client-Directed Brokerage Arrangements so that
  1. they do not require the commitment of a certain portion of Brokerage to a single Broker, and
  2. Commissions are negotiated and seeking to obtain Best Execution is still relevant.
- C. The Investment Manager should request from its Client in any Client-Directed Brokerage Arrangement written instructions that
  1. restate the Investment Manager's continuing responsibility for seeking to obtain Best Execution,
  2. list the eligible Brokers,
  3. specify the approximate target percentage or dollar amount of transactions to be directed, and
  4. state procedures for monitoring the Arrangements.
- D. The Investment Manager should regularly communicate with the Client for the purpose of jointly evaluating the Client-Directed Brokerage Arrangement, including
  1. the potential for achieving Best Execution,
  2. the list of Brokers and their trading skills,
  3. the target percentage of transactions to be directed to the selected Brokers, and
  4. the Investment Manager's trading style and liquidity needs.

## Appendix B

### Permissible Research Guidance

Central to whether a product or service constitutes “Research” that can be paid for with Client Brokerage is whether the product or service provides lawful and appropriate assistance to the Investment Manager in carrying out its investment decision-making responsibilities. This determination pivots on whether the product or service aids the Investment Decision-Making Process instead of the general operation of the firm.

CFA Institute Soft Dollar Standards add guidance by requiring that the primary use of the Research must directly assist the Investment Manager in its Investment Decision-Making Process and not in the management of the investment firm.

Formulating what is allowable Research is not subject to hard and fast rules. Rather, the context in which something is used and the particulars of an Investment Manager’s business form the framework for this determination. In evaluating a practice, the substance of *actual* usage will prevail over the *form* of some possible usage.

#### Three-Level Analysis

CFA Institute Soft Dollar Standards assist the Investment Manager in making this determination by setting forth a three-level analysis to assist the Investment Manager in determining whether a product or service is Research. In the vast majority of cases, if the criteria of all three levels are satisfied, the Investment Manager can then feel comfortable in using Client Brokerage to pay for the Research. When conducting the analysis, the Investment Manager must consider the ethical framework of the Soft Dollar Standards. In conjunction with the Soft Dollar Standards’ Client disclosure requirements, an Investment Manager must be able to explain to its Client how the Research—and when applicable, its component parts—assists in the Investment Decision-Making Process. Stated another way, the Investment Manager should only obtain Research with Client Brokerage if the Manager would feel comfortable disclosing and explaining the decision in a face-to-face meeting with the Client.

**Level I—Define the Product or Service.** The first step is for the Investment Manager to define the product or service to be purchased with Client Brokerage. In most instances, the product or service is clearly defined (e.g., an industry report). However,

many products and services consist of different components that are related only to the ability of the product or service to assist the Investment Manager in its Investment Decision-Making Process (e.g., a computer work station that runs Research software). For such multicomponent products or services, the Investment Manager, consistent with the Soft Dollar Standards’ ethical framework, must narrowly construe the component parts that are necessary for the products or services to directly assist the Investment Manager in the Investment Decision-Making Process.

For example, the computer work station could be considered a closely related component of the product or service that constitutes the “Research.” The electricity needed to run the computer, however, is not closely related and, if paid with Client Brokerage, would violate the ethical principles of the Soft Dollar Standards.

**Level II—Determine Usage.** The second step is for the Investment Manager to determine that the primary use of the product or service, as defined by the Investment Manager in the Level I analysis, will directly assist the Investment Manager in its Investment Decision-Making Process.

For example, an Investment Manager subscribes to the Bloomberg Service and uses this service only to enable all persons visiting the Investment Manager’s offices to look up the price of securities and analyze market trends. Under the Level I analysis, the Investment Manager defines the service as the market data received from Bloomberg, plus the Bloomberg supplied terminal and the dedicated line necessary to receive the Bloomberg service in the Investment Manager’s offices. However, under the Level II analysis, the Investment Manager does not use the Bloomberg service to directly assist it in its Investment Decision-Making Process. To the contrary, the Investment Manager subscribes to the Bloomberg Service as a benefit to the firm. The Bloomberg Service, therefore, cannot be paid for with Client Brokerage.

