NICSA

"THE BEST EXECUTION QUAGMIRE": SOLUTIONS FOR SUCCESSFUL NAVIGATION

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DAVID A. STURMS is a partner of Vedder, Price, Kaufman & Kammholz and a member of its investment services practice in its Chicago office. Vedder Price provides a full range of services to a diverse financial services clientele. The firm's investment services group, one of the largest in the country, is experienced in all aspects of investment company, investment adviser, broker-dealer, bank, ERISA and tax matters. Clients include hundreds of open and closed-end fund portfolios (with assets ranging from less than $100 million to the multi-billion dollar level), investment advisers, group trusts, investment limited partnerships and other pooled-investment vehicles.

Prior to joining Vedder, Price, Kaufman & Kammholz, Mr. Sturms was a principal of the investment management firm Stein Roe & Farnham, also serving as a Vice President and Legal Counsel of the Stein Roe Mutual Funds. Mr. Sturms has extensive experience in advising investment companies and investment advisers on all aspects of the Investment Company Act of 1940 and the Investment Advisers Act of 1940, and in counseling independent directors of investment companies on their duties and responsibilities under the law. He is a frequent speaker and author on investment management issues, including mergers and acquisitions of investment companies and investment advisers, federal and state registration of investment companies and investment advisers, investment company independent directors, money market funds, mutual fund advertising and derivative instruments. Mr. Sturms also served on the Investment Company Institute's SEC Rules and State Liaison Committees as well as the money market funds, advertising, compliance, creditor's rights and various other ad hoc committees. Mr. Sturms currently is a member of the Chicago Bar Association's Investment Companies Sub-Committee and Investment Services Sub-Committee and the American Bar Association's Investment Company Sub-Committee. Mr. Sturms also serves on the Illinois Securities Advisory Committee.

I. BEST EXECUTION

A. The Nature of the Fiduciary Relationship Between the Adviser and its Clients

To understand an Adviser's best execution obligations, one must first understand the basic nature of the fiduciary relationship between the Adviser and its clients.

1. Common Law Agency Principles

Under common law, the fiduciary relationship between an Adviser and its client is founded on principles of agency. Under the common law, agents are fiduciaries who owe certain fiduciary duties to their principals regarding matters within the scope of their agency. These duties arise by reason of the agent's undertaking "to act primarily for the benefit of [the principal] in matters connected with his undertaking."[1]

Extending this common law principle of agency, the courts and the Securities and Exchange Commission (the "Commission" or the "SEC") agree that Advisers, like agents, are fiduciaries and owe certain fiduciary duties to their clients.[2]

Under common law agency principles, the agent's fiduciary duties vary depending upon the nature of its relationship with the principal. The courts and commentators have found that a higher level standard of fiduciary duty will arise in situations where greater trust and reliance is placed on the agent. In applying agency principles to Advisers, the courts and the Commission have concluded that clients place "the highest degree of trust and confidence" in their Advisers. In the absence of a different standard effectively established by agreement, the courts will likely impose a high standard of conduct on an Adviser, since Advisers, by the nature of their relationship with clients, generally ask for and receive a high level of trust and confidence.[3]

Although the existence and extent of the fiduciary duties of an agent to its principal generally may be determined by agreement between the parties, there are practical limitations on the ability of the Adviser to restrict the duties it owes to its clients. If the Adviser's limited duties as agreed to by the client are later found by a court to be "unfair" to the client, there may be a presumption that the client did not exercise informed and independent consent, and the Adviser's conduct could be deemed fraudulent. The burden would be on the Adviser to prove that it had obtained fully informed and independent consent from its client. If

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[1] RESTATEMENT (SECOND) OF AGENCY " 13 comment a (1958).

[2] *See*, Arleen W. Hughes, 27 S.E.C. 624, 635 (1948), *aff" d* 174 F.2d 969 (D.C. Cir. 1958).

[3] As a general rule, "[t]he existence and extent of the duties of the agent to its principal are determined by the terms of the agreement between the parties [creating the relationship], interpreted in light of the circumstances under which [the agreement] was made, except to the extent that fraud, duress, illegality, or the incapacity of one or both of the parties to the agreement modifies it or deprives it of legal effect." RESTATEMENT (SECOND) OF AGENCY " 376 (1958). Where the agreement does not specifically define the extent of the agent"s duties, the courts will impute those duties and standards of conduct that are reasonable and fair in light of common experience.

an Adviser wishes to negotiate duties lesser than those duties which a reasonable person would expect, the Adviser must provide sufficient disclosure to overcome any claim of fraud, which, as a practical matter, may be difficult.

A fiduciary relationship may be found to exist prior to the agreement establishing the agency. Under common law, the Adviser, as agent, is under a duty to deal fairly with the client, and to disclose all facts that the Adviser knows or should know would reasonably affect the client's judgment, at least with respect to arranging the terms of compensation of the employment. With regard to terms other than compensation, the Adviser is limited in negotiating the advisory agreement by the standards of fraud, duress, illegality and incapacity. In sum, the common law fiduciary duties and standards applicable to agents generally will be imputed to an Adviser, unless there is an effective agreement to the contrary. Such common law duties include the duty of care and duty of loyalty.

Regardless of whether there is a heightened degree of trust and confidence in the relationship between an Adviser and its clients, as a practical matter an Adviser needs to provide a high degree of disclosure to satisfy either (1) the standard that it did not commit fraud, or (2) the standard that it dealt fairly with its clients and obtained fully informed and independent consent to any adverse interest. At a minimum, the Adviser must disclose any and all facts that the Adviser knows or should know could reasonably affect the client's decision. If a client is not a sophisticated investor, the Adviser must ensure that the client understands all of the implications of the limitation of the Adviser's fiduciary duties. The Adviser must determine whether the client is capable of exercising, and does, in fact, exercise, independent judgment. Because each of these standards is subjective, there are no hard and fast rules that tell an Adviser what it must do to limit its fiduciary duties.

Under an imputed duty of loyalty, the Adviser may take an interest in a transaction connected with its advisory duties, which is potentially adverse to its client's interest only with the client's informed consent. In seeking the client's consent, the Adviser must deal fairly with the client and disclose all facts that the Adviser knows or should know could reasonably affect the client's judgment. If the adverse interests of the Adviser are such that the transaction is unfair to the client, a presumption will arise that the client did not exercise independent and informed consent.[4]

2. Federal Law

(a) The Advisers Act

[4] It should be noted that a client"s consent to an adverse interest does not relieve the Adviser of its other fiduciary duties. For example, even if the Adviser discloses adequately the receipt of a commission on a transaction that it executes on behalf of its client, the Adviser must satisfy its duty of care and skill by having a reasonable basis for recommending the transaction as well as a good faith belief that the transaction is in the best interests of its client.

Federal regulation of Advisers arises primarily under the Investment Advisers Act of 1940 (the "Advisers Act"). Under the Advisers Act, an Adviser is a fiduciary to its clients. While the Act does not enumerate specifically all the fiduciary duties which an Adviser owes its clients, several sections of the Act impose duties similar to those arising under common law agency principles. For example, Section 205 sets forth fiduciary duties regarding the fee charged by an Adviser and the ability of an Adviser to assign the advisory contract.

