MEMO# 5530

January 27, 1994

TWO SEC CASES RELATED TO SOFT DOLLAR PRACTICES

January 27, 1994 TO: COMPLIANCE COMMITTEE NO. 1-94 INVESTMENT ADVISER ASSOCIATE MEMBERS NO. 7-94 INVESTMENT ADVISER MEMBERS NO. 7-94 SOFT DOLLARS TASK FORCE RE: TWO SEC CASES RELATED TO SOFT DOLLAR PRACTICES ____ The Securities and Exchange Commission recently imposed sanctions in one settled case and affirmed an appeal from an administrative law judge decision in another case, both of which related to soft dollar practices. A copy of both cases is attached. 1. Commission Settlement The Commission sanctioned an investment adviser and its president and majority shareholder in connection with their acceptance of "soft dollar" payments for investment advisory services. Specifically, the Commission found that, among other things, the investment adviser had entered into advisory service contracts providing that fees could be paid either in cash or with soft dollars. Clients who chose to pay in soft dollars were told that they could pay $1 in cash for every dollar of service purchased or $2 in soft dollars for the same services. The Commission found that the adviser failed to disclose in its Form ADV how fees were charged, including the fact that fees payable in soft dollars were twice the amount of fees payable in cash, and that the adviser received 15-20% more revenue for the same services when payment was made in soft dollars rather than hard dollars. The Commission also found that the adviser had failed to disclose the terms of its soft dollar arrangements with the relevant broker-dealers. The Commission found that the adviser willfully violated Sections 204 and 207 of the Investment Advisers Act and Rule 204-1(b) thereunder and that the president willfully violated Section 207 and willfully aided and abetted the other violations. The Commission also found that certain of the adviser's soft dollar clients had enough trading volume to generate more directed brokerage commissions than the amount needed to pay the adviser for its advisory services. The adviser offered to maintain bank accounts for these clients, and used the accounts to pay invoices for products and services at client direction. The adviser charged these clients 5% of the gross commissions generated for these services. The Commission found that the adviser thereby obtained custody of client funds but did not obtain surprise annual examination of the funds by an independent accountant, and failed to make certain related disclosure in its Form ADV. The Commission found that the adviser thus willfully violated Sections 204 and 206(4) of the Investment Advisers Act and Rules 204-1(b) and 206(4)-2 thereunder. Without admitting or denying the allegations, the adviser and the president consented to a cease and desist order, payment of civil penalties, registration of a brokerage subsidiary, and an independent audit of client funds in custody. 2. Commission Ruling on Appeal A registered investment adviser and one of its former principals appealed a decision from an administrative law judge, which found that the adviser, aided and abetted by the principal, had improperly used soft dollars. Specifically, the law judge found that the adviser's use of soft dollars to pay a consultant who assisted the adviser in hiring and training a new client services director was in violation of the antifraud, reporting and disclosure requirements of the Advisers Act. In responding to the respondents' assertion that the soft dollar arrangement was not in violation of the Advisers Act because it did not involve "paying up", the Commission concluded that nevertheless the adviser had an undisclosed conflict of interest. The respondents also argued that disclosure about the arrangement was not required because the amount of commissions used to satisfy the adviser's soft dollars obligations was not material in that thesoft dollar commissions constituted less than 1% of total commissions generated by the customer accounts for the year in issue. The Commission disagreed, concluding that the existence of this potential conflict of interest was a material fact that should have been disclosed to the adviser's clients. In addition, the Commission found that the services paid for by the soft dollars were not within the scope of the safe harbor in Section 28(e) of the Securities Exchange Act in that the adviser did not receive "brokerage and research services" and the services it did receive were not "provided by" a broker or a third party who had contracted with a broker. Based on the foregoing, the Commission agreed with the law judge that a censure of the adviser is appropriate in the public interest. The Commission, however, dismissed the proceedings with respect to the adviser's principal noting that he had an otherwise unblemished record after thirty years, was suffering from a progressive, terminal disease and is no longer in the business. Thomas M. Selman Assistant Counsel Attachments