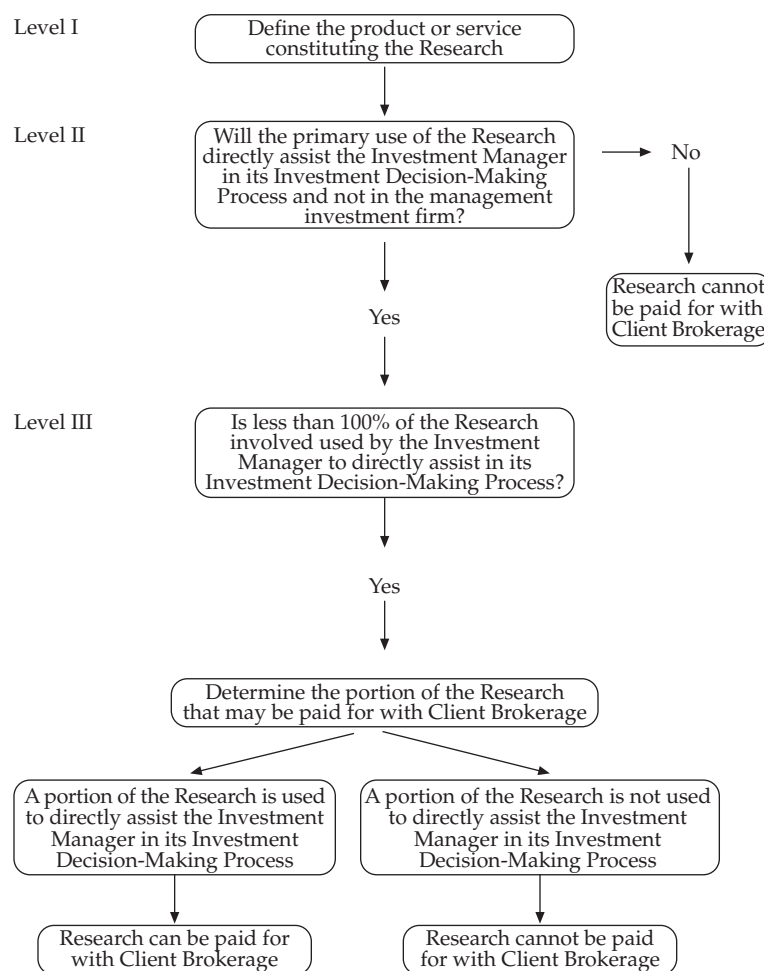
**Level III—Mixed-Use Analysis.** The third step occurs only after the Investment Manager determines that the product or service is Research by completing the Level I and Level II analysis above. The Investment Manager must then determine what portion of the Research is used by the Investment Manager to directly assist it in the Investment

Decision-Making Process. If less than 100 percent of the Research is used for assistance in its Investment Decision-Making Process, the Investment Manager must consider the Research as Mixed-Use Research. With Mixed-Use Research, the Investment Manager can use Client Brokerage to pay for only that portion of the Research used by the Investment Manager in the Investment Decision-Making Process and not in the management of the investment firm.

For example, if the Bloomberg service discussed in the Level II analysis was actually used 50 percent of the time to determine market and industry trends as part of the Investment Manager’s Investment Decision-Making Process, the Investment Manager could pay for 50 percent of the Bloomberg service with Client Brokerage.

## Conclusion

The Investment Manager can establish that the product or service is Research that can be purchased with Client Brokerage only after the Investment Manager has taken two steps. First, the Investment Manager must have defined the product or service (Level I analysis). Second, the Investment Manager must have determined that the primary use of the product or service will directly assist the Investment Manager in the Investment Decision-Making Process rather than in the management of the investment firm (Level II analysis). The final step is for the Investment Manager to determine what portion of the Research will be used by the Investment Manager in the Investment Decision-Making Process and pay only for that portion with Client Brokerage (Level III analysis).





## Appendix C

### Case Study under the CFA Institute Soft Dollar Standards

XYZ Firm is an Investment Manager that seeks to comply with the CFA Institute Soft Dollar Standards and claim such compliance. XYZ, a Member of CFA Institute, manages a variety of accounts: separate accounts, including accounts of employee benefit plans subject to ERISA, accounts of non-ERISA institutional investors, and accounts of wealthy individuals; several collective investment vehicles, including a group trust for employee benefit plans subject to ERISA and/or governmental plans; a “hedge fund” for institutional and other “sophisticated” individual investors; and three SEC-registered investment companies, including an equity fund, a fixed-income fund, and a money market fund.

XYZ executes trades for its Client accounts with several broker–dealers who conduct trades for XYZ on both a principal and agency basis. Some of the broker–dealers have offered to provide XYZ with the following products and/or services for XYZ’s own use, to be paid for with XYZ’s Client Brokerage business: (1) desks and office equipment; (2) trading room television sets that receive the Financial News Network and other financial news services supplied by cable and satellite television services; (3) the Bloomberg Service, which includes a Bloomberg terminal; and (4) software that will assist XYZ in analyzing economic trends in industries followed by the Firm, as well as a widely available computer work station on which to install and operate the software. In addition, XYZ has received the following requests from Clients: (5) a pension fund Client subject to ERISA has requested that XYZ direct a portion of its Brokerage from its separate account to Broker ABC to obtain research information to be provided to the plan trustees; (6) a public pension plan has requested that XYZ direct a portion of its Brokerage to Broker ABC in return for cash credits to be paid to the Plan; (7) a non-ERISA institutional investor in XYZ’s hedge fund has requested that XYZ direct a portion of the hedge fund’s brokerage to Broker ABC to compensate Broker ABC for research services provided to the institutional investor; and, (8) the SEC-registered investment companies have requested that XYZ direct a portion of the equity fund’s Brokerage to Broker ABC in return for credits to be used to reduce or eliminate all of the registered investment companies’ custodian fees.

What steps or other actions must or should XYZ take to comply with the Soft Dollar Standards and/or other CFA Institute Standards of Professional Conduct?