Section 206 of the Advisers Act is the provision most often cited by the courts in connection with an Adviser's fiduciary duties.[5] The precise fiduciary duties owed by an Adviser under Section 206 are unclear, due to that section's broad language. The Supreme Court's decision in Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.,[6] however, offers the best available guidance as to how fiduciary duties under Section 206 may be identified and construed. The Supreme Court in Capital Gains examined the legislative history of the Advisers Act and concluded that Congress found that a "delicate fiduciary relationship" existed between an Adviser and its clients. The Court in Capital Gains did not rule that the mere existence of a conflict of interest is per se fraudulent. However, the Court interpreted Section 206(2) of the Advisers Act as providing that the failure of an Adviser to fully disclose any potential or existing material conflict of interest constitutes a "transaction, practice or course of business which operates as a fraud or deceit" and therefore, is a violation of Section 206. The disclosure requirement of Capital Gains applies even if the Adviser treats its clients fairly and places their interests above its own.

The Capital Gains analysis could be applied to any of the fiduciary duties of an Adviser existing under common law. Unless otherwise agreed, clients can reasonably expect that their Advisers will adhere to the industry standards for the duties of care, skill, loyalty and any other duties that are imputed to an Adviser under common law principles. In order to enter into an advisory relationship based upon other than normal industry standards, or to vary the

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[5] Section 206, 15 U.S.C. 80b-6 (1981), provides:

It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly

(1)to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction;

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

[6] 375 U.S. 180 (1968).

standards at a later time, it is generally advisable for the Adviser to provide disclosure and obtain the client's consent.

The Advisers Act imposes an objective standard regarding the adequacy of disclosure similar to the standards established under other federal securities laws. In Capital Gains, the Court reasoned that in order to ensure that an Adviser's advice was disinterested, the Advisers Act "empowers the courts to require disclosure of material facts." Although the standard for "materiality" is not defined in Capital Gains, that term, as it is used in the Securities Act of 1933 and the Securities Exchange Act of 1934, is defined in TSC Industries, Inc. v. Northway[7] to be an objective standard.[8]

In interpreting the requirements of the Advisers Act, the Commission and its staff have, with relative consistency, followed the holding of Capital Gains and looked to the duties under the common law of agency in determining when a matter is required to be disclosed. Under Capital Gains, an Adviser may enter into a transaction in which the Adviser has an interest that conflicts with the interest of its client, provided the Adviser fully discloses its interest. Indeed, many of the rules adopted by the Commission are consistent with the theory that, with sufficient disclosure, conflicts of interest or other variations from common law agency standards are permissible under the Advisers Act.

Under the Advisers Act, the test is not whether a particular person actually understood the implications of the transaction, but whether there was sufficient disclosure so that a reasonable person would have understood the implications.[9] The Ninth Circuit, in examining an Adviser's conduct under Section 206, found that the Adviser's conduct "must be measured from the viewpoint of a person unskilled and unsophisticated in investment matters." A conservative conclusion is that all disclosure materials prepared by an Adviser should be drafted for the unsophisticated advisory client.

Thus, under the Advisers Act, the Adviser generally may engage in practices where it has a conflict of interest, provided that full and fair disclosure is provided to the client regarding the nature and extent of the Adviser's adverse interest and any possible consequences which the conflict might have upon the client. The degree of disclosure required is dependent upon the complexity of the proposed transaction and the adverse interest at issue. In general, a blanket consent to a course of conduct obtained through a general disclosure that does not address potentially disadvantageous consequences to the client may be viewed by the Commission as inadequate.

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7 426 U.S. 438 (1976).

8 Specifically, in TSC Industries, Inc. the Court held that a fact would be deemed material if there is "a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of a reasonable shareholder."

9 The objective standard of materiality was applied in connection with the Advisers Act in Sullivan v. Chase Investment Services of Boston, Inc., 79 F.R.D. 246 (N.D. Cal. 1978). The Sullivan Court cited the standard in TSC Industries, Inc. as the appropriate standard for judging the materiality of misrepresentations and omissions under Section 206 of the Advisers Act.

Regardless of the degree of disclosure actually given by the Adviser, if the disclosed transaction is not one to which a reasonable person fully informed of the material facts would consent, courts are likely to presume that the disclosure was not adequate. For example, the staff of the Commission has taken the position that a specified arrangement may be so complicated that it would be difficult to fashion sufficient disclosure. Indeed, in the past, the staff has gone even further and said that the conflicts of interest created by the arrangement in question were so corrupt in nature that the existence of the conflict itself would be deemed fraudulent. This latter position, which goes well beyond the finding in Capital Gains, has been the subject of substantial criticism. Indeed, a special advisory committee to the Commission properly questioned how "something could be fully disclosed and still be fraudulent."

Advisers should bear in mind when preparing disclosures concerning particularly troublesome conflicts of interest that the disclosure will be judged after the fact. Where an arrangement has proved to be particularly disadvantageous to the client, the disclosure will be more closely scrutinized.

(b) ERISA

If an Adviser manages accounts that hold assets of an ERISA plan, the Adviser is subject to ERISA, which imposes additional overlapping and in some respects superseding fiduciary duties. A "fiduciary" under ERISA is any person who:

- exercises discretionary authority or control respecting the management of an ERISA plan or its assets,
- renders investment advice for a fee, or
- has discretionary authority or responsibility in the administration of the plan.[10]

A plan sponsor and a plan administrator are fiduciaries by virtue of their authority and responsibility in the administration of the plan and the overall management of its assets. An Adviser is a fiduciary with respect to any ERISA account it manages by virtue of its rendering its investment advice for a fee.

Unlike under the Advisers Act and common law, the fiduciary duties of an Adviser subject to ERISA are imposed by statute and may not be varied except pursuant to and in accordance with a statutory or administrative exemption. Section 404 of ERISA imposes duties on each plan fiduciary to act for the exclusive benefit of the plan participants and beneficiaries and to exercise the care, skill and diligence that a prudent man acting in a like capacity and familiar with such matters would exercise under like circumstances. The Department of Labor ("DOL") has interpreted ERISA's exclusive benefit rule and the prudent

[10] ERISA " 3(21)(A).

man rule as requiring an Adviser in all events to obtain the best execution of all of the transactions it executes on behalf of its ERISA accounts.

In addition to complying with these general fiduciary duties, an Adviser subject to ERISA must not engage in any of the prohibited transactions set forth in Section 406, absent a statutory or administrative exemption. ERISA Section 406(a)[11] prohibits a fiduciary from causing a plan to enter into certain kinds of transactions with a "party in interest." Section 406(b)[12] prohibits a fiduciary from dealing with plan assets in such a way as to benefit itself or acting in ways which would constitute a conflict of interest. Section 406, on its face, would prohibit an Adviser from executing transactions on behalf of an ERISA plan with an affiliated broker or otherwise entering into a transaction or engaging in a business practice that creates an interest on the part of the Adviser that may conflict with the interests of the plan, unless such practice is otherwise exempted.

The strictness of Section 406 is tempered by Section 408, which provides for certain specified exemptions from the prohibited transaction rules. This section empowers the DOL to grant conditional or unconditional exemption for individual fiduciaries or transactions or for a particular class of fiduciaries or transactions. Of particular interest to Advisers are Section 408(b)(2) and Prohibited Transaction Class Exemption 86-128.[13] Section 408(b)(2) exempts from the prohibitions of Section 406(a) the payment by a plan to a party in interest for a service performed by such party in interest if: (a) the service is necessary for the establishment or operation of the plan, (b) the service is furnished under a contract or arrangement which is reasonable, and (c) no more than reasonable compensation is paid for the service. PTE 86-128 exempts from the prohibitions of Section 406(b) the effecting or execution by plan fiduciaries of certain securities transactions.

