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Client Alert

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SEC Approves Interpretive Guidance On Section 28(e) Soft Dollar Practices

Section 28(e) of the Securities Exchange Act establishes a safe harbor for money managers who use client funds to purchase brokerage and research services for their managed accounts. Under Section 28(e), a money manager is protected from liability for a breach of fiduciary duty solely on the basis of having paid more than the lowest commission rate to receive "brokerage and research services" provided by a broker-dealer, so long as the manager determines in good faith that the amount of the commission is reasonable in relation to the value of the brokerage and research services received.

Last October, the SEC published for comment a proposed interpretive release on Section 28(e), focusing particularly on the scope of brokerage and research services which may be paid for with client commissions (sometimes referred to as "soft dollars"). Last week, the SEC voted to approve the proposed interpretive release with few changes. The interpretive release will be effective upon publication in the Federal Register. However, money managers may continue to rely on prior SEC interpretations until six months after that date.

I. Summary

The new SEC Release takes into account evolving technologies and industry practices and is generally consistent with new UK Financial Services Authority rules. Third party research will continue to fall within the safe harbor, but physical items such as computer hardware generally will not.

The Release states that eligible research services are limited to advice, analyses and reports that reflect substantive content – that is, the expression of reasoning or knowledge. Accordingly, traditional research reports and market data are eligible for the safe harbor as research, but computer hardware, mass-marketed publications, office overhead and travel expenses are not.

The Release also clarifies the situations where a broker-dealer, in order to fall within the safe harbor, is deemed to be "effecting" the money manager's trades and "providing" research. The broker-dealer is deemed to be "providing" research to the manager if the broker-dealer is either legally obligated to pay for the research or pays the research preparer directly and takes steps to confirm that the services to be paid for with client commissions are eligible brokerage or research.

II. Section 28(e) Background

As fiduciaries, money managers are obligated to act in the best interest of their clients, and cannot use client assets (including client commissions, or soft dollars) to benefit themselves, absent client consent. Money managers who obtain brokerage and research services with soft dollars do not have to purchase those services with their own funds, which creates a conflict of interest for the money managers. Section 28(e) addresses these conflicts by permitting money managers to pay more than the lowest commission rate (sometimes referred to as "paying up") to obtain brokerage and research services, so long as they make a good faith determination regarding the reasonableness of commissions paid. Paying up under circumstances not protected by Section 28(e) could constitute a breach of fiduciary duty by the money manager under state or federal laws, including the Investment Advisers Act, the Investment Company Act and ERISA, and could subject broker-dealers to aiding and abetting liability if they facilitate the violation.

The SEC has interpreted Section 28(e) as encompassing commissions on agency transactions, as well as fees on riskless principal transactions in which both legs are executed at the same price and

the transactions are reported under NASD trade reporting rules. The safe harbor is not available for other principal trades or transactions in other instruments traded net with no explicit commissions. Further, client-directed brokerage transactions (whether to recapture a portion of the commission for the client or to pay client expenses such as sub-transfer agent fees, consultants' fees, or for administrative services) do not fall within the Section 28(e) because the safe harbor is available only to persons who are exercising investment discretion.

III. SEC's Interpretive Guidance

A. Brokerage and Research Services

The Release articulates that the analysis of whether a particular product or service falls within the safe harbor involves three steps. First, the money manager must determine whether the product or service is eligible research or eligible brokerage under Section 28(e). Second, the manager must determine whether the eligible product or service actually provides lawful and appropriate assistance in the performance of his investment decision-making responsibilities. Where a product or service has a mixed use, a money manager must make a reasonable allocation of the costs of the product according to its use. Finally, the manager must make a good faith determination that the amount of soft dollars paid is reasonable in light of the value of products or services provided by the broker-dealer.

1. Research Services

"Research services" are eligible for the Section 28(e) safe harbor. Under Section 28(e)(3), a person provides research services "insofar as he (A) furnishes *advice*, either directly or through publications 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; or (B) furnishes analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts."