### Discussion

XYZ Firm is facing a set of decisions that typically confronts Investment Managers in connection with their use of Client Brokerage. XYZ should approach these decisions in a logical and systematic fashion to identify all relevant issues and ensure compliance with applicable law and CFA Institute Soft Dollar Standards. As an initial matter, XYZ should clearly isolate and identify the proposed transactions contemplated. Then, in order to determine compliance with applicable law and CFA Institute Soft Dollar Standards, XYZ should (1) consider fundamental principles that apply to the conduct of CFA Institute Members, (2) identify applicable laws and regulations and analyze the proposed transactions in light of those laws and regulations, and (3) identify the CFA Institute Soft Dollar Standards and analyze the proposed transactions in light of those Standards. XYZ may pursue the proposed transactions only after satisfying itself that the transactions pass this systematic, multilevel analysis.

#### *Isolate and Define the Proposed Transactions.*

One of the benefits of the CFA Institute Soft Dollar Standards is that they help Investment Managers to clearly define their practices as they relate to their Clients’ Brokerage. By referring to the definitions contained in the Soft Dollar Standards, XYZ should determine that the broker–dealers’ offer to provide the products and services in Transactions 1–4 described in the “Facts” section possibly constitutes a Soft Dollar Arrangement. Because XYZ is contemplating directing transactions to the broker–dealers to receive execution on trades and to receive products and services that will benefit XYZ directly, this offer may meet the CFA Institute Soft Dollar Standards definition of a Soft Dollar Arrangement. An additional measure of whether Transactions 1–4 qualify as Soft Dollar Arrangements under the CFA Institute Soft Dollar Standards is whether the products and services received by XYZ qualify as Research as defined in the Soft Dollar Standards. Transactions 5–8 may constitute Client-Directed Brokerage Arrangements, as defined in the CFA Institute Soft Dollar Standards,

if XYZ determines that the *clients* are directing that their trades be routed through specific broker–dealers in order that the *clients* may receive benefits *in addition to* execution services.

*Fundamental Principles.* In considering the transactions that have been proposed, XYZ should adhere to a set of fundamental principles contained in three of the CFA Institute Standards that generally govern a Member’s conduct in this area. Standard I (Fundamental Responsibilities) of the CFA Institute Standards of Professional Conduct requires that a Member be familiar and comply with all applicable laws governing their professional activities. XYZ is thus charged with a duty to know and apply the provisions of law that are implicated by the proposed transactions. Even if XYZ has adopted the CFA Institute Soft Dollar Standards, compliance with these Standards does not absolve XYZ of the responsibility to comply with applicable law. For situations in which the CFA Institute Standards impose a higher degree of responsibility or disclosure than, but do not conflict with, applicable law, XYZ must adhere to the provisions of the CFA Institute Standards *in addition to* any provisions of applicable law.

Moreover, Standard I of the CFA Institute Soft Dollar Standards contains fundamental principles that govern any of XYZ’s activities involving Soft Dollar Arrangements. Standard I states that (1) Brokerage is the property of the Client and (2) XYZ has an ongoing duty to ensure the quality of transactions effected on behalf of its Clients, which includes

- seeking to obtain Best Execution,
- minimizing transactions costs, and
- using Client Brokerage to benefit Clients.

These principles are reflected in the CFA Institute Soft Dollar Standards’ requirement that XYZ, in considering a Soft Dollar Arrangement, must act for the benefit of its Clients and place its Clients’ interests before its own.

Finally, Standard V of the CFA Institute Soft Dollar Standards, governing Client-Directed Brokerage Arrangements, requires that XYZ must not use Brokerage from another Client account to pay for a product or service purchased under the Client-Directed Brokerage Arrangement.

*Applicable Laws and Regulations.* Members are expected at all times to comply with the applicable laws of the countries in which they do business. For example, in the United States, the Securities Exchange Act of 1934, Investment Company Act of 1940, Investment Advisers Act of 1940, and Employ-

ment Retirement Income Security Act of 1974 would govern certain or possibly all of the transactions that XYZ is considering. Regardless of the country in which XYZ is doing business, as a threshold matter, it must analyze each transaction for compliance with applicable law. Only those transactions that comply with local laws are eligible for subsequent analysis under the CFA Institute Soft Dollar Standards.

*Applicable Relevant Standards.* Assuming each of the proposed transactions has “survived” the first two stages of analysis, they must still comply with provisions of the CFA Institute Soft Dollar Standards in order for XYZ to pursue them. Because XYZ has previously determined that each of the transactions qualifies as a possible Soft Dollar Arrangement (depending on whether the products or services qualify as Research under the CFA Institute Soft Dollar Standards) or a Client-Directed Brokerage Arrangement (depending on whether XYZ’s Client is directing its trades to receive a benefit), XYZ must satisfy the following three broad requirements to claim compliance with the Soft Dollar Standards:

- Determine that each arrangement is permitted by the CFA Institute Soft Dollar Standards.
  - Disclose the Investment Manger’s Soft Dollar policies to its Clients.
  - Maintain the specified records.
- A. Determinations of Eligibility. Standard III of the CFA Institute Soft Dollar Standards requires that, as an initial matter in selecting any broker, XYZ must consider the capabilities of the broker to provide Best Execution. Once XYZ has satisfied itself that a particular broker will provide Best Execution, XYZ must next evaluate any additional research provided by the broker under the following four criteria specified in Soft Dollar Standard IV:
- The research under consideration must meet the definition of Research contained in the Soft Dollar Standards.
  - The Research must benefit XYZ’s clients.
  - XYZ must be able to document the basis for its determination.
  - Under certain fiduciary regulations (i.e., ERISA, the Investment Company Act of 1940), for trades conducted on a principal basis, the Research must directly benefit the Client account generating the trade. If not so limited by such regulations, the Research must directly benefit the Client account generating the trade, unless XYZ has made disclosure and obtained prior Client consent.

