



UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

October 15, 1990

Ronald H. Hoenig
President
Hoenig & Co., Inc.
770 Lexington Avenue
New York, NY 10021

Re: Availability of Section 28(e) for Certain Principal Transactions.

Dear Mr. Hoenig:

This responds to your letter of August 29, 1990 in which you inquired about the Division of Market Regulation's views concerning whether money managers effecting certain transactions in exchange-listed securities, in which broker-dealers act in a principal capacity, would be entitled to rely upon the safe harbor in Section 28(e) of the Securities Exchange Act of 1934 ("Exchange Act").

As noted in your letter, on July 25, 1990, the Commission authorized the Division to issue a letter to the Department of Labor which indicated that principal transactions, including riskless principal transactions, are not afforded the protection of the safe harbor in Section 28(e). In the Division's view, transactions do not fall within the safe harbor if the broker-dealer executes the transaction as a principal. Moreover, the fact that the broker-dealer imposes a charge, that is denominated as a "commission" or "commission equivalent," rather than a mark-up, would not be relevant to the application of Section 28(e) if the firm, in fact, acted in a principal or riskless principal capacity. Thus, for example, a money manager would not be able to rely upon the safe harbor in Section 28(e) for transactions involving the purchase of securities through a broker-dealer, if the firm fills the order from its own inventory, or effects the transaction on a riskless principal basis, even though confirmation received by the money manager reflects a commission equivalent.¹ In summary,

¹ In this regard, the Division notes that Exchange Act Section 11(d)(2) and Rule 10b-10 require that a broker-dealer indicate the capacity in which it acts in executing a transaction. Where the broker-dealer is acting
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Section 28(e) applies to the amount of commission paid to a broker-dealer acting in an agency capacity, and a transaction fee paid to a broker-dealer for effecting a transaction in a principal capacity is not within the safe harbor, irrespective of the label placed on the fee.

As noted in the Division's letter to the Department of Labor, Section 28(e) provides a "safe harbor" from charges that a money manager paid more than the lowest amount of commission, if the money manager determines "in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by [the broker-dealer] viewed in terms of either that particular transaction or [the money manager's] overall responsibilities with respect to the accounts as to which he exercises investment discretion." The statute was enacted to alleviate the disruption in accepted market practices that might occur when fixed exchange commission rates were eliminated. A transaction that is not covered by Section 28(e), such as a transaction effected by a broker-dealer in a principal capacity, is not as a consequence necessarily illegal or improper. Rather, an evaluation of a transaction executed outside the safe harbor requires analysis of the requirements of particular applicable statutes, such as the Employee Retirement Income Security Act and the Investment Company Act of 1940, and of the general fiduciary principles embodied in the federal securities laws and state laws.

A money manager has a duty to obtain "best execution" of client transactions, whether or not the transaction is covered by Section 28(e). The Division believes that money managers executing transactions in large size ("block transactions") should consider carefully their best execution obligations. In certain situations, a money manager may obtain better overall execution by dealing with a broker-dealer that will commit its own capital (i.e., act in a principal capacity) for all or a portion of a block transaction. Although, as stated above, the portion handled by the broker-dealer as principal would not be covered by Section 28(e), if a better trade price execution was obtained through a broker-dealer

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as agent, Rule 10b-10 requires disclosure of the amount of commission. Where the broker-dealer acts in a principal capacity, Rule 10b-10 in some cases requires disclosure of the mark-up. Use of the term "commission," or use of similar terms, when the broker-dealer acts as principal in a transaction may be misleading and would not comply with the requirements of Rule 10b-10 where mark-up disclosure is required.

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with the ability to commit its own capital, that better trade price could far outweigh the benefit to the client of paying a lower commission rate to another broker-dealer without comparable execution facilities.

Sincerely,



Richard G. Ketchum
Director