In determining that a particular product or service falls within the safe harbor, the money manager must conclude that it constitutes "advice", "analyses" or "reports" within the meaning of the statute and that its subject matter falls within the categories specified in (A) or (B) above. These categories include other topics related to securities and the financial markets; *e.g.*, a report concerning political factors that are interrelated with economic factors could be within the scope of the safe harbor. The form (*e.g.*, electronic, paper or oral discussions) of the research is irrelevant.

As discussed above, an important common element among advice, analyses, and reports is that each reflects substantive content – that is, the expression of reasoning or knowledge. The content may be original research or a synthesis, analysis or compilation of the research of others. Thus, in determining whether a product or service is eligible as research under Section 28(e), the money manager must conclude that it reflects the expression of reasoning or knowledge and relates to the subject matter identified in Section 28(e)(3)(A) or (B). Traditional research reports analyzing the performance of a particular company or stock clearly would be eligible. Discussions with research analysts, meetings with corporate executives to obtain oral reports on the performance of a company, corporate governance research and corporate governance rating services, software that provides analyses of securities portfolios as well as seminars or conferences may all be eligible under Section 28(e) so long as they reflect the expression of reasoning or knowledge (i.e., furnishing advice) relating to the subject matter in Section 28(e)(3)(A) or (B), such as the advisability of investing in securities.

The Release distinguishes the eligibility of certain publications under Section 28(e) based on the audience to which it is marketed. Publications that are mass-marketed may not be purchased through the use of soft dollars. The Release describes mass-marketed publications as those publications that are intended for and marketed to a broad, public audience. These mass-marketed publications are more appropriately considered as overhead expenses of money managers. Only those publications marketed to a narrow audience, such as financial newsletters, trade magazines or technical journals which serve the specialized interests of a narrow group, may be paid for with client commission dollars. Availability over the Internet of a narrowly focused publication will not alter its status as research.

In contrast, products or services that do not reflect the expression of reasoning or knowledge, including products with inherently tangible or physical attributes (such as telephone lines, office furniture or computer hardware), are not eligible as research under the safe harbor. A money manager's operational overhead expenses would not constitute eligible research services. Excluded items include travel expenses, entertainment, and meals associated with attending seminars that may qualify as research or trips to meet with the corporate executives whose reports are within the safe harbor. Similarly, office equipment, office furniture and business supplies, telephone lines, salaries (including research staff), rent, accounting fees and software, Website design, e-mail software, Internet service, legal expenses, personnel management, marketing, utilities, membership dues, professional licensing fees, and software to assist with administrative functions such as managing back-office functions, operating systems, and word processing are other examples of overhead items that are not eligible under the safe harbor. Reversing a 1986 interpretative position, the Release states that computer hardware and computer accessories, while they may assist in the delivery of research,

would not be eligible research services because they do not reflect substantive content related in any way to making decisions about investing. The peripherals and delivery mechanisms associated with computer hardware, including telecommunications lines, transatlantic cables, and computer cables, are also outside the research services safe harbor.

As noted above, even if a money manager properly concludes that a particular product or service is an analysis, advice or report that reflects the expression of reasoning or knowledge, it would be eligible research only if the subject matter of the product or service falls within the categories specified in Section 28(e)(3)(A) and (B). Thus, for example, consultants' services may be eligible for the safe harbor if the consultant provides advice with respect to portfolio strategy, but such services would not be eligible if the advice relates to the managers' internal management or operations.

Based on comments received, the SEC clarified in the Release that advice, analyses and reports regarding the market for securities, or market research, may be eligible under the safe harbor if they otherwise satisfy the research criteria. For example, pre-trade and post-trade analytics, including trade analytics transmitted through order management systems ("OMS"), software and other products that depend on market information to generate market research, including research on optimal execution venues and trading strategies, may be eligible. However, if these products and services also contain non-eligible brokerage or research or if they are not used in a way that provides assistance in investment decision-making, they may be mixed-use items. Advice from broker-dealers on order execution, including advice on execution strategies, market color and the availability of buyers and sellers (and software that provides these types of market research), may also be eligible research.

