

SEC to Release Guidance for Use of Soft Dollars by Money Managers

On September 21, 2005, the Securities and Exchange Commission (the "SEC") held an open meeting to discuss, among other issues, the publication for comment of interpretive guidance regarding money managers' use of client commissions, or "soft dollars," to pay for research and brokerage services under Section 28(e) of the Securities Exchange Act (the "Exchange Act"). The SEC voted to approve publication of the proposed interpretive guidance.¹

The proposed interpretive guidance governing the use of soft dollars aims to clarify the SEC's position on the use of client commissions. It creates a framework to help determine the scope of the products and services that are covered under the statutory safe harbor of Section 28(e) by supplying standards as to what constitutes "research" and "brokerage" products and services.

Under the SEC's proposed standards, only those research items which provide "intellectual and informational content," and which provide "lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities," may be paid for with soft dollars. As a result, under the proposed guidance, managers will be unable to pay for overhead expenses, such as order management systems and computer hardware, with client commissions.

Additionally, the proposed guidance creates a temporal standard which limits the scope of brokerage services protected by the safe harbor.

The Commissioners stressed that this guidance is the first step toward developing a robust framework governing the use of soft dollars. The SEC intends to press forward by developing disclosure and recordkeeping requirements.

Background

Section 28(e) of the Exchange Act was adopted in 1975 in connection with the abolition of fixed commission rates. It provides a safe harbor to money managers who use client commission dollars to obtain investment research and brokerage services. The section generally states that a money manager does not breach fiduciary duties under state or federal law solely by reason of his paying brokerage commissions greater than the amount another broker-dealer would have charged if the manager determines in good faith that the commission paid is reasonable in relation to the value of brokerage and research services received.² Therefore, no violations of state or federal law occur where a manager uses client commissions to pay for research, as long as the value of the research is reasonable in relation to the amount paid.

In 1976, the SEC issued an interpretive release concerning Section 28(e). The release provided that the safe harbor does not protect "products and services that are readily and customarily available and offered to the general public on a

¹ At the time of the drafting of this Alert, the SEC had not published the proposed release. The Alert is based on the SEC Webcast of its open meeting, available at <http://www.sec.gov/cgi-bin/goodbye.cgi?www.connectlive.com/events/seopenmeetings/sec-092105-archive.ram>, and its Press Release 135-2005 (September 21, 2005), available at <http://www.sec.gov/news/press/2005-134.htm>.

² Rel. No. 34-12251, at 2 (March 24, 1976).

commercial basis.”³ This release was aimed at targeting soft dollar abuses and excluded items such as office supplies and airline tickets from protection under the safe harbor. The release did little to clarify the scope of permissible “research products and services.”

Subsequently, in 1986, the SEC issued a second and more comprehensive interpretive release which attempted to clarify the actual scope of what research products and services were covered under Section 28(e). The release states that the “controlling principle to be used in determining whether something is research is whether it provides lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities.”⁴

In addition to providing a flexible standard for products and services constituting “research,” the release required money managers to reasonably allocate expenses associated with mixed-use items (*i.e.*, those items that are used for both research and non-research purposes) between research and non-research costs and to keep records of such allocations. Moreover, the 1986 Release expressly addressed the permissibility of third party arrangements and reiterated the money manager’s duty of obtaining best execution of clients’ transactions.

Given the history of Section 28(e) and the lack of clarity as to its scope, Chairman Cox pointed out a number of problems that persist with the safe harbor at the Open Meeting held on September 21. He expressed concern regarding:

- The lack of transparency of soft dollars expenditures
- The creation of conflicts of interest between the interests of the money manager and those of its clients
- The potential that soft dollars may distort the market for brokerage and advisory services

Reasons for the Proposed Guidance

The SEC’s proposed guidance aims to provide much needed clarity to the use of soft dollars by money managers. Chairman Cox stated that the SEC can no longer go after abuses one at a time and must establish

clear guidance. According to the Chairman, there has been an inconsistent and aggressive interpretation of the safe harbor by the industry, occasionally resulting in SEC enforcement activity. Commissioner Atkins echoed the Chairman’s concern by mentioning that he was “troubled” by the sheer volume of investor assets used by managers to purchase research and other products and specifically referred to an SEC Staff (the “Staff”) report detailing abuses such as the use of client commissions to fund travel and entertainment expenses and even college tuition payments.

On the other hand, Commissioner Atkins also pointed out that the use of soft dollars to pay for research can benefit investors and smaller funds and that the SEC must continue to resist the temptation to focus solely on the lowest cost of trade as being the best alternative. This need to balance the potential for abuse with the desire to maintain a competitive and active market in research, coupled with a strong push from the industry, led the SEC to issue the proposed guidance.

The Proposed Guidance

According to Robert Colby, Acting Director of the Division of Market Regulation, the proposed guidance does not entirely supersede the 1986 Release. Rather, the proposed guidance supplements the standard that research products must provide lawful and appropriate assistance to managers in carrying out their decision-making responsibilities, while leaving those portions of the 1986 Release dealing with best execution, third party brokerage and mixed-use allocation intact. Additionally, Mr. Colby reiterated that broker-dealers must be financially responsible for the brokerage and research products provided to money managers, and that they must be involved in effecting the trade.

In drafting the proposed guidance, the Staff consulted market participants, the NASD Mutual Fund Taskforce, and foreign regulators, notably the Financial Services Administration in the United Kingdom (“FSA”). The proposed guidance adopts several recommendations made by the NASD Taskforce in its 2004 report, in addition to incorporating aspects of rules adopted by the FSA earlier this year. Commissioner Nazareth lauded the Staff’s consultation with the FSA and noted that the SEC anticipates a greater convergence of standards as firms conduct transactions globally and incur increasingly difficult costs in complying with widely disparate standards.

