

FEDERAL RESERVE BANK OF DALLAS
DALLAS, TEXAS 75222

Circular No. 80-214
November 7, 1980

PROPOSED POLICY STATEMENT CONCERNING THE USE OF BROKERAGE
COMMISSIONS TO PAY FOR RESEARCH SERVICES

TO THE CHIEF EXECUTIVE OFFICER
OF THE STATE MEMBER BANK OR
TRUST COMPANY ADDRESSED IN THE
ELEVENTH FEDERAL RESERVE DISTRICT:

Enclosed are the Board's press release and proposed policy statement concerning payments to brokers for research and brokerage services by trust institutions subject to the Board's supervision.

Sincerely yours,

Robert H. Boykin

First Vice President

Enclosure

FEDERAL RESERVE press release



For immediate release

October 27, 1980

The Federal Reserve Board today proposed for public comment a policy statement concerning payments to brokers for research and brokerage services by trust institutions subject to the Board's supervision.

The Board asked for comment by December 22, 1980.

The proposed policy statement would apply to the trust activities of State member banks and State-chartered nondeposit trust companies that are subsidiaries of bank holding companies.

It would call upon such institutions to establish written policies and procedures -- where the trust department exercises investment discretion over accounts of customers -- for the internal identification and review of brokerage commission practices involving payment for research services using brokerage commissions, and for the disclosure of its commission practices to owners of the accounts.

The Board proposed the policy statement in connection with a provision of the Securities Exchange Act permitting money managers to pay reasonable commissions in excess of the lowest commission rates available in order to pay for brokerage and research services.

The Board invited comment particularly on:

- The impact of the proposed policy statement where the bank has authority, in a nondiscretionary account, to select the broker to be used.
- Whether the regulatory impact on smaller institutions can be lightened by the inclusion in the policy statement of a de minimus rule.

These and other provisions of the proposed policy statement are spelled out in the attached notice of the Board's proposal.

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Attachment

FEDERAL RESERVE SYSTEM

Policy Statement Concerning the Use of
Brokerage Commissions to Pay for Research Services

[Docket No. R-0330]

AGENCY: Board of Governors of the Federal Reserve System

ACTION: Proposed Policy Statement

SUMMARY: This policy statement reflects the judgment of the Board that each trust institution subject to the Board's supervisory jurisdiction 1/ exercising investment discretion over the accounts of customers should: (1) establish written policies and procedures providing for the identification and periodic review of so-called "soft-dollar" practices involving the payment for research services with brokerage commissions to ensure compliance with applicable provisions of law, and (2) prepare and make available to its customers a disclosure statement setting forth specific information relating to the brokerage and research services received from, or on behalf of, brokers in exchange for commission dollars. A sample disclosure statement is provided to aid trust institutions in the making of such disclosures.

COMMENT PERIOD: All comments should be received by December 22, 1980.

ADDRESS: Comments, which should refer to Docket No. R-0330, may be mailed to Theodore E. Allison, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, Northwest, Washington, D.C. 20551, or delivered to Room B-2223 between 8:45 and 5:15 p.m. Comments received may also be inspected at Room B-1122 between 8:45 and 5:15 p.m., except as provided in section 261.6(a) of the Board's Rules Regarding Availability of Information (12 CFR § 261.6(a)).

FOR FURTHER INFORMATION CONTACT; Robert S. Plotkin, Assistant Director ((202) 452-2782), or Walter R. McEwen, Attorney ((202) 452-2521), Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, Washington, D. C. 20551.

SUPPLEMENTARY INFORMATION: Prior to the May 1, 1975 elimination of fixed commission rates charged by brokers which execute transactions on national

1/ State member banks and State-chartered, nondeposit, trust company subsidiaries of bank holding companies.

securities exchanges, it had been common practice for many brokers to provide research analysis and other market services and to compete on the basis of these services as well as on the basis of execution capacity. Money managers, including bank trust departments, were able to obtain research and other services from brokerage firms at no cost beyond the fixed commission rate then in effect for the execution of securities transactions; in effect, paying for such services with so-called "soft-dollars." The elimination of the fixed commission rate structure, however, threatened to disrupt this practice since many money managers feared that, under fiduciary law, they would be obliged to seek the lowest execution cost for transactions and the payment of higher commissions for execution plus research could give rise to liability. This could have interrupted the availability and distribution of research services with potentially harmful consequences to investors. In order to prevent such an occurrence, section 28(e) was added to the Securities Exchange Act of 1934 to provide a safe harbor for money managers that use commission dollars, at rates in excess of the lowest rates available, to pay for brokerage and research services where the money manager has determined that the commission paid is reasonable in relation to the value of the services provided by the broker-dealer.