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11 Section 406(a) provides that except as provided in Section 408:

(1) A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect:

(A) sale or exchange, or leasing, of any property between the plan and a party in interest;

(B) lending of money or other extension of credit between the plan and a party in interest;

(C) furnishing of goods, services, or facilities between the plan and a party in interest;

(D) transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan; or

(E) acquisition, on behalf of the plan, of any employer security or employer real property in violation of section 407(a).

(2) No fiduciary who has authority or discretion to control or manage the assets of a plan shall permit the plan to hold any employer security or employer real property if he knows or should know that holding such security or real property violates section 407(a).

12 Section 406(b) provides as follows:

(b) A fiduciary with respect to a plan shall not:

(1) deal with the assets of the plan in his own interest or for his own account, (2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or (3) receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

13 51 Fed. Reg. 41,686 (1986).

(c) Which Law Governs?

In determining how to conduct its brokerage placement practices, the Adviser must keep in mind that all client-related transactions must meet both federal and common law requirements. In addition, the Adviser must comply with any applicable state statutes regulating Advisers. As a general rule, compliance with common law also will assure compliance with federal securities laws and vice versa. However, one body of law occasionally will impose a higher degree of care upon an Adviser than will another. For example, common law and federal securities laws impose different standards regarding the amount of disclosure required by an Adviser with an interest adverse to that of its clients.

Common law requires: Disclosure sufficient to be understood by each particular clie

Advisers Act requires: Disclosure sufficient to be understood by a reasonable person.

Thus, in a case where an Adviser has an unusually unsophisticated and dependent clientele, common law would require that it provide sufficient disclosure so that the most unsophisticated and dependent client could provide independent and informed consent.

One notable exception to this general rule is found in Section 28(e) of the Securities Exchange Act of 1934 discussed below. That section, which provides a safe harbor for the practice of paying soft dollars for research under certain circumstances, supersedes any other federal or state law. Another interesting distinction to note between federal and common law is that a private right of action for damages to an aggrieved client is not available under Section 206 of the Advisers Act. This, however, provides little comfort to an Adviser who is subject to Commission sanctions under Section 206 and the possibility of injunctive relief for violations of the Advisers Act. Finally, Advisers managing ERISA accounts or investment company assets must satisfy any additional obligations imposed under applicable federal statutes.

B. The Adviser's Fiduciary Duties in Brokerage Placement Practices: The Development of the "Best Execution Rule"

The application of common law principles of agency by the courts and the Commission to the Adviser's selection of brokers to execute client securities transactions has resulted in the recognition of a duty of the Adviser to obtain the "best execution" of those transactions. The parties may, by express agreement, establish a different standard, but absent such an enforceable agreement, the duty of best execution will apply. The Adviser's duty to seek best execution as currently defined by the Commission hereinafter shall be referred to as the Best Execution Rule.

Although the obligation of an Adviser to obtain best execution was originally interpreted by the Commission as a rigid rule requiring the Adviser to obtain the best net price, regardless of other circumstances, the Commission currently defines the duty to obtain best execution as requiring an Adviser to seek the best combination of price and execution, taking into consideration the full range and quality of a broker's services, including the value of research and other services provided, execution capability, commission rate, responsiveness and financial responsibility.

1. Origin and Development of the Best Execution Rule

Under common law principles, agents employed to buy or sell for the principal have a duty, unless otherwise agreed to by the parties, to use reasonable care to obtain terms which best satisfy the objectives of the principal. The courts have interpreted this imputed duty, when applied to brokers, as requiring the broker to secure the highest market price obtainable when selling securities for a client. The Commission continued this line of reasoning, holding that a broker "was obligated to obtain for [his clients] the best possible prices and to divulge all profits he made."[14]

The Commission extended theories previously applied to brokers to an Adviser, but expressly allowed the Adviser to deviate from the standard of best execution, provided that sufficient disclosure was made. In Arleen W. Hughes,[15] the Commission noted that the imputed standard under the fiduciary duty of loyalty requires the Adviser to execute its clients' securities transaction at the best price. The Commission stated, however, that the Adviser could fulfill its duty of loyalty in this regard even if it did not obtain the best price for its client's securities, provided that the Adviser fully disclosed the best price at which the securities transactions could be effected elsewhere. Thus, the Commission recognized that the imputed duty of best execution does not apply to an Adviser that fully discloses that it will not obtain the best execution of its client's securities transaction.

In Kidder, Peabody & Co., Inc.,[16] the Commission applied the rule enunciated in Arleen W. Hughes in a different fashion requiring the Adviser to obtain the best net price for the securities in the transactions executed on behalf of its clients. The Commission stated that "[o]ne of the basic duties of a fiduciary is the duty to execute securities transactions for clients in such a manner that the clients' total cost or proceeds in each transaction is the most favorable under the circumstances." The Commission determined that the Adviser was obligated to execute the securities transactions as an agent, thereby securing the best net price on behalf of its clients.[17] Thus, the initial focus of the Adviser's duty of best execution was solely on the price of the security and the execution costs. As explained below, however, this "best net price" standard was viable only under a fixed commission rate system, which was not to last.

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14 In Herbert R. May and Russel H. Phinny, 27 S.E.C. 814 (1948).

15 27 S.E.C. 629 (1948).

16 49 S.E.C. 911 (1968).

17 In Kidder, Peabody & Co., Inc., the Commission did not dispute that the securities transactions were effected on behalf of the clients at the best available prices. Nevertheless, the evidence demonstrated that the commissions charged by the Adviser for securities transactions it effected on an agency basis were lower than the markups and markdowns that it charged on transactions it executed as a dealer.

Prior to May 1, 1975, the New York Stock Exchange ("NYSE") fixed the commission rates that could be charged by its members for trades executed on the exchange. These fixed rates far exceeded the brokers' costs in executing large orders. Accordingly, brokers competed for brokerage business by offering a number of arrangements under which the Advisers or their clients could recoup some benefit of such "excessive" commissions. One such practice was the soft dollar transaction. In a soft dollar transaction, a broker would typically provide financial or investment research or other products and services to the Adviser, in addition to performing securities execution services, in return for the standard commission. The "excessive" commission rates, by stimulating soft dollar transactions, served to finance the preparation and wide dissemination of broad-based investment research, which Advisers came to rely upon in performing their advisory services. Because commission rates were fixed, these soft dollar arrangements generally did not result in higher costs and, thus, did not present a challenge to the best net price standard.

In Delaware Management Co.,[18] the Commission addressed the issue of whether an Adviser was prohibited from obtaining a price for its client other than the best net price available in order to obtain research products and other services. The Commission took a narrow view of the Adviser's best execution obligation, indicating that an Adviser was not justified in paying a price other than the best price available in order to obtain research. The Commission noted that it was "common practice" to execute portfolio transactions through broker-dealers who provide research or statistical services to Advisers of investment companies. Nevertheless, the Commission reasoned that "[w]here the investment company . . . receives something less than the best prices and executions solely because the executing broker provides research services to the investment adviser, the assets of the investment company are in effect used to enrich the investment adviser at the expense of the fund shareholders."