³ *Id.* at 6.

⁴ Rel. No. 34-23170 (April 23, 1986) (the “1986 Release”).

The proposed guidance would reiterate earlier SEC positions by defining brokerage and research as satisfying three criteria:

- The products or services fall within the specific eligibility and definitional criteria of Section 28(e)⁵
- The products or services provide “lawful and appropriate assistance” to the investment manager in carrying out its decision-making responsibilities⁶
- The investment manager makes a good faith determination that the commissions paid are reasonable in relation to the value of the products and services provided by the broker-dealer

Commissioner Campos remarked that the proposed guidance confirms a manager’s statutory obligation to make a good faith value determination of the products or services received. He also reiterated that a manager’s obligation to seek best execution remains intact.

The proposed guidance would be the first SEC release to discuss both the scope of research services and products that are protected by the safe harbor, as well as the scope of protected brokerage services.

Research

The proposed interpretive release would define eligible research services under Section 28(e) to include advice, analyses, and reports that have “intellectual and informational content.” That definition attempts to capture products and services that will provide high

⁵ Section 28(e)(3) of the Exchange Act states: “For purposes of this subsection a person provides brokerage and 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; (B) furnishes analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts; or (C) effects securities transactions and performs functions incidental thereto (such as clearance, settlement, and custody) or required in connection therewith by the rules of the Commission or a self-regulatory organization of which such person is a member or person associated with a member or in which such person is a participant.”

⁶ Rel. No. 34-23170, *supra*, note 4.

quality information to managers while preventing abusive squandering of client assets.

Mr. Colby stated that market, financial, economic, and similar data would be included within the safe harbor as protected research services, whereas computer hardware and similar items would not. Other research products and services discussed at the meeting include:

- **Mixed-use Items.** The proposed guidance would still require managers to allocate costs with respect to mixed-use items among their research and non-research uses. This allocation must be reasonable and documented.
- **Commercial and Mass Media Publications.** The proposed guidance would not include a specific standard applicable to commercial or mass media publications. Citing the difficulty in creating a clear division between specialized and mass-targeted publications, the Staff stated that managers would have to make individualized decisions as to whether such publications are covered under Section 28(e) utilizing the framework provided in the proposed guidance. The Staff will include the issue of mass media publications as a question for comment in its release. Moreover, the SEC, according to Commissioner Glassman, would consider implementing a well articulated standard governing mass media publications if it receives comments that suggest an appropriate standard during the comment period.
- **Operational and Overhead Expenses (e.g., salary of research staff, hardware).** Commissioner Cox noted that the proposed guidance would exclude operational overhead expenses from coverage under the safe harbor.
- **Order Management Systems.** The proposed guidance would exclude order management systems from protection under Section 28(e) unless they comprise a part of a mixed-use system, in which case only the portion of the system used for research could be paid for with commission dollars.
- **Third Party Research and Commission Sharing Arrangements.** Commissioner Campos noted that the proposed guidance would reaffirm the SEC’s position that research provided through third party arrangements falls within the statutory safe harbor

so long as the broker is obligated to the third party to pay for the research services.

- **Seminars.** Seminars attended by managers may fall under the safe harbor if their content meets the standards set forth in the proposed release and if it assists in investment management decisions. Related expenses, such as travel and accommodations, however, would not fall within the safe harbor.

Commissioner Campos emphasized that the lists in the interpretation will not be exclusive.

Brokerage

For the first time since the enactment of the Section 28(e) safe harbor in 1975, the SEC has attempted to define the scope of brokerage services covered under the statute. The proposed guidance would define brokerage services based on a temporal standard. Brokerage services would be those products and services related to the execution of the trade, beginning from the point at which the money manager communicates with the broker-dealer for the purposes of transmitting an order for execution to the point where funds or securities are delivered or credited to the buyer's account.

Solicitation of Comments

As mentioned by Commissioner Glassman, requesting public comment on an interpretive release is not the usual practice of the SEC. However, in the case of soft dollar transactions, the SEC aims to ensure that the ultimate interpretation is fully informed and that it draws clear lines as to when it is permissible to pay for services with investors' money. The proposed interpretive release will be held open for a 30-day comment period. Commissioner Atkins specifically requested comments concerning the following:

- The proposed interpretation includes market data within the safe harbor. Should market data be excluded? Does it fit within the framework articulated in the proposed interpretation?
- The release would allow analytic software to be included within the safe harbor. Should post-trade analytics be included?
- How will the interpretation affect current practices? Will time be needed to assess existing

arrangements for compliance with the guidance and to amend contracts? How much time will be needed?

- Does the guidance adequately address third party arrangements?
- Does a temporal standard defining brokerage services invite gamesmanship?
- Are there other products and services that are being paid for with soft dollars now (e.g., proxy voting services) that should be addressed in the guidance?
- How will the new guidance with respect to brokerage affect current brokerage arrangements?

Conclusion

The issuance of the proposed interpretive release governing the scope of the Section 28(e) safe harbor is likely the first step in restricting current soft dollar practices of money managers. The Commissioners, in addition to Meyer Eisenberg, Acting Director of the Division of Investment Management, all expressed concern with the lack of transparency with respect to the use of soft dollars by money managers. For example, Commissioner Nazareth stated that the current soft dollar regulatory regime was opaque, thereby making it impossible for investors to evaluate an adviser's portfolio management expenses. To address this problem, she suggested that there must be disclosure that provides information to fund boards to assess the value that their clients receive for soft dollars.

Mr. Eisenberg views the transparency issue as an "urgent matter" and is working