With respect to data services, such as those that provide market data or economic data, the Release reasons that because market data aggregate current information related to the subject matter identified in the statute, and in light of the history of Section 28(e), market data such as stock quotes, last sale prices, and trading volumes contain substantive content and constitute "reports concerning . . . securities" and thus would be eligible as research services under the safe harbor. Similarly, other data would be eligible under the safe harbor if it reflects substantive content – that is, the expression of reasoning or knowledge – related to the subject matter identified in the statute. For example, company financial data and economic data (such as unemployment and inflation rates or gross domestic product figures) would be eligible as research.

Proxy services, including research and voting products and services provided by proxy service providers, may be treated as mixed-use items, as appropriate. For example, reports and analyses on issuers, securities, and the advisability of investing in securities that are transmitted through a proxy service provider may be within Section 28(e), while products or services offered by a proxy service provider that handles mechanical aspects of voting, such as casting, counting, recording and reporting votes, are administrative overhead expenses of the manager and are ineligible under Section 28(e).

As discussed above, in order for a product or service to be within the safe harbor, it must not only satisfy the specific criteria of the statute, but also must provide the money manager with lawful and appropriate assistance in making investment decisions. This standard focuses on how the manager uses the eligible research. Although analyses of the performance of accounts are eligible research items because they reflect the expression of reasoning or knowledge regarding subject matter included in Section 28(e)(3)(B), these items when used for marketing purposes are not within the safe harbor because they are not providing lawful and appropriate assistance to the money manager in performing his investment decision-making responsibilities. As discussed below with respect to mixed-use items, if the manager uses account performance analyses for both marketing and investment purposes, the manager may use client commissions only to pay for the allocable portion of the item attributable to use for investment decision-making.

2. Brokerage Services

Under Section 28(e)(3)(C), a person provides "brokerage . . . services" insofar as he "effects securities transactions and performs functions incidental thereto (such as clearance, settlement, and custody) or required in connection therewith…." Thus, the activities required to effect securities transactions and the functions incidental thereto are eligible for the safe harbor. The Release states that the following post-trade services relate to functions incidental to executing a transaction and are eligible under the safe harbor as "brokerage services": post-trade matching; exchanges of trade related messages among broker-dealers, custodians, and institutions; electronic communication of allocation instructions between institutions and broker-dealers; routing settlement instructions to custodian banks and broker-dealers' clearing agents; and short-term custody related to effecting particular transactions in relation to clearance and settlement of the trade. Similarly, comparison services required by SEC or SRO rules are eligible under the safe harbor. For example, in certain circumstances the use of electronic confirmation and affirmation of institutional trades is required in connection with settlement processing.

The Release states that eligible brokerage services begin when an order is transmitted to a broker-dealer and end at the conclusion of clearance and settlement of the transaction. Specifically, for purposes of the safe harbor,

brokerage begins when the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution and ends when funds or securities are delivered or credited to the advised account or the account holder's agent. Unlike brokerage, research services include services provided before the communication of an order. Thus, advice provided by a broker before an order is transmitted may fall within the research portion of the safe harbor, but not the brokerage portion of the safe harbor.

Under this "temporal standard," communications services related to the execution, clearing, and settlement of securities transactions and other incidental functions, i.e., connectivity service between the money manager and the broker-dealer and other relevant parties such as custodians (including dedicated lines between the broker-dealer and the money manager's order management system; lines between the broker-dealer and order management systems operated by a third-party vendor; dedicated lines providing direct dial-up service between the money manager and the trading desk at the broker-dealer; and message services used to transmit orders to broker-dealers for execution) are eligible brokerage services. In addition, trading software used by a broker-dealer to route orders to market centers and algorithmic trading software is brokerage.

On the other hand, hardware, such as telephone or computer terminals, including those used in connection with OMS, and trading software are not eligible for the safe harbor as brokerage because they are not sufficiently related to order execution and fall outside the temporal standard for brokerage. In addition, software functionality used for record keeping or administrative purposes, such as managing portfolios, and quantitative analytical software used to test "what if" scenarios related to adjusting portfolios, asset allocation, or portfolio modeling do not qualify as brokerage as they are not integral to the execution of orders by the broker-dealers. Also, managers may not use client commissions under the safe harbor to meet their compliance responsibilities, such as analyzing the quality of executions for best execution purposes, for trade financings, such as stock lending fees, or for capital introduction and margin services, as these services are not sufficiently related to order execution. Similarly, error correction trades or related services are not related to the initial trade since they are separate transactions to correct the manager's error, not to benefit the advised account, and thus are not eligible brokerage services under the safe harbor.