The meaning of the term “Research” is crucial to XYZ’s evaluation under Soft Dollar Standard IV. “Research” is defined in the CFA Institute Soft Dollar Standards to mean services and/or products 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.

**Transaction 1—Use of Client Brokerage to Pay for Desks and Office Equipment.** Transaction 1 would not qualify for Research as defined in the Soft Dollar Standards because desks and office equipment would not satisfy the Soft Dollar Standards’ definition of Research. Although XYZ should be able to determine that desks and office equipment do not qualify as Research based on the plain terms of the definition, the result becomes clear when XYZ applies the three-level analysis. Under that analysis, XYZ would first define the products or services that it desires to purchase with Client Brokerage. The desks are a discrete and simple product that can be clearly identified. Although office equipment is a somewhat general term, XYZ should also be able to clearly identify the office equipment being offered (e.g., photocopier, fax machine, etc.). XYZ next would analyze the primary use of these products to determine whether they will directly assist XYZ’s Investment Decision-Making Process. At this point, XYZ clearly should understand that desks and most office equipment cannot be considered to aid directly in the Investment Decision-Making Process and hence do not qualify as Research under the CFA Institute Soft Dollar Standards. Because the Soft Dollar Standards only permit XYZ to receive Research as defined in the CFA Institute Soft Dollar Standards, XYZ could not engage in Transaction 1 and claim compliance with the CFA Institute Soft Dollar Standards.

**Transaction 2—Use of Client Brokerage to Pay for Trading Room Television Sets.** Transaction 2 involves a service that is more difficult than office equipment to analyze under the definition of Research contained in the Soft Dollar Standards. The service that XYZ desires to purchase is really a composite of products and services that may or may not qualify as Research under the definition provided in the Soft Dollar Standards. XYZ’s first task is to define the service under the first level of analysis. Accordingly, XYZ should narrowly construe the component parts that are *necessary* for the service at issue in this example (i.e., financial news networks) to assist XYZ in its Investment Decision-Making

Process. In this situation, XYZ could reasonably conclude that the component parts (i.e., television sets, individual financial news services, and cable or satellite providers) are necessary for the total service to assist XYZ in its Investment Decision-Making Process. Thus, the service is potentially eligible to be paid for with client brokerage, *provided* that the total service satisfies the next level of analysis.

Applying the next level of analysis would allow XYZ to conclude that the service may qualify as Research if the primary use of the service is to directly aid the Investment Manager in its Investment Decision-Making Process. Even if financial news services have a broader use than to provide data to Investment Managers for purposes of making investment decisions, it would be consistent with the Soft Dollar Standards for XYZ to conclude that such services meet the primary use analysis—if based on actual use.

**Transaction 3—Use of Client Brokerage to Pay for the Bloomberg Service.** Transaction 3 involves a similar analysis under the definition of Research contained in the CFA Institute Soft Dollar Standards. As with Transaction 2, XYZ’s first step is to define the products or services that XYZ proposes to purchase with Client Brokerage. Again, XYZ should narrowly construe the component parts and could reasonably conclude that the Bloomberg terminal is a necessary component to receive the Bloomberg Service.

In applying the next level of analysis, XYZ may also reasonably conclude that the primary use of the Bloomberg Service, with its specific focus on real-time market news and analysis, does directly aid in the Investment Decision-Making Process. The service, therefore, may satisfy the first two levels of analyzing the definition of Research contained in the Soft Dollar Standards. However, if XYZ uses the Bloomberg Service and terminal to allow Clients to access financial information, the primary use of the service would not be to assist XYZ in its Investment Decision-Making Process, and the service would not qualify as Research under the CFA Institute Soft Dollar Standards. If XYZ uses the Bloomberg Service and terminal both in its own Investment Decision-Making Process and for Client purposes, at the third level of analysis, XYZ must make a good faith determination as to what portion of the service is actually used in the Investment Decision-Making Process. Only this portion may be paid for with Client Brokerage. XYZ must reevaluate this allocation on an annual basis.

**Transaction 4—Use of Client Brokerage to Pay for Software and Computer Work Stations.** At this point, XYZ should be comfortable applying the three-level analysis required to define Research under the Soft Dollar Standards. Transaction 4 involves the same analysis that confronted XYZ in the first three transactions. In defining the product in Transaction 4 (i.e., the research software), XYZ might reasonably determine that each of the component parts (the software and workstation) is necessary for the product to assist in the Investment Decision-Making Process.

Furthermore, XYZ might reasonably conclude under the second level of analysis that the software (and its component parts) will directly aid XYZ's Investment Decision-Making Process. If the primary use of the software is to directly assist XYZ in its Investment Decision-Making Process (as indicated by Level II analysis), XYZ may purchase the software using Client Brokerage. However, as with Transaction 3, only that portion actually used by XYZ in its Investment Decision-Making Process (as determined by Level III analysis) may be paid for with Client Brokerage, and any mixed-use allocation must be reevaluated annually.