Since the enactment of section 28(e), considerable uncertainty has arisen concerning the extent to which specific products and services do qualify for the protections afforded by section 28(e)(1). In addition, a recent investigation by the Securities and Exchange Commission into soft dollar arrangements utilized by several money managers, including banks, disclosed practices that were not believed to fall within the safe harbor provisions and, in several cases, resulted in the reimbursement of commission dollars to the affected accounts.^{2/} Because failure to comply with the safe harbor provision of section 28(e) may subject the money manager to liability where certain products and services are acquired with commission dollars, the Board believes it is incumbent upon each trust institution subject to its supervisory jurisdiction to establish written policies and procedures providing for the identification and periodic review of practices involving payment for research services with commissions in order to ensure conformance with the provisions of section 28(e).^{3/} Moreover, the Board believes that the potential for liability can be further minimized and the public interest better served if disclosures of such practices are made known to interested customers.

^{2/} Securities and Exchange Act Release No. 16679, dated March 19, 1980.

^{3/} Where a trust institution acts as fiduciary with respect to an employee benefit plan, the failure to comply with section 28(e) could result in a violation of section 406(b)(3) of the Employee Retirement Income Security Act of 1974 which prohibits a fiduciary from receiving any consideration for his own account in connection with a transaction involving the assets of the plan.

To assist the Board in determining the feasibility of implementation of the policy and disclosure requirements contained herein, the Board invites comment on the provisions of this policy statement. In particular, comment is invited on that portion of the policy statement which would suggest establishment of written policies and procedures to ensure that commission dollars generated by nondiscretionary accounts be applied to the purchase of brokerage and research services (other than execution) only with the knowledge and consent of the customer or other holder of the direction power. This provision was inserted in recognition of the fact that the safe harbor provision of section 28(e)(1) literally is available only to persons "in the exercise of investment discretion with respect to an account." In some direction trusts the customer or other third party not only has the power to make investment decisions but also may direct the selection of the broker to be used in effecting transactions for the account. On the other hand, there may be some direction trusts where the bank has full authority to select the broker to be used in effecting transactions for the direction trust. Query: To what extent would this category of accounts be impacted by the proposed policy statement? Also, it should be noted that the policy statement as proposed contemplates that orders from discretionary and nondiscretionary accounts be separately identified.

The policy statement would make it clear that it does not apply to any trust institution which does not receive products and services for commission dollars from brokers other than brokerage services. The Board is concerned about the burden of compliance with the policy statement on smaller institutions and invites comment as to whether some other criteria might be used consistent with the Board's statutory responsibilities. For example, should an institution that paid brokerage commissions for research and execution services of not more than a de minimis dollar amount (say \$5,000) during the past year be exempt? Or should the institution be exempt where the total amount of commissions paid for research and execution did not exceed some de minimis percentage of total commissions paid? If so, what should such dollar amount or percentage be? In responding to these questions, it should be kept in mind that the Board is seeking information as to developing a cut-off point below which the payment of higher brokerage commissions in return for research services is not material to either the bank or the customer.

A regulatory impact analysis has been prepared; this analysis focuses on the burdens and benefits imposed by the proposed policy statement, as compared to alternative methods of dissemination of the same information. The conclusion of the regulatory impact analysis is that the proposed policy statement appears to be the most effective and least costly means of guaranteeing that disclosure statements be furnished only to those persons who desire the information provided in the disclosure statement.

The policy statement would be issued pursuant to the authority granted to the Board by section 28(e)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78 bb (e)(2)), and pursuant to the Board's supervisory authority contained in section 9 (12 U.S.C. § 321 et seq.) of the Federal

Reserve Act, the Financial Institutions Supervisory Act of 1966 (12 U.S.C. 1818 (b)), and the Bank Holding Company Act of 1956 (12 U.S.C. 1844 and 1847).

Statement of Policy Concerning the Use of
Brokerage Commissions to Pay for Research Activities

Section 28(e)(1) of the Securities Exchange Act of 1934, as amended, relieves money managers exercising investment discretion over accounts of customers of liability under fiduciary law that might accrue to them if they cause the accounts which they manage to pay a brokerage commission in excess of the amount another broker would have charged for effecting the same transaction if the higher commission is determined in good faith to be justified by the value of brokerage and research services provided by the broker. In order to rely upon this safe harbor provision, the following conditions must be observed: (1) The trust institution must exercise investment discretion over the accounts generating the commissions used to pay for the additional services provided; (2) the services acquired must be brokerage and research services and be provided by the broker to the trust institutions; and (3) the trust institution must determine in good faith that the commission being paid is reasonable in relation to the value of the services provided.