The Commission held that the Adviser's practices in Delaware Management Co. constituted a fraud upon the client (under Sections 206(1) and (2) of the Advisers Act, Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder) because the Adviser had disclosed that it would follow the practice of seeking the most favorable prices and executions of orders, which was directly contrary to the practice actually followed. The Commission's opinion did not directly address whether the Adviser's practice would have been permissible with the proper disclosure, but implies that it would have been. Thus, a reasonable interpretation of Delaware Management Co. is that is a disclosure case, which does not impose an absolute duty to seek the most favorable prices and executions of orders. By finding that failure by an Adviser to disclose that the Adviser would not seek best execution would be materially misleading, the Commission implicitly determined that "best execution" would be the presumed standard of behavior of Advisers, but not the required standard of behavior.

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[18] Delaware Management Co., Inc. Exchange Act Release No. 8128, [1966-1967 Transfer Rules] Fed. Sec. L. Rep. (CCH) ¶77,468 (July 14, 1967) (an Adviser to an investment company paid soft dollars for research and the distribution of the investment company shares by selling, through a broker-dealer firm that provided the Adviser with research, its clients' securities at a lower price than the Adviser could have obtained through another broker-dealer that did not provide such research).

Regardless of this actual, more limited holding of the case, Delaware Management Co. was interpreted by the money management industry as prohibiting an Adviser from consummating a securities transaction at an inferior price regardless of the value of any research or other services provided by the executing broker. Accordingly, as the industry moved toward fully negotiated commission rates, concern arose with respect to the viability of the process by which broad-based research was being prepared and widely disseminated by brokers. Specifically, the industry was concerned that Delaware Management Co. might be interpreted as prohibiting Advisers from paying soft dollars to brokers for research if commissions were to be fully negotiated.

In response to these and other concerns, in February 1972 the Commission issued a policy statement on the Future Structure of Securities Markets,[19] wherein it stated:

> In our opinion, the providing of investment research is a fundamental element of the brokerage function for which the bona fide expenditure of the beneficiary's funds is completely appropriate, whether in the form of higher commissions or outright cash payments.

The Commission quickly became concerned that the Policy Statement was being interpreted by the public as relieving Advisers of their best execution obligation. In response, it issued a release interpreting the Policy Statement, clarifying that it did not sanction the disregard of the best execution obligations of Advisers, but rather that it sanctioned consideration of other factors in addition to price and commission rates in seeking and determining best execution. In this subsequent release, the Commission noted that:

> [A]n investment manager should have discretion, in assigning an execution or negotiating the commission to be paid therefor, to consider the full range and quality of a broker's services which benefit the account under management and need not solicit competitive bids on each transaction. Requiring a manager to seek the lowest possible commission cost could interfere with the purpose and obligation of managers to seek best performance by excluding the accounts they manage from information, analysis and service which may be of value to them.[20]

Implicit in both the Policy Statement and the subsequent release is the premise that investment research distributed by brokers benefits not only the Adviser, but its clients as

[19] SEC Policy Statement - Future Structure of the Securities Markets, 37 Fed. Reg. 5286 (1972) Fed. Sec. L. Rep. (CCH) No. 409, 35-49 (Feb. 4, 1972).

[20] Applicability of the Commissions Policy Statement on the Future Structure of the Securities Markets to Selection of Brokers and Payment of Commissions by Institutional Managers, Securities Act Release No. 5250, Exchange Act Release No. 9598, Advisers Act Release No. 318 [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) " 78, 776 (May 9, 1971).

well. The Commission reasoned that an Adviser may purchase products and services that benefit its clients by paying commissions on its clients' securities transactions that are higher than the lowest rates available. This was not to be considered a retreat from the position the Commission took in Delaware Management Co., but merely an extension of its policy to an era of competitive rates. Accordingly, the Commission noted that where there is no self-dealing and an Adviser is not affiliated with the broker, "it is reasonable to presume that the commission rate paid . . . reflects the full range and quality of the broker's service and is in the beneficiary's best interest," but that Advisers must "stand ready to demonstrate that such expenditures were bona fide." Where an Adviser is affiliated with or has a relationship with the broker, however, the Commission cautioned that "particular care must be exercised so that the Adviser's fiduciary obligation to act solely in the interest of the beneficiary is satisfied."

Despite these statements by the Commission, the advisory industry continued to have concerns about satisfying its fiduciary duties with respect to client brokerage placement in a fully competitive commission rate structure. As a result, Congress began in 1973 to consider legislation dealing with this issue. On January 23, 1975, the Commission adopted Rule 196-3 under the Securities Exchange Act of 1934, which abolished fixed commission rates as of May 1, 1975.[21] On June 4, 1975, the President signed into law the Securities Act Amendments of 1975, abolishing fixed commissions as a matter of statutory law. Included in the 1975 Amendments was Section 28(e) of the Securities Exchange Act of 1934, which provided that an Adviser could not be held to have breached its fiduciary duty "solely by reason" of purchasing research with soft dollars.

Various comments by the Commission have led Advisers to question whether Section 28(e) should be interpreted as a statutory exemption or a safe harbor rule. Depending upon the context, Section 28(e) may be either. The legislative history of the 1975 Amendments indicates that Congress considered Section 28(e) to be a safe harbor rule. Section 28(e), which provides that an Adviser will not be deemed to have breached its fiduciary duties under the Best Execution Rule solely by paying soft dollars for research if the conditions of the section are met, can be seen as establishing a safe harbor. A transaction that falls outside of the safe harbor does not automatically result in a breach of an Adviser's fiduciary duties. On the other hand, Section 28(e) operates as a statutory exception with respect to ERISA and the fiduciary duties imposed upon Advisers thereunder. As discussed below, an Adviser to an ERISA account may not pay soft dollars for research without the exemption provided by Section 28(e), even though to do so would not be in derogation of the Adviser's duties under the Best Execution Rule.

In response to various questions that arose regarding Section 28(e), the Commission issued an interpretative release in 1976 which noted the position of the Commission that products and services that were "readily and customarily available" to the public on a commercial basis "were not entitled to the protection of Section 28(e)." The "commercially available" standard led to a significant amount of uncertainty and confusion on the part of Advisers. This interpretation by the Commission was unduly restrictive; Section 28(e) and its

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[21] Exchange Act Release No. 11203 [1974-1975 Transfer Rider] Fed. Sec. L. Rep. (CCH) ¶ 80,867 (June 23, 1975).

legislative history clearly indicate that the terms "brokerage" and "research" should have broad meaning encompassing all forms of investment advice, analysis and execution services.

On April 25, 1986, some ten years after its initial Section 28(e) release and in the midst of a different regulatory climate, the Commission issued a release in which it clarified its interpretation of the Best Execution Rule.[22] Specifically, the Commission stated that when an Adviser places brokerage on behalf of a client's account, the " . . .determinative factor [to be considered] is not the lowest possible commission cost but whether the transaction represents the best qualitative execution for the managed account." Thus was completed the evolution of the Adviser's best execution duty from a rigid requirement to seek the best net price available to a more flexible standard under which the Adviser can consider the full range and quality of the broker's services in determining whether it is obtaining best execution.

2. Elements of the "Best Execution Rule"

Under the Best Execution Rule, the Adviser is required to seek to obtain the best qualitative execution of its clients' orders. In selecting brokers, the Adviser may consider the broker's execution capability, commission rates, responsiveness and financial responsibility and the value of brokerage and other products and services provided.