**Client-Directed Transactions.** The eligibility of Transactions 5–8 must be determined under the portions of the CFA Institute Soft Dollar Standards related to Client-Directed Brokerage Arrangements. Standard V of the CFA Institute Soft Dollar Standards requires that, in considering Transactions 5–8, XYZ must not use Brokerage from another Client account to pay for a product or service purchased under the Client-Directed Brokerage Arrangement. Standard V also recommends that XYZ attempt to structure the Client-Directed Brokerage Arrangement in accordance with certain recommended practices under the CFA Institute Soft Dollar Standards.

**Transaction 5—Directing of Brokerage by ERISA Client to Benefit Plan Trustees.** In considering Transaction 5, XYZ must be particularly cognizant of the definition of Client contained in the Soft Dollar Standards. The Standards define Client to refer to “the entity, including a natural person, investment fund, or separate account, designated to receive the benefits, including income, from the Brokerage generated through Securities Transactions.”

Although this definition of Client also recognizes that a Client may be represented by a trustee or other Fiduciary, XYZ must be sensitive to the fundamental principle contained in Standard I of the CFA Institute Soft Dollar Standards that stresses that

Brokerage is the property of the *Client*, not the trustee or Fiduciary representing the Client. XYZ should immediately question whether Transaction 5 qualifies as a Client-Directed Brokerage Arrangement because the additional benefit flows not to the Client but to the Client's trustees. Because Transaction 5 likely does not qualify as a proper Client-Directed Brokerage Arrangement, if XYZ were to pursue it, XYZ would be violating the fundamental principle that requires the use of Client Brokerage to benefit Clients. XYZ should, therefore, decline to pursue Transaction 5.

**Transaction 6—Directing of Brokerage by Public Pension Plan to Obtain Cash Credits for the Plan.** Transaction 6, however, would be a permissible Client-Directed Brokerage Arrangement under the Soft Dollar Standards because Client Brokerage would be used to generate cash credits that solely benefit the Client. XYZ should attempt to structure the arrangement in conformity with the recommended practices for Client-Directed Brokerage Arrangements that are contained in the Soft Dollar Standards, which would require XYZ to:

- Disclose to the Client XYZ's duty to continue to seek to obtain Best Execution.
- Disclose to the Client that committing a certain percentage of the Client's Brokerage to a particular broker-dealer may affect XYZ's ability to seek to obtain Best Execution and purchase adequate Research.
- XYZ should receive written assurance from the plan trustees that the Client-Directed Brokerage Arrangement will solely benefit plan beneficiaries.
- XYZ should attempt to structure the Client-Directed Brokerage Arrangement so that it does not require the commitment of a certain portion of Brokerage to a single broker and so that commissions are negotiated and seeking to obtain Best Execution is still relevant.
- XYZ should request from the Client written instructions that (1) restate XYZ's continuing responsibility for seeking to obtain Best Execution, (2) list eligible brokers; (3) specify the target percentage of transactions to be directed, and (4) state procedures for monitoring the arrangement.
- XYZ should regularly communicate with the Client for the purpose of jointly evaluating the Client-Directed Brokerage Arrangement, including (1) the potential for achieving Best

Execution, (2) the list of brokers and their trading skills, (3) the target percentage of transactions to be directed to selected brokers, (4) XYZ's trading style and liquidity needs, and (5) other factors identified by the Client as relevant to the selection of brokers.

**Transaction 7—Directing of Brokerage by Institutional Investor in Hedge Fund to Compensate Broker for Research Provided to Investor.**

Transaction 7 raises issues under Standard V of the CFA Institute Soft Dollar Standards because Standard V requires that XYZ not use Brokerage from another Client account to pay for a product or service purchased under the Client-Directed Brokerage Arrangement. In Transaction 7, XYZ's hedge fund is a commingled pool containing numerous investors. The CFA Institute Soft Dollar Standards define Client to refer to the beneficiaries of an *entity*, including, as in this case, *all* of the beneficiaries of an investment fund. However, the product or service purchased under this particular Client-Directed Brokerage Arrangement has benefited *only* the institutional investor in the hedge fund, not all of the Client's underlying investors and thus may be construed to violate the principles in Standard V of the CFA Institute Soft Dollar Standards. XYZ, therefore, should not pursue Transaction 7.

**Transaction 8—Directing of a Portion of One Fund's Brokerage by Three Investment Companies to Benefit All Three Companies.**

Transaction 8 raises similar concerns as Transactions 5 and 7. XYZ is apparently directed by three distinct Clients (each of the three registered funds) to direct brokerage of one Client (i.e., the equity fund) to benefit all three Clients. XYZ should not pursue this arrangement because it would violate the principle in Standard V of the CFA Institute Soft Dollar Standards, which states that brokerage from another Client account should not be used to pay for a product or service purchased under a Client-Directed Brokerage Arrangement.