Finally, the Release also clarified the use of client commissions in connection with custody. Short-term custody related to effecting particular transactions and clearance and settlement of those trades fit into the safe harbor because the custody is tied to processing the trade between the time the order is placed and settlement of the trade. On the other hand, long-term custody and custodial recordkeeping provided post-settlement and relating to long-term maintenance of securities positions are not within the safe harbor since they are not considered incidental to effecting securities transactions.

3. "Mixed-Use" Items

Reaffirming a 1986 interpretation, the Release indicates that where a product has a mixed use, a money manager should make a reasonable allocation of the cost of the product according to its use. The money manager must keep adequate books and records concerning allocations in order to make the required good faith determination. According to the Release, the allocation determination itself poses a conflict of interest for the money manager that should be disclosed to the client. The Release notes that some managers may have made questionable mixed-use allocations and failed to document the bases for their allocation decisions. In this regard, the Release indicates that an allocable portion of the cost of portfolio performance, evaluation services or reports may be eligible as research, but money managers must use their own funds to pay for the allocable portion of such services or reports that is used for marketing purposes.

B. Good Faith Determination as to Reasonableness

Section 28(e) requires a money manager to make a good faith determination that the commissions paid are reasonable in relation to the value of the brokerage and research services received. The burden of proof in demonstrating this good faith determination rests on the money manager. According to the Release, a money manager satisfies Section 28(e) if he can demonstrate that the item is eligible under the language of the statute, he has used the item in performing decision-making responsibilities for accounts over which he exercises investment discretion, and, in good faith, the manager believes that the amount of commissions paid is reasonable in relation to the value of the research or brokerage product or service received, either in terms of the particular transaction or the manager's overall responsibilities for discretionary accounts.

Under this analysis, a money manager may purchase an eligible item of research with client commissions if he uses the information in formulating an investment decision, but another money manager could not rely on Section 28(e) to acquire the very same item if he did not use the item for investment decisions or if he determined that the commissions paid are not reasonable. Similarly, a money manager may not obtain eligible products, such as market data, to camouflage the payment of higher commissions to broker-dealers for ineligible services, such as mutual fund shelf space or client referrals. Further, if research products or services that are eligible under Section 28(e)(3) have been simply copied, repackaged, or aggregated, the money manager must make a good faith determination that any

additional commissions paid in respect of such copying, repackaging, or aggregation services are reasonable. Finally, where a broker-dealer also offers its research for an unbundled price, that price should inform the money manager as to its market value and help the manager make its good faith decision.

C. Third-Party Research and Client Commission Arrangements

1. "Provided by" the Broker-Dealer

The Release reiterates the Commission's view that the safe harbor encompasses third-party research and proprietary research on equal terms. However, the Release modifies the Commission's interpretation of "provided by" and "effecting" under Section 28(e) to permit the industry to flexibly structure arrangements that are consistent with the statute and best serve investors.

Section 28(e) requires that the broker-dealer receiving commissions for effecting transactions must "provide" brokerage or research services. The SEC has interpreted this to permit, in certain circumstances, money managers to use soft dollars to pay for research produced by someone other than the executing broker-dealer (third-party research). The Commission believes, however, that the safe harbor was not meant to allow money managers to use 28(e) arrangements to conceal the payment with client commissions to intermediaries (including broker-dealers) that provide benefits only to the money manager. Thus, the Commission has modified its interpretation of "provided by." Under the Release, research is "provided by" a broker-dealer if the broker-dealer (i) prepares the research, (ii) is financially obligated to pay for the research, or (iii) is not financially obligated to pay for the research but such broker-dealer pays the research provider directly and takes steps to assure itself that the client commission dollars that the manager directs it to use to pay for such services are used only for eligible brokerage and research. The Release provides that the following attributes can help to determine if the "provided by" element is satisfied and the safe harbor may be used: (i) the broker-dealer pays the research preparer directly; (ii) the broker-dealer reviews the description of the services to be paid for with client commissions for red flags that indicate the services are not eligible research or brokerage services and agrees with the money manager to use soft dollars only to pay for those items that reasonably fall within the safe harbor; and (iii) the broker-dealer develops and maintains procedures so that research payments are documented and paid for promptly. Note that research provided by a third party is eligible under the safe harbor even if the money manager participates in selecting the research services or products that the broker-dealer will provide. The third party may also send the research directly to the broker-dealer's customer.