(a) Execution Capability

In selecting a broker, one of the primary factors the Adviser should consider is the execution capability of the broker. In this context, execution capability means the relative ability of a broker to execute an order at the best available price. A broker may have different execution capabilities with respect to different types of orders and different types of securities. For example, a market maker may have excellent execution capability with respect to the securities in which it makes a market, but relatively poor execution capabilities with respect to other securities. Or a broker may have good execution capability with respect to most orders of exchange traded securities, but poor execution capability with respect to large block positions. Accordingly, an Adviser may be required to allocate its orders among different brokers depending upon the type of transaction and the execution capabilities of the brokers selected.

(b) Commission Rates

The Adviser's consideration of the commission rates charged by a broker is similar to, and an extension of, its consideration of the broker's execution capabilities. Generally, the Adviser should consider the broker's commission rates applicable to various types of transactions. With respect to over-the-counter traded securities, the Adviser should consider the broker's policies with respect to markups and markdowns.

(c) Value of Products and Services Provided

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22 Soft Dollar Arrangements, Exchange Act Release No. 23170, 4 Fed. Sec. L. Rep. (CCH) ¶26,579A (April 23, 1986).

Consistent with its obligations under the Best Execution Rule, an Adviser may pay soft dollars for certain types of products and services, provided certain conditions are met. An Adviser may pay soft dollars for products and services, provided the Adviser can demonstrate that the amount which it pays is commensurate with a reasonable and good faith determination of the value of the products or services obtained. An Adviser in effect pays soft dollars for products or services furnished by an executing broker either when the broker obtains a transaction price for the subject securities that is other than the best available market price (a rare situation) or when the broker charges commission rates or markups that are higher than the rates otherwise generally available for execution of a similar securities transaction.

(d) Responsiveness and Financial Responsibility

In selecting a broker, the Adviser is further permitted to consider the responsiveness of the broker to the Adviser's requests. The term "responsiveness" encompasses a number of factors, including the willingness of the broker to take a financial risk on the execution of large block orders, the accommodative nature of the broker's representatives, its accuracy in preparing confirmations, or other similar factors. In selecting a broker, an Adviser may consider the overall willingness and ability of the broker to accommodate the Adviser's needs. Although the responsiveness of the broker may not in itself justify the broker's selection by the Adviser, it may be taken into account as a factor to be considered along with the other factors discussed above. Moreover, the Adviser may (and should) consider the broker's financial responsibility and such other factors as may affect the Adviser's confidence in the broker.

The Best Execution Rule does not require the Adviser to obtain the "best possible execution" of or "best net price" for each and every securities transaction it places on behalf of its clients. Rather, the rule requires the Adviser to exercise reasonable and good faith judgment in selecting a broker that it reasonably believes will consistently provide "valuable services" for its clients for a "reasonable fee." The value of the products and services and the reasonableness of the fee should be evaluated in light of fees generally charged in the industry for similar products and services. Indeed, where the Adviser is not affiliated with the broker selected and has no interest in the transaction by reason of receipt of research or other products and services, there would be a strong presumption that the Adviser satisfied its obligations under the Best Execution Rule, provided it performs adequate monitoring and evaluation activities. On the other hand, where an Adviser selects an affiliated broker or a broker that provides products and services to the Adviser, the Adviser must be able to demonstrate that it reasonably and in good faith determined that the broker was capable of consistently providing valuable products and services for the Adviser's clients for a reasonable fee.

II. Investment Company Board of Directors and Soft Dollars

A. Soft Dollars

Because brokerage commissions are generally viewed as an asset of an investment company (a "Fund"), it is appropriate for the board of directors of a Fund to consider an Adviser's portfolio trading policies, including, in particular, the use of soft dollars. Attached as Annex A is a sample memo to a Fund board of directors. Below is an analysis of a board's duties with respect to soft dollars.

The term "soft dollars" has come to describe a variety of practices - some covered by the "safe harbor" in Section 28(e) of the Securities Exchange Act of 1934[23] and others not. Therefore, it is important to clarify at the outset the three major variations of so-called "soft dollar" arrangements:

(a) The first practice – "proprietary research" - involves the provision to an Adviser by executing brokers of the brokers' internally-produced investment research in return for agency trading business, usually in unspecified amounts. Typically, proprietary research does not have an identified price and is not available for cash or "hard dollar" payments. Accordingly, an Adviser does not commit, either formally or informally, to any particular level of commission business to receive this research. These arrangements generally are covered by the safe harbor in Section 28(e); in fact, it was primarily this type of arrangement that Congress arguably sought to protect in enacting Section 28(e).

(b) The second practice – "third-party research" - involves payment by executing brokers of a portion of their agency commissions to third parties for research products or services provided by those third parties to advisers. Typically, these products or services have a hard-dollar price and are available for cash purchase; and payments are made by the executing brokers in accordance with a "conversion ratio" agreed upon between an Adviser and the broker (e.g., 1.6 to 1 or \$1.00 of research for every \$1.60 in commissions). Because the broker usually has advanced cash to purchase the research product or service from the third party, the Adviser will be expected, or may make at least an informal commitment, to transact enough business with the broker to cover the purchase. Although not specifically described by Congress in enacting Section 28(e), the SEC staff has taken the position that this type of arrangement can fall within the safe harbor provided,

[23] Section 28(e) provides in part: No person using the mails, or any means or instrumentality of interstate commerce, in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law unless expressly provided to the contrary by a law enacted by the Congress or any State subsequent to June 4, 1975, solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion.

among other things, that the products and services qualify as research.

(c) The third practice – "directed brokerage" – is using agency commissions to pay expenses for the account whose trades are generating the commissions. In these cases, the client (e.g., a pension plan sponsor or a mutual fund), rather than the Adviser, establishes the arrangement with the broker and then asks the Adviser to place a target percentage or dollar amount of the account's trades through the designated broker. The broker pays the account expenses (such as custodian fees, transfer agent fees, printing bills, and the like), again in accordance with an agreed-upon conversion ratio. The Section 28(e) safe harbor is not available here for various reasons, including the fact that the recipient of the soft dollar benefits is not the party exercising investment discretion over the account. However, if structured properly, the safe harbor is not necessary, as this is in essence the account recapturing a portion of its own asset – the brokerage commissions on its portfolio trades.

B. Fiduciary Duties

Fund directors and trustees ("directors"), like corporate directors generally, are subject to certain fiduciary duties which have largely been delineated by court cases. One of those duties, the duty of care, requires directors to act with reasonable care and skill in light of their actual knowledge and any knowledge they should have obtained in functioning as directors. As noted by the United States Supreme Court, the 1940 Act places unaffiliated directors in the enhanced role of "independent watchdogs," entrusted with "the primary responsibility for looking after the interest of the funds' shareholders."[24]

Commensurate with their duty of care, fund directors may bear some responsibility to recognize that a fund's order flow is a valuable asset (an asset that belongs to the fund), and to see that the fund obtains concrete benefits, directly or indirectly, from that order flow. The question of what broker-dealer to use for portfolio transaction execution services is normally a management matter for the Adviser to decide, but directors may establish broad policies for management to follow, including whether the fund should use broker-dealers that offer soft dollar brokerage arrangements.

