



STATE INVESTMENT BOARD
BOARD ADOPTED POLICIES

POLICY NUMBER: 2.05.400

EFFECTIVE DATE: 9/16/99

TITLE: Soft Dollar

SUPERSEDES: 9/16/93

BOARD ADOPTION: 9/16/99

APPROVED: *James F. Parker*

PURPOSE:

This policy provides guidelines for the use of soft dollars by the State Investment Board (SIB).

Definition:

Soft dollar arrangements involve an informal or explicit understanding where, in exchange for brokerage commissions from transactions, SIB or SIB investment managers can receive soft dollar "credits" from a broker/dealer to pay for research or investment-related expenses. The amount of "credit" per commission dollar is negotiated between the soft dollar broker and their client (SIB or investment manager). SIB and the investment managers negotiating soft dollars with brokers can direct a percentage of the "credits" to SIB. Soft dollars are used to pay third-party providers for services through commission revenue, rather than direct payment of the funds through "hard dollars." Commission rebates (also known as commission recapture arrangements) may be negotiated in some circumstances in lieu of commission credits. Commission rebates are received in the form of "hard dollars."

Legal Authority:

Soft dollar arrangements are granted safe harbor against violation of a federal or state law if they meet the requirements of Section 28(e) of the Securities Exchange Act of 1934. That statute provides, in part, that "...no person... 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..." entered into certain soft dollar arrangements. As there have been no laws enacted either in Washington State or by Congress which expressly prohibit soft dollar arrangements, Section 28(e) remains applicable to the SIB.

Services provided to a fiduciary for soft dollar agreements must satisfy three criteria in order to be protected under Section 28(e):

1. Services must be "provided" by the broker, meaning that the broker must actually select or arrange for the services;
2. Services must be provided to an entity with investment discretion;
3. Services must be "brokerage and research" services, which are defined as:
 - a. furnishing advice, either directly or through publication or writings, as to the value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of securities or purchasers or sellers of securities;
 - b. furnishing analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts; or,
 - c. effecting securities transactions and performing functions incidental thereto (such as clearance, settlement, and custody) or required in connection therewith by the rules of the SEC or a self-regulatory organization of which such a person is a member or person associated with a member or in which such a person is a participant.

Computer equipment, software, and services related to investment research also fall within the provisions of Section 28(e). Services that are considered "readily and customarily available to the general public on a commercial basis", such as newspapers, magazines, periodicals, government publications, office equipment, etc., are not protected by Section 28(e) and cannot be purchased using soft dollars.

In addition to federal SEC regulations, the SIB is governed by state laws relating to expenditure authority, procurement, and accounting/reporting requirements. Such state laws may impose other restrictions on the types of services for which soft dollars may be used.

POLICY:

The generation of commissions is a by-product of the purchase and/or sale of public securities. It is standard operating procedure for many pension plans to use a portion of the commissions to defray expenses which otherwise would have been incurred in the implementation of the investment programs.

Commission recapture ("hard" dollar) arrangements are preferred over commission credit ("soft" dollar) arrangements and will be negotiated where prudent and feasible. Monies received from commission recapture arrangements will be returned to the fund(s) that originally generated the commission through investment transactions.

It is SIB policy, within the parameters cited below, to utilize soft dollars to defray necessary expenses.

Services:

1. Only those services that are "brokerage and research" services as defined above, or investment-related computer hardware and software, may be considered for soft dollar purchase;
2. "Brokerage and research" services includes "investment counseling" as that term is used in RWC 43.84.160.
3. The services or products obtained in this manner must be essential for the support of the investment programs and justifiable as an expenditure of unappropriated funds if the services or products were purchased directly;
4. The value of the services must be reasonable and represent a direct benefit to the SIB.

Investment Managers:

All SIB investment managers are required to achieve the "best net execution" on all investment transactions. Where that can be achieved and soft dollar credits are credited, the SIB will direct the manager to utilize brokerage firms and correspondent brokers firms with which the SIB has established a soft dollar arrangement.

Brokers:

1. The SIB will authorize the use of brokerage firms and correspondent brokerage firms that offer soft dollar arrangements. The brokerage firms must be capable of providing trade transactions based on "best net execution";
2. Brokerage firms, correspondent brokerage firms, and managers will proceed only upon specific written instructions concerning the purpose of the service, its cash value, and the expected commission required to satisfy the commitment. The terms under which the SIB will reimburse the broker will also be included in the confirmation of the soft dollar arrangement;
3. Staff (and external managers directed by staff) may direct a portion of the normal trading activity to brokers for reimbursement of third-party services provided to the SIB;

4. Brokerage firms and correspondent brokerage firms will get approval from the SIB on all invoices received for payment on behalf of the SIB and will provide to the SIB a copy of all invoices paid. A monthly statement identifying commissions received and the commission expectation balance will also be provided to the SIB for accounting purposes.

Payment Control:

1. The commission paid for the service may not exceed the combined cost of the brokerage service plus the additional goods or services had they been obtained separately.
2. SIB staff will record the cost ratio, expected commission commitment, provider of the service, and user for all soft dollar services provided. Records will be maintained to identify the trade and commissions generated. The correspondent broker will perform monthly reconciliation by balancing the manager and custodian commission reports to trade authorizations. Discrepancies will be resolved; staff will audit the reconciliation.
3. As the SIB negotiates trades with a broker with which it has a soft dollar agreement, the commissions that are generated from the transactions are applied to the repayment of the obligation.

Reporting:

1. SIB staff will prepare quarterly reports for executive staff reflecting service provided, expected commission, total commitment paid to date, and balance outstanding.
2. Annual detail reports will be produced by staff and submitted to the Board for their information.

PROCEDURES:

The executive director will establish appropriate internal controls and operating procedures for the approval, use, acquisition, payment, accounting, and reporting of soft dollars.

Original Policy adopted 9/16/93

Revised 9/6/99