

MEMO# 14291

January 4, 2002

SEC ISSUES INTERPRETATIVE GUIDANCE ON RISKLESS PRINCIPAL TRANSACTIONS UNDER SECTION 28(E) OF THE EXCHANGE ACT

[14291] January 4, 2002 TO: SEC RULES MEMBERS No. 1-02 COMPLIANCE ADVISORY COMMITTEE No. 1-02 EQUITY MARKETS ADVISORY COMMITTEE No. 1-02 INVESTMENT ADVISER MEMBERS No. 1-02 CLOSED-END INVESTMENT COMPANY MEMBERS No. 1-02 RE: SEC ISSUES INTERPRETATIVE GUIDANCE ON RISKLESS PRINCIPAL TRANSACTIONS UNDER SECTION 28(e) OF THE EXCHANGE ACT The Securities and Exchange Commission has issued interpretative guidance on the application of Section 28(e) of the Securities Exchange Act of 1934.¹ Section 28(e) provides a safe harbor to money managers who use the commission dollars of their advised accounts to obtain research and brokerage services. The SEC's interpretative guidance clarifies that the term "commission" for purposes of Section 28(e) encompasses, among other things, certain transaction costs, even if not denominated a "commission." Previously, the SEC interpreted Section 28(e) to be available only for research and brokerage services obtained in relation to "commissions" paid to a broker-dealer acting in an agency capacity. The SEC reconsidered its interpretation of Section 28(e) in response to a request by the Nasdaq Stock Market. The SEC states in the interpretative guidance that when it issued its initial guidance on Section 28(e) in 1995, an agency transaction had more cost transparency than a principal transaction and that fees on principal transactions were not quantifiable and fully disclosed in a way that would permit a money manager to determine that the fees were reasonable in relation to the value of research and brokerage services received. However, the SEC states that the NASD recently modified its trade reporting rules to require riskless principal transactions in which both legs of the transaction are executed at the same price to be reported once, in the same manner as an agency transaction, exclusive of any markup, markdown, commission equivalent, or other fee. The SEC further notes that under Rule 10b-10 of the Exchange Act, this price would be disclosed on a confirmation that also fully discloses the remuneration paid to the NASD member for effecting the transaction. 1 Securities Exchange Act Release No. 45194 (December 27, 2001). The interpretative guidance is available on the SEC's website at <http://www.sec.gov/rules/interp/34-45194.htm>. 2 In recognition of the increased transparency for these types of riskless principal transactions, the SEC determined to interpret the term "commission" in Section 28(e) of the Exchange Act to include a markup, markdown, commission equivalent or other fee paid by a managed account to a dealer for executing a transaction where the fee and transaction price are fully and separately disclosed on the confirmation and the transaction is reported under conditions that provide

independent and objective verification of the transaction price subject to self-regulatory organization oversight.² Ari Burstein Associate Counsel Attachment Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (<http://members.ici.org>) and search for memo 14291, or call the ICI Library at (202) 326-8304 and request the attachment for memo 14291. Attachment (in .pdf format) 2 Riskless principal transactions in the debt market and other securities that do not meet these conditions are not eligible to rely on the interpretation.

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