A somewhat analogous situation to the current soft dollar focus arose in the early 1970s, during the era of fixed commission rates, when courts were called upon to decide whether fund advisers and directors had any duty to recapture, on behalf of their funds, excess brokerage

[24] Burks v. Lasker, 441 U.S. 471 (1979).

commissions generated on fund portfolio transactions. In Tannenbaum v. Zeller,[25] the Court stated that, while there was no per se duty to recapture such commissions, the directors had a responsibility to use their "informed discretion" to decide whether such recapture was in the fund's best interests. The Court explained:

> The decision to forego recapture here did not violate the fiduciary obligations of either the Fund's adviser or directors under Section 36 of the Investment Company Act if the independent directors (1) were not dominated or unduly influenced by the investment adviser; (2) were fully informed by the adviser and interested directors of the possibility of recapture and the alternative uses of brokerage; and (3) fully aware of this information, reached a reasonable business decision to forego recapture after a thorough review of all relevant factors.

The directors in Tannenbaum had an obligation to "reach a reasonable business decision" respecting recapture because recapture could provide a material economic benefit to the fund and its shareholders. Similarly, if soft dollar brokerage arrangements can produce material economic benefits for a fund, the Adviser also has an obligation to inform the directors of the possibility of such benefits, and the directors in turn have an obligation to make a "reasonable business decision" as to whether the fund should seek, or forego, those benefits.

In other words, the directors should consider whether to use the fund's assets (i.e., brokerage commissions), for the fund's own direct benefit (i.e., through directed brokerage) and/or whether to permit the adviser to use the fund's commissions for the adviser's direct benefit (i.e., by obtaining proprietary and third-party research), which in turn may benefit all the Adviser's clients, including the funds. In considering such action, the directors should weigh the advantages and disadvantages of the various types of soft dollar arrangements.

C. Research

1. Advantage

The primary advantage of allowing the adviser to use fund brokerage to obtain research is that the research provides the Adviser "lawful and appropriate assistance" in the carrying out of the adviser's responsibilities. As Congress recognized in enacting Section 28(e), broker-dealers provide an "important service" by "producing and distributing investment research" to advisers.

2. Disadvantages

[25] 552 F.2d 402 (2d Cir. 1977).

Notwithstanding the Section 28(e) safe harbor, the use of brokerage commissions to purchase research services leads to potential conflicts of interest between the Adviser and the funds. These potential conflicts are as follows:

(i) Best Execution. Soft dollar arrangements may motivate an adviser, in order to obtain research services, to ignore its best execution obligations by directing fund transactions to brokers who could not adequately execute the transactions.[26]

(ii) Churning. Soft dollar arrangements may give advisers incentives for excessive trading of fund securities to generate soft dollar credits for research services.

(iii) Advisory Fees. Soft dollar arrangements diminish the ability of a fund to evaluate the expenses it incurs in obtaining portfolio management services and may hinder the ability of the fund to negotiate fee agreements, because the costs of Adviser services are "hidden" from the fund in brokerage commissions. By permitting Advisers to use fund brokerage to pay for research services that the advisers otherwise would have to purchase with "hard dollars," soft dollar arrangements permit Advisers to charge fees that do not fully reflect the cost of portfolio management.

D. Directed Brokerage

1. Advantage

The primary advantage for a fund to direct brokerage is that the fund may realize a cost savings to the extent that the commissions charged by the broker are less than the cost of the services paid for by the broker plus the commissions charged by other brokers that do not provide such services.

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[26] Measuring "best execution" is, at best, an art, and certainly not a science. It is, therefore, often difficult to measure whether a soft dollar broker is providing execution equivalent to an execution-only broker. Logic suggests, however, that there is no free lunch. Much of the proprietary research probably would be produced anyway by brokerage firms, in which case it may add no incremental cost to the trading function. However, a broker who charges $.06 per share and sends $.03 to a third-party research provider has, in essence, executed the trade for $.03 per share. Brokerage firms should be expected to understand their cost structures and respond accordingly. For example, a number of major institutional brokers who engage in soft-dollar business use separate trading desks (or even separate entities) to handle third-party research trades. While these brokers insist that execution quality at the two desks is the same, some have suggested that it is unlikely that one desk may be willing to give away half or more of its gross commissions.

2. Disadvantage

As with soft dollar arrangements under which the Adviser receives research services, a fund may risk sacrificing best execution and may create an environment that motivates excessive trading. As the SEC staff noted in the Market 2000 report: Where the client directs a large proportion of its commissions to a particular broker, the Adviser may feel pressured to use that broker for trades that the broker cannot capably handle, regardless of the client's *pro forma* instruction to use the broker only where "consistent with best execution." Directed brokerage also constricts the Adviser's use of soft dollars by diverting many trades to the broker selected by the client rather than to the soft dollars broker desired by the Adviser. These conflicting demands on commission dollars could tempt an Adviser to trade more frequently than that Adviser otherwise would, or to execute trades pursuant to a soft dollar arrangement that the Adviser otherwise would reserve for special handling. This, in turn, could threaten execution quality and impair account performance.

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Annex A

SAMPLE BOARD MEMO ON PORTFOLIO TRANSACTION POLICIES AND PROCEDURES

To: The Board of _______________

Re: Portfolio Transactions Policies and Procedures

As the Boards are aware, issues regarding mutual fund portfolio transactions policies and procedures have received a lot of attention recently. To assist the Boards in their oversight duties, we have consolidated in this report various information that has been previously discussed with the Boards (both in writing and orally), along with additional new information where necessary to supplement the discussions.

General Portfolio Transaction Procedures

The Adviser places the orders for Fund portfolio transactions with the overriding objective of seeking the best combination of price and execution.

Brokerage Allocation (including "soft dollars")

With respect to transactions involving brokerage commissions, when more than one broker is believed to be capable of providing the best combination of price and execution, the Adviser will often direct the trade to a broker that has furnished it with research. Commissions are directed in two ways:

1. through the Adviser's Equity Trading Desk for research provided generally to the Adviser consisting of:

    a. traditional in-house broker research

    b. "third party" services

2. by the Fund portfolio managers for research provided directly to the Funds.

Allocation of Transactions

The Adviser's overriding objective, both in priority of execution and allocation of price, is fairness to its clients. Generally, orders are processed and executed on a first-in, first-out basis (with delineated exceptions).

Use of Fund Brokerage to Pay Fund Expenses

The Funds do not attempt to use brokerage to pay Fund expenses.

Recapture of Underwriting Concessions

The Funds do not attempt to recapture underwriting discounts or selling concessions (except, to the extent practical, in tax-exempt and foreign securities).

GENERAL PORTFOLIO TRANSACTION PROCEDURES

The Adviser places the orders for the purchase and sale of each Fund's portfolio securities and options and futures contracts. The Adviser's overriding objective in effecting portfolio transactions is to seek to obtain the best combination of price and execution. The best net price, giving effect to brokerage commissions, if any, and other transaction costs, normally is an important factor in this decision, but a number of other judgmental factors may also enter into the decision. These include: the Adviser's knowledge of negotiated commission rates currently available and other current transaction costs; the nature of the security being traded; the size of the transaction; the desired timing of the trade; the activity existing and expected in the market for the particular security; confidentiality; the execution, clearance and settlement capabilities of the broker or dealer selected and others which are considered; the Adviser's knowledge of the financial stability of the broker or dealer selected and such other brokers or dealers; and the Adviser's knowledge of actual or apparent operational problems of any broker or dealer. Recognizing the value of these factors, a Fund may pay a brokerage commission in excess of that which another broker or dealer may have charged for effecting the same transaction. Evaluations of the reasonableness of brokerage commissions, based on the foregoing factors, are made on an ongoing basis by the Adviser's staff while effecting portfolio transactions. The general level of brokerage commissions paid is reviewed by the Adviser, and reports are made annually to the Board of Trustees.