2. Effecting Transactions

Section 28(e) requires that the broker-dealer providing the research also be involved in "effecting" the trade. This provision is intended to preclude the paying of "give-ups", a practice developed during the fixed commission era in which a portion of the commission charged by the executing broker-dealer was paid to another broker-dealer. The broker-dealer receiving the give-up may have had no role in the transaction generating the commission, and, instead, was being compensated for services that benefited the manager but not his clients, such as steering clients to the manager. In 1986, however, the SEC indicated that payment of a part of a commission by an executing or clearing broker-dealer to an introducing broker would not necessarily be a give-up outside the protection of Section 28(e).

Some investment managers today use commission sharing arrangements to execute trades with one broker-dealer and obtain research or other services from a different broker-dealer. In some commission sharing arrangements, the introducing broker-dealer accepts a customer order and then may execute the trade and provide research, while a second broker-dealer clears and settles the transaction. In other commission sharing arrangements, an introducing broker-dealer facilitates access to research and has little, if any, role in accepting customer orders or in executing, clearing, or settling any portion of the trade. Rather, another broker-dealer (the clearing broker) executes, clears, and settles the trade, receiving a portion of the commission for its services. In some instances, the introducing broker is unaware of the daily trading activity of its customers because the orders are sent by the money manager directly to the clearing broker-dealer.

Where more than one broker-dealer is involved in a commission sharing arrangement, the SEC takes the view that the introducing broker must be engaged in securities activities of a more extensive nature than merely the receipt of commissions paid to it by other broker-dealers for research services provided to money managers. The fact that the parties to a commission sharing arrangement have a clearing agreement prepared in accordance with NYSE or NASD requirements is not dispositive of whether the "effecting" requirement has been met. To satisfy 28(e), each broker-dealer must play a role in effecting securities transactions that goes beyond the mere provision of research services to money managers. Step-outs may be within Section 28(e) if each broker performs substantive functions (*e.g.*, clearance and settlement) in effecting the trade. The nature of the activities actually performed by each broker-dealer determines whether the commission sharing arrangement qualifies under Section 28(e).

In a change from the proposed interpretive guidance, the Release states that the statutory term "effecting" requires that, in order for a money manager to use the safe harbor, a

broker-dealer that is "effecting" the trade must perform at least one of the four minimum functions discussed below and take steps to see that the other functions have been reasonably allocated to one or another of the broker-dealers in the arrangement in a manner that is fully consistent with their obligations under SRO and SEC rules. Notwithstanding these functions, a broker-dealer is deemed to be effecting transactions if it is executing, clearing or settling the trade.

These four functions are: (1) taking financial responsibility (*i.e.*, be at risk for the customer's failure to pay) for all customer trades until the clearing broker-dealer has received payment (or securities); (2) making and/or maintaining records relating to its customer trades required by SEC and SRO rules, including blotters and memoranda of orders; (3) monitoring and responding to customer comments concerning the trading process; and (4) generally monitoring trades and settlements.

In order to determine whether its guidance requires further clarification, the SEC is soliciting additional comment on its revised interpretation of the safe harbor with respect to client commission arrangements under Section 28(e).

IV. Request for Comment

The SEC will consider comments on evolving developments in connection with industry practices with respect to client commission arrangements to evaluate whether additional guidance might be appropriate in the future. Based on comments received, the Commission may supplement the guidance in the Release in the future.

A footnote in the Release also indicated that the SEC is considering whether, at a later time, to propose requirements for disclosure and recordkeeping of soft dollar arrangements to clients.

We recommend that broker-dealers, money managers and others affected by the Release carefully assess its potential impact on their existing business practices. We would be happy to discuss with you any of the matters addressed in this *Client Alert* or the Release. If we can be of assistance, please contact the lawyers listed below.

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