Since the enactment of section 28(e), considerable uncertainty has arisen concerning the extent to which specific products and services received in exchange for commission dollars do qualify for the protections afforded by section 28(e)(1). Because the types of products and services received in exchange for commission dollars are many and varied, the Board recognizes that it is not possible to establish definitive guidelines that would be applicable to all situations. For this reason, the burden necessarily falls upon each trust institution to satisfy itself by a good faith determination that its brokerage allocation practices qualify for the protections of section 28(e), if liability under fiduciary law is to be avoided or at least minimized. The Board, therefore, expects each trust institution subject to its supervisory jurisdiction that exercises investment discretion over the accounts of customers, to establish written policies and procedures, suitable to its circumstances, to ensure that its obligations under the law are properly observed. Such policies and procedures should, at a minimum provide for: (1) the identification and reporting to an appropriate senior management level of all services received for which commissions in excess of the lowest available commission rate, consistent with safe and speedy execution, are being paid; (2) the periodic review of such services to ascertain whether the services reasonably enhance the institution's research capability; and (3) the documentation of management's determination that the provision of such services justifies the amount of commissions paid. Operating procedures should also be established to ensure that commission dollars used or allocated for the payment of such products and services are generated only by: (1) accounts over which the institution exercises investment discretion; and (2) other accounts, with the knowledge and consent of the customer or other holder of the direction power.

The Board also recognizes that brokerage placement practices could have a material influence on the decisions of many persons in selecting a particular bank or trust institution to act in their behalf or on behalf of their designated beneficiaries in effecting securities transactions. Brokerage expenses may constitute a significant cost to a customer's account over a period of years. Although the use of commission dollars to pay for research services ultimately enhances the money managers' ability to service, in the aggregate, customers' accounts, it is possible that a particular account will be structured in such a way that research purchased with its commission dollars is of little or no use to the account. On the other hand, research services, which were obtained by commissions generated by other accounts, may be used to service a particular account. Accordingly, the Board believes that information concerning a trust institution's brokerage placement practices should be made available to its customers. However, the Board recognizes that not all customers would have an interest in this type of information and, indeed, some may even object to the unsolicited receipt of information of this nature. Accordingly, the Board concludes that the public interest would be served to the extent the customers of trust institutions are informed that a disclosure statement of this nature will be provided to them upon request.

Therefore, the Board expects each trust institution subject to its supervisory jurisdiction which exercises investment discretion over the accounts of customers and pays higher brokerage commissions in return for research services to prepare and make available to such customers a disclosure statement setting forth certain specific information relative to its brokerage allocation practices. To ensure that interested customers are aware of the existence of the disclosure statement, each such trust institution is expected to make part of, or append to, its fee schedules and periodic statements of account, a notice of the right to receive the disclosure statement, without charge and upon request.

The disclosure statement to be made available to interested customers should, at a minimum, (1) identify the general types of products and services, other than execution, for which a higher commission rate was paid than that which a competing broker may have charged for a similar transaction; (2) indicate the aggregate commission dollars allocated in payment of these services (including execution) during the previous calendar year stated both in dollars and as a percentage of total commission dollars paid during the previous calendar year; (3) indicate the extent to which any such arrangements permit the trust institution to recapture commissions paid on a transaction basis in lieu of purchasing certain goods and services; and (4) describe the use to which these services are put and indicate generally how they benefit the management of customers' accounts. The disclosure statement should be revised at any time there is a material change in the information required to be contained therein. A sample disclosure statement is attached for the guidance of trust institutions.

This policy statement would not apply to any trust institution which does not receive products and services for commission dollars from brokers other than brokerage services.

By order of the Board of Governors, October 23, 1980.

(Signed) Theodore E. Allison

Theodore E. Allison
Secretary of the Board

(SEAL)

SAMPLE DISCLOSURE STATEMENT

Brokerage and Research Services Acquired Through Allocation of Brokerage Commissions

We regularly utilize brokers in executing orders who have been selected on the basis of the amount and quality of brokerage and/or research services that they provide to us, either directly or through a third party. In return for such services, we pay a higher commission rate than that which a competing broker may charge for execution of the transaction alone. Services acquired in this manner are said to be acquired with "soft dollars" because they do not entail explicit payment of separate amounts for each component service that is provided.

Description and Use of Services

Specific services for which we have paid a higher commission rate than that which a competing broker would have charged are as follows: (Describe services received such as analytical reports, pricing tapes, market information, financial data, etc.). During 19__ (the previous calendar year), we allocated aggregate commission dollars, including cost of execution, amounting to \$_____ on transactions totalling \$_____ among _____ brokers in payment for these services. This amount represents ___% of total commission dollars paid during the calendar year.

None of the above service arrangements permit us to recapture for a client's account any commissions paid on a per transaction basis in lieu of the purchase of these services. In the case of each such arrangement, we have made a good faith determination that the amount of commissions paid is reasonable in relation to the value of the services received and reserve the right to terminate the arrangement at any time that we may determine that the value of the service no longer justifies the cost.

Effect of Brokerage Commission Payments Upon Accounts

The research services obtained from brokers in exchange for commission dollars provides us with information which improves the ability of our analysts to monitor the securities markets and to keep abreast of financial developments in the various companies whose securities are held in the accounts of our clients. The research received is used by us to service all of our managed accounts. However, not all such services may be used by us in connection with a particular account even though that account may have generated some of the commissions used to pay for the services. Alternatively, certain research services may be used in connection with a particular portfolio which were obtained with brokerage commissions generated by other accounts.