With respect to issues of securities involving brokerage commissions, when more than one broker or dealer is believed to be capable of providing the best combination of price and execution with respect to a particular portfolio transaction for a Fund, the Adviser often selects a broker or dealer that has furnished it with research products or services such as research reports, subscriptions to financial publications and research compilations, compilations of securities prices, earnings, dividends, and similar data, and computer data bases, quotation equipment and services, research-oriented computer software and services, and services of economic and other consultants. Selection of brokers or dealers is not made pursuant to an agreement or understanding with any of the brokers or dealers; however, the Adviser uses an internal allocation procedure to identify those brokers or dealers who provide it with research products or services and the amount of research products or services they provide, and endeavors to direct sufficient commissions generated by its clients' accounts in the aggregate, including the Funds, to such brokers or dealers to ensure the continued receipt of research products or services the Adviser feels are useful. In certain instances, the Adviser receives from brokers and dealers products or services that are used both as investment research and for administrative, marketing, or other non-research purposes. In such instances, the Adviser makes a good faith effort to determine the relative proportions of such products or services which may be considered as investment research. The portion of the costs of such products or services attributable to research usage may be defrayed by the Adviser (without prior agreement or understanding, as noted above) through brokerage commissions generated by transactions by clients (including the Funds), while the portions of the costs attributable to non-research usage of such products or services is paid by the Adviser in cash. No person acting on behalf of a Fund is authorized, in recognition of the value of research products or services, to pay a commission in excess of that which another broker or dealer might have charged for effecting the same transaction. Research products or services furnished by brokers and dealers may be used in servicing any or all of the clients of the Adviser and not all such research products or services are used in connection with the management of the Funds.

With respect to a Fund's purchases and sales of portfolio securities transacted with a broker or dealer on a net basis, the Adviser may also consider the part, if any, played by the broker or dealer in bringing the security involved to the Adviser's attention, including investment research related to the security and provided to the Fund.

BROKERAGE ALLOCATION

BACKGROUND

A. History of Soft-Dollar Arrangements

Under long-standing applications of common law agency principles and the Federal securities laws, an investment adviser has a duty to obtain the best combination of price and execution in buying and selling securities on behalf of a client. A number of judgmental factors make up the "Best Execution Rule," one of which is the level of brokerage commissions paid. While commission rates are a <u>factor</u> that must be considered, they are not determinate. An investment adviser may also consider such factors as a broker's execution capabilities, a broker's willingness and ability to accommodate a trade, and the broker's financial and operational condition. Recognizing these and other factors, an adviser may effect a trade at a brokerage commission in excess of what another broker would have charged for the same transaction.

Prior to May 1, 1975 ("May Day"), the level of brokerage commissions was, in essence, a non-factor because commission rates were fixed. This fixed commission schedule resulted in commissions being paid to brokers that were, for most trades, far in excess of the brokers' cost. Accordingly, brokers competed for brokerage business by offering research products and services to investment advisers in return for the fixed commission. (This practice became known as a "soft dollar" arrangement.)

On May 1, 1975, fixed commission rates were abolished and brokers were free to compete on commission rates. The investment community, however, was concerned that such competition could result in the unbundling of broker-provided research services, which would inhibit or eliminate the receipt of such services, which, in turn, could affect the level of services provided overall by an adviser to its clients. Furthermore, the investment community was concerned that if an investment adviser continued to participate in soft dollar arrangements, such adviser could be considered to have violated its fiduciary duty to its clients to obtain Best Execution. In response to those concerns, Congress enacted Rule 28(e), as a safe harbor, which provided that an adviser could not be held to have breached its fiduciary duty "solely by reason" of purchasing research with soft dollars.

Over the years, the 28(e) safe harbor has, in addition to preserving the continued flow of traditional "in-house" research to investment advisers, fostered the development of "third party" research services.

B. Soft-Dollar Arrangements Under Section 28(e)

1. <u>Conditions.</u> Products/services may be acquired through allocation of commissions (but not dealer selling concessions on underwriting discounts on new issues) under Section 28(e) if the following conditions are met:

(a) The product/service must be "brokerage or research" related (as opposed to "administrative" in nature). A person is considered to provide "brokerage or research" if he:

(i) furnishes advice, either directly or through publications or writings, as to the value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of securities or purchases or sellers of securities;

(ii) furnishes analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts; or

(iii) effects securities transactions and performs functions incidental thereto (such as clearance, settlement, and custody) or required in connection therewith, by rules of the Commission or a self-regulatory organization of which such person is a member or person associated with a member in which such person is a participant.

(b) The adviser must determine in good faith that the value of the product/service is commensurate with the cost thereof;

(c) Where products/services have a "mixed use," the adviser must make a reasonable allocation of the cost of the products/services in accordance with the adviser's anticipated research and non-research uses, and the cost attributable to non-research use must be paid for in hard dollars;

(d) <u>Section 28(e) protects only the allocation of commissions paid in securities transactions.</u> The SEC staff has opined that principal transactions, including riskless principal transactions, and commissions paid on futures transactions do not fall within the protection of Section 28(e). Therefore, the allocation for research of dealer selling concessions and underwriting discounts in purchases of new issues is *not* permitted; and

(e) The product/service must be provided to the adviser by the executing broker (or its correspondent broker); acquisition of third party research may be permissible but only if the broker (not the adviser) is obligated to pay the third party producer for the research.

2. Permissible Products/Services. A particular product/service may be paid for in soft dollars *only* if it provides "lawful and appropriate assistance to the money manager in the performance of his investment decision making responsibilities." The SEC generally will not express a view as to whether a specific product/service may be paid for in soft dollars, but the following classification of

items is widely accepted. The item marked with an asterisk usually has a mixed use requiring a cost allocation between research (permissible) and non-research (impermissible) uses.

(a) Permissible Items

- Investment research publications and subscriptions
- Computer hardware and quotation equipment*
- Fees for research conferences and seminars
- Performance rating services used in investment process

(b) Impermissible Items

- Overhead expenses (*e.g.*, office space, typewriters, furniture, clerical assistance)
- Expenses incidental to research conferences/seminars (*e.g.*, air fare, hotels, meals, entertainment)
- Performance rating services used for client reporting/new business presentations

Adviser's Brokerage Allocation Policies

The Adviser, the investment adviser to the Funds, places the orders for the purchase and sale of portfolio securities on behalf of each Fund. The Adviser's overriding objective in effecting portfolio transactions is to seek to obtain the best combination of price and execution (*i.e.*, the Adviser follows the Best Execution Rule).

A. Commission Rates

In effecting trades, the Adviser uses the following commission rate schedule (although the Equity Trading Department uses its best judgment in negotiating commissions and, in some cases, may agree to a higher or lower commission):

(a) $50 flat fee per trade for trades of 0-499 shares;

(b) $0.10/share for trades of 500-1999 shares; and

(c) $0.07/share for trades of 2000 shares or more, subject to negotiation.

B. Brokerage Allocation

With respect to transactions in securities involving brokerage commissions, when more than one broker is believed to be capable of providing the best combination of price and execution, the Adviser will often direct the trade to a broker that has furnished it with research. Commissions are directed for research in one of two ways: (1) through the Advisers's Equity Trading Desk for research provided generally to the Adviser[27]; and (2) by the Fund portfolio managers for research specifically for their respective Funds.