B. Disclosure. In order to claim compliance with the CFA Institute Soft Dollar Standards, XYZ must also meet specific disclosure obligations relating to its Brokerage practices. In addition to XYZ's disclosure obligations described above in the discussion of the transactions, XYZ must clearly disclose the following information relating to its Soft Dollar and Client-Directed Brokerage Arrangements:

- XYZ must disclose to Clients and potential Clients whether XYZ may use the Research to benefit Clients other than those whose trades generated the Brokerage and whether the trades generating the Brokerage involved transactions conducted on a principal basis.
  - XYZ must disclose to Clients (1) a description of the types of Research received through the arrangements, (2) the extent of its use, and (3) whether any broker affiliate of XYZ was involved.
  - XYZ must provide each Client with a statement that any Soft Dollar or Client-Directed Brokerage Arrangements with respect to its account comport with the CFA Institute Soft Dollar Standards (this statement must be provided at least annually).
  - XYZ must disclose in writing to its Clients that additional information in accordance with the CFA Institute Soft Dollar Standards concerning XYZ's Soft Dollar and Client-Directed Brokerage Arrangements is available on request. Such additional information should include (1) a firmwide description of the products and services that were received from each broker pursuant to a Soft Dollar Arrangement, including the identity of those Brokers; (2) for a specific Client account, the total amount of Commissions generated for the Client through Soft Dollar Arrangements, detailed by Broker and reporting the amount of Brokerage directed by the Client to specific brokers; and (3) the aggregate percentage of XYZ Brokerage derived from Client-Directed Brokerage Arrangements and the amount of the particular Client's Directed Brokerage as a percentage of the aggregate, subject to a 10 percent *de minimis* amount.
- C. Record Keeping. In addition to the eligibility determinations and disclosure obligations, in order to claim compliance with the CFA Institute Soft Dollar Standards, XYZ must also maintain, when applicable, all records that
- are required by applicable law;
  - are necessary to supply Clients on a timely basis with the information required by Soft Dollar Standard VI;
  - document arrangements, oral or written, obligating the Investment Manager to generate a specific amount of Brokerage;

- document arrangements with Clients pertaining to Soft Dollar or Client-Directed Brokerage Arrangements;
- document any agreements with Brokers pertaining to Soft Dollar Arrangements;
- document transactions with Brokers involving Soft Dollar Arrangements, including (1) a list of Proprietary or Third-Party Research providers and (2) a description of the service or product obtained from the provider;
- document the bases of allocation in determining to use Client Brokerage to pay for any portion of a Mixed-Use service or product;
- indicate how the services and products obtained through Soft Dollar Arrangements directly assist XYZ in the Investment Decision-Making Process;
- show compliance with the CFA Institute Soft Dollar Standards, including the identity of XYZ personnel responsible for determining such compliance;
- are copies of all Client disclosures and authorizations.

## Appendix D

### Analysis of Proposed Transactions under Applicable U.S. Law

Section 28(e) of the U.S. Securities Exchange Act of 1934 provides a “safe harbor” for investment managers from claims that they breached a fiduciary duty owed to a client by causing a client to pay higher commission costs in return for receipt of “brokerage and research services” that benefit the investment manager.<sup>5</sup> Regulations under the U.S. Investment Advisers Act of 1940 require investment managers who are registered with the U.S. Securities and Exchange Commission to provide disclosure to clients regarding their allocation of client brokerage, including whether the receipt of research that benefits the manager is a consideration in allocating brokerage. In addition, provisions of the U.S. Investment Company Act of 1940 govern transactions that apply to investment company assets, and provisions of the U.S. Employee Retirement Income Security Act (ERISA) of 1974 will apply to any transaction that involves the assets of a “plan” as the term is defined in ERISA. Assuming XYZ is doing business in the United States, XYZ is charged with the responsibility under the CFA Institute Standards of Practice of knowing and complying with the relevant provisions of these laws.

**Transactions 1–4.** XYZ must first consider whether Transactions 1–4 would satisfy the SEC’s definition of permissible research for purposes of Section 28(e). Research or brokerage products or services are the only products or services that are covered by the Section 28(e) safe harbor. Thus, XYZ will only be protected from potential legal challenges based on its paying a higher commission rate if the goods or services offered in the proposed transactions qualify as research as defined by the SEC. With the exception of Transaction 1, each of the proposed transactions would probably satisfy the SEC’s definition of “research,” which is that the product or service provides lawful assistance to XYZ in making investment decisions. Because Transaction 1 would likely *not* satisfy this standard, it would not qualify for the protection of the Section 28(e) safe harbor and

<sup>5</sup>As a “safe harbor,” Section 28(e) cannot be violated but offers protection from violations that might otherwise be deemed to occur under relevant laws.

would need to be analyzed in light of any restrictions imposed by other applicable laws. Transaction 1 quite possibly would raise best execution concerns under existing SEC interpretations and, if connected with investment company brokerage, would raise additional concerns under provisions of the Investment Company Act that restrict affiliates of a mutual fund from receiving compensation as an agent for the sale of the fund’s property. Moreover, if Transaction 1 involved plan assets as defined in ERISA, it would raise concerns under provisions of ERISA that require fiduciaries (including XYZ) to act solely in the interest of the plan’s beneficiaries and for the exclusive purpose of providing benefits to the plan’s beneficiaries.

**Transactions 5–8.** Transactions 5–8 would *not* fall within the Section 28(e) safe harbor because Section 28(e) requires that the person *selecting* the broker–dealer be the person exercising investment discretion over the account. In XYZ’s case, because the *client* is selecting the broker–dealer, Transactions 5–8 would not fall within the Section 28(e) safe harbor.

Nevertheless, because brokerage is an asset of the client, such arrangements may still be accomplished, provided they do not violate other relevant provisions of U.S. law. Transaction 5 should raise immediate concerns for XYZ because the benefit of the research information is flowing to the plan’s trustees and in-house staff, and is not used for the *exclusive benefit* of the plan beneficiaries. XYZ should conclude that to follow client instructions in Transaction 5 would likely result in a violation by XYZ of the substantive prohibitions of ERISA. Similarly, Transaction 8 should raise immediate concerns for XYZ under provisions of the Investment Company Act because brokerage of the equity fund is being used to reduce custody expenses of *all* three registered investment companies. Such an arrangement is likely prohibited by sections of the Investment Company Act that affirmatively prohibit joint transactions among affiliated funds. XYZ should, therefore, also determine that Transaction 8 is prohibited by the Investment Company Act.

**Summary.** Transactions 1, 5, and 8 do not qualify for the safe harbor protection of Section 28(e). Transaction 1 may be permissible under existing law if XYZ provides full disclosure and obtains informed client consent, provided that the transaction does not involve investment company or

benefit plan assets. Because Transaction 5 clearly involves plan brokerage, it would be prohibited by ERISA. Similarly, Transaction 8 is prohibited by provisions of the Investment Company Act. Transaction 5 and Transaction 8, therefore, do not survive XYZ's initial analysis under applicable U.S. law.



## Appendix E

### Analysis of Proposed Transactions under Applicable Canadian Law

The Ontario Securities Commission (the OSC) and the Commission des Valeurs Mobilières du Québec (the CVMQ) have respectively adopted OSC Policy Statement 1.9 and CVMQ Policy Statement No. Q-20, (the Soft Dollar Policies). The other securities administrators have not released formal policies with respect to soft dollars. The Soft Dollar Policies govern the use by dealers of commissions on brokerage transactions as payment for goods or services other than order execution services,<sup>6</sup> services directly related to order execution, or investment decision-making services.<sup>7</sup> The negotiation of commissions on brokerage transactions executed on behalf of a manager<sup>8</sup> of a portfolio or fund of securities is governed by the general obligation of the manager to act in the best interests of the beneficiaries of the portfolio or fund. Accordingly, such commissions must be used only as payment for goods or services that are for the benefit of the beneficiaries and should not be used as payment for goods or services that are for the benefit of the manager.

The Soft Dollar Policies provide that a dealer may not use any portion of the commissions earned on brokerage transactions executed on behalf of the manager as payment for goods or services provided to the manager, other than order execution services or investment decision-making services. It also provides that a manager may not direct brokerage transactions to a dealer as payment for goods or services provided to the manager, other than order execution services or investment decision-making services. As there is concern about widening the

<sup>6</sup>“Order execution services” means (1) order execution and (2) services directly related to order execution, such as clearance, settlement, and custody, whether the services are provided by a dealer directly or by a third party.

<sup>7</sup>“Investment decision-making services” means (1) advice as to the value of securities and the advisability of effecting transactions and securities, (2) analysis and reports concerning securities, portfolio strategy, performance, issuers, industries, or economic or political factors and trends, and (3) databases or software to the extent they are designed mainly to support the services referred to in (1) and (2), whether the services are provided by a dealer directly or by a third party.

<sup>8</sup>A manager is a person or company entrusted with the management of a portfolio or fund on behalf of third-party beneficiaries.

categories of permissible soft dollar transactions, the OSC has decided that staff should only grant exemptions on a case-by-case basis because they are contemplated by the OSC Policy 1.9.

**Disclosure.** On request, managers must disclose to the relevant commission, beneficiary, or trustee of a portfolio or fund the names of the persons or companies that have provided any investment decision-making services to the manager and a summary of the nature of those services that were paid for by commissions on brokerage transactions.

**Dealer as Principal.** When transacting as principal, a dealer may not buy securities from or sell securities to a manager if the price of the securities has been adjusted to compensate the dealer for goods or services provided to the manager, other than order execution services or investment decision-making services.

**Mutual Funds.** Similarly, mutual fund managers may not pay dealers for the distribution of shares or units of the mutual fund by directing brokerage transactions to the dealer or, at the request of the dealer, to a third party, unless the commission rates charged are equivalent to those which would have been normally charged by the dealer if the dealer did not distribute shares or units of the mutual fund and if certain disclosure requirements are met. In addition, such payments cannot be made as inducement or reward for the dealer or the principal distributor selling or having sold securities of the mutual fund or maintaining or having maintained particular levels of securities of the mutual fund in accounts of clients. Furthermore, all brokerage must be directed through representatives designated as the institutional representatives of the dealer, as opposed to retail representatives.

The offering documents of a mutual fund must disclose the actual use of commission dollars, including the names of the persons or companies who have provided any investment decision-making services to the mutual fund, a summary of the nature of those services, and a best estimate of the aggregate amount of any commissions on brokerage transactions that were directed to dealers since the date of the last offering documents for which the commissions were linked to the distribution of shares or units of the mutual fund by the dealers.

**Transactions.** Assuming XYZ is doing business in Canada, XYZ is charged with the responsibility under the CFA Institute Standards of Professional Conduct of knowing and complying with the relevant provisions of these laws.

**Transaction 1—Use of Client Brokerage to Pay for Desks and Office Equipment.** The use of client brokerage to pay for desks and office equipment would not qualify as “investment decision-making services” or “order execution services” as these terms are defined by the Soft Dollar Policies. Thus, this transaction would be prohibited.

**Transactions 2–4.** Each of the proposed transactions would likely satisfy the OSC’s definition of “investment decision-making services.”

**Transaction 2—Use of Client Brokerage to Pay for Trading Room Television Sets (Including Individual Financial News Services and Cable or Satellite Providers).** These services provide an analysis of industries or economic or political factors and trends. Therefore the services fit within the definition of investment decision-making services.

**Transaction 3—Use of Client Brokerage to Pay for the Bloomberg Service.** The Bloomberg Service focuses on real-time market news and analysis. Thus, the service fits within the definition of investment decision-making services.

**Transaction 4—Use of Client Brokerage to Pay for Software and Computer Work Stations.** The definition of investment decision-making services specifically includes databases or software to services such as analysis and reports concerning economic trends. The software is designed to analyze economic trends in industries followed by the firm. Accordingly, this part of Transaction 4 would be allowed. Although the work station is not specifically included in the definition of investment decision-making services, it is required to support the software and would be allowed by implication.

**Transaction 5—Directing of Brokerage by ERISA Client to Benefit Plan Trustees.** In Canada, a private pension plan governed by provincial pension benefits standards legislation or the federal Pension Benefits Standards Act would be the approximate equivalent of an ERISA plan under U.S. law. The Ontario Pension Benefits Act provides that the administrator of a pension plan is not entitled to any benefit from the pension plan other than pension

benefits, ancillary benefits, or a refund of contributions and fees and expenses related to the administration of the pension plan and permitted by the common law or provided for in the pension plan.

Because Transaction 5 confers a benefit on the trustee of the pension fund, rather than on the beneficiaries or members of the pension plan, and a specific benefit is not being conferred on the administrator of the pension plan, this transaction would be prohibited.

Of interest is the Canadian securities administrators’ concern regarding the practice whereby a pension plan sponsor requires the pension plan manager to direct brokerage transactions to a particular dealer who will use a portion of the commission income from this transaction to provide the sponsor with goods or services.

**Transaction 6—Directing of Brokerage by Public Pension Plan to Obtain Cash Credits for the Plan.** No direct parallel exists in Canada to a U.S. “public pension plan” concept wherein the plan is not subject to some form of provincial or federal pension standards legislation (i.e., most public sector plans are subject to pension benefit standards legislation).

Transaction 6 would not violate Canadian legislation. Because the goods and services contemplated in Transaction 6 would not be provided to the manager from the dealer, the Soft Dollar Policy would not be violated and the manager would not be in violation of the manager’s general obligation to benefit beneficiaries.

**Transaction 7—Directing of Brokerage by an Institutional Investor in a Hedge Fund to Compensate the Broker for Research Provided to the Investor.** The term “hedge fund” is not defined under Canadian securities law; the marketplace uses this term to refer to funds that leverage their assets through the use of derivative contracts.

In this transaction, the dealer is not receiving payment for goods or services provided to the manager. Nevertheless, the manager has a general obligation to act in the best interests of the beneficiaries of the fund, including the requirement to satisfy “best execution” obligations when directing brokerage. Consequently, commissions may only be used as payment for goods and services that are for the benefit of the beneficiaries. Directing brokerage at the request of one investor will not satisfy these obligations.

**Transaction 8—Directing of a Portion of One Fund’s Brokerage by Three Investment Companies to Benefit All Three Companies.** As in Transaction 7, the manager must act to the benefit of the beneficiaries. Because this transaction appears to benefit the beneficiaries, the transaction would not be prohibited.

**Summary.** Transactions 1, 5, and 7 are prohibited by the Soft Dollar Policies. Transaction 1 provides

the manager with a good that does not qualify as an “investment decision-making service.” Transaction 5 provides the plan trustee with a benefit that the trustee is not entitled to receive under pension benefits standards legislation. Similarly, Transaction 7 uses brokerage commissions in a manner that is not in the best interests of the beneficiaries of the fund. These transactions, therefore, do not “survive” XYZ’s initial analysis under applicable Canadian law.

## Sample Reports

The following sample reports are intended to clarify the disclosure obligations contemplated under Standard VI, which imposes on an Investment Manager the duty to provide certain information on Client request. Where relevant, reference is provided to the applicable Standard.

### Sample Report A

Client Name:

Date of Report:

Investment Firm:

Time Period Covered (12 months):

1. Total Dollar Amount of Commissions Generated from Client Account, Detailed by Broker [C.2.a.]

Broker X:	\$230,000
Broker Y:	\$650,000
Broker Z:	\$120,000
Total Amount:	\$1,000,000
2. Total Dollar Amount of Brokerage Directed by Client [C.2.b.] \$267,000

### Sample Report B

Client Name:

Date of Report:

Investment Firm:

Time Period Covered (12 months):

Description of Research Purchased through Soft Dollar Arrangements on a Firmwide Basis, Detailed by Broker [C.1]

Broker A

- Access to health care analysts
- Access to biotech analysts

Broker B

- Bloomberg services
- Reuters services
- Oil industry reports and analyses

Broker C

- Market analysis of fixed-income instruments