1. The Adviser Firm-Wide Research

The Adviser's Director of Research and his professional staff periodically prepare "target" brokerage allocation lists for research products and services received by the firm. The list has two parts: (1) traditional in-house research received from brokers, and (2) research products and services received from brokers ("third party" services).

(a) Traditional In-House Research

The Adviser generally receives traditional in-house research from most of the brokers through which it executes trades. On a periodic basis, the Adviser research analysts grade the level of research received by the firm. Based upon those grades, the Adviser develops target commission dollars that it endeavors to direct so as to ensure that it continues to receive traditional in-house research that it feels is useful. [Attached as Exhibit 1 is the research target list and status report.]

(b) "Third Party" Services

In addition to the traditional type of in-house research that the Adviser receives from most of the brokers through which it executes trades, the Adviser also receives what is called "third party" services. Third party services generally include the types of products and services that may be available on a hard-dollar basis. In evaluating such services, the Adviser attempts to ascribe both a soft-dollar and a hard-dollar price for the services. Like the target list for traditional research, the Adviser also develops target commission dollars that it endeavors to direct so as to ensure that it continues to receive the services that it feels are useful. [Attached as Exhibit 2 is the third party research target list and status report. Attached as Exhibit 3 is a description of current third party research soft-dollar services.]

[27] Section 28(e) does not require an adviser to trace the benefit derived from a particular research service to the account of the client paying the commission to the broker which provided the service. Thus, for example, an adviser permissibly may allocate commissions on transactions for the accounts of clients invested solely in equity securities to a broker providing research services related to fixed-income securities.

2. Fund-Specific Research

In addition to the Adviser firm-wide research, each of the equity Fund portfolio managers may also direct up to 25% of the Fund's commission dollars to pay for research products/services used by such Fund.

SUMMARY
For the Year Ended 12/31/9_

	Fund A	Fund B	Fund C	Fund D	Fund E
Total Commissions Paid					
Average Commission Rate					
In-House Research					
Total Commissions Paid					
Percent of Total Commissions					
Average Commission Rate					
Third Party Research					
Total Commissions Paid					
Percent of Total Commissions					
Average Commission Rate					
Fund-Specific Research					
Total Commissions Paid					
Percent of Total Commissions					
Average Commission Rate					

PROCEDURES FOR EXECUTION AND ALLOCATION OF ADVISER CLIENT PORTFOLIO TRANSACTIONS

OBJECTIVES

- Fairness to clients both in the priority of execution of orders for their accounts and in the allocation of the price (and commission, if applicable) obtained in execution on aggregated orders for the accounts of more than one client.

- Timeliness and efficiency in the execution of orders.

- Accuracy of the Adviser's records regarding orders given for client accounts and of client security positions, in compliance with applicable regulatory requirements.

GENERAL PROCEDURES

- Orders are executed only based on written trade tickets received by the trading desk. Similarly, the modification or cancellation of any client transaction, whether at the request of the portfolio manager or the trading desk, must also be recorded in writing on a trade ticket.

- All orders are time-stamped automatically if entered through the automated order entry system or manually if entered on a hand-written ticket. Tickets are time-stamped a second time upon receipt by the trading desk of notification of execution.

- Orders are generally processed and executed on a first-in, first-out basis, in the order received by the trading desk, with the following exceptions:

    - In the interest of efficiency, execution of orders for the accounts of clients which have designated particular brokers to be used on a "restricted" basis may and generally will be delayed until execution of other pending (non-designated or "free-to-execute") orders has been completed.

    - Traders may, in consultation with the responsible portfolio manager, delay the execution of orders in a particular security when, in their judgment, market conditions in the security to be purchased or sold make such delay advisable.

    - When the trader has been advised or is otherwise aware that multiple orders for the purchase or sale of the same security can be expected, the earliest orders received may be held unexecuted, to be aggregated for block execution with later orders received.

AGGREGATED ("BLOCK") EXECUTIONS

- All client accounts participating in an aggregated execution shall receive the same execution price (and commission, if any).

- Where the full amount of the aggregated order is not executed, the partial amount actually executed shall be allocated among the participating client accounts pro-rata on the basis of order size, subject to rounding to "round lot" amounts. Partial order tickets shall be re-written for the remaining unexecuted amounts.

- Where the executing broker-dealer establishes an intra-day "average pricing" account to collect series of "working order" executions during the course of the trading day, the full amount actually executed shall be allocated to the participating client accounts at the average price (and commission, if any) actually obtained before the end of the day to close out the position in the average price account.

    - "Average price" account amounts may *not* be carried overnight without allocation to client accounts.

    - Partial order tickets shall be re-written for the remaining unexecuted amounts, if any.

<u>NEW ISSUES</u>

- All managers must indicate interest <u>by account or fund</u> at least 24 hours prior to the pricing of the deal.

- The Adviser's allocation will be distributed on the basis of equity assets under management for each <u>individual account or fund</u>.

- If, after the allocation process, a manager decides that the position allocated is too small to be maintained in the original interested account or fund, those unwanted shares must be sold in the secondary market. Shares may not be reallocated to other accounts or funds. (Cross-transactions between mutual funds may be allowed under Rule 17a-7 procedures.)

- Accounts with restricted brokerage are not eligible to participate in new issue offerings.

- All allocations will be made in round lots, with the accounts with the least equity assets being allocated first.

USE OF FUND BROKERAGE TO PAY FUND EXPENSES

From time to time, the Funds and the Adviser are approached with proposals to use Fund brokerage to pay Fund expenses. Because the Funds' brokerage is an asset of Funds, the manner in which the Fund brokerage is used is periodically reviewed by the Funds' Boards of Trustees.

The Boards of Trustees have reviewed the legal issues pertaining to and the costs (in terms of cost and research to the Adviser from "soft dollars" and the risk of sacrificing best execution) from using Fund brokerage to pay Fund expenses and have adopted a policy of a not seeking to use Fund brokerage to pay Fund expenses.

However, as new proposals from the brokerage community are presented to the Funds and the Adviser, the Funds' officers will evaluate such proposals and, if appropriate, review them with the Boards.

RECAPTURE OF UNDERWRITING CONCESSIONS

The Board of Trustees has reviewed the legal issues pertaining to and the practicability of attempting to recapture underwriting discounts or selling concessions when portfolio securities are purchased in underwritten offerings. However, the Board of each Trust has adopted a policy of not seeking recapture of transaction costs from securities firms in United States distributions, except as to tax-exempt securities and foreign securities, because of restrictions imposed under the Rules of Fair Practice of the National Association of Securities Dealers.

EXHIBIT 1

IN-HOUSE RESEARCH COMMISSIONS

Brokerage Firm	Target	Actual Commissions	YTD Balance

EXHIBIT 2

THIRD PARTY RESEARCH COMMISSIONS

Brokerage Firm	Research Service	Target	Actual Commissions	YTD Balance

EXHIBIT 3

DESCRIPTION OF CURRENT THIRD PARTY RESEARCH
SOFT-DOLLAR SERVICES

Amex Quotes (Price information) used as pricing inputs on American Stock Exchange-listed securities on all Adviser terminals with intraday prices. Hard dollar price based on usage is estimated at $32,000; soft dollar target through Boston Institutional is $48,000.

Bloomberg Services (Securities analysis package and market information) used by Fixed Income Research. Hard dollar price is $50,625; soft dollar target is $101,000 through Interstate.

CMS (Bond portfolio analysis system) used by bond department. Hard dollar varies with usage, but is estimated at $54,600; soft dollar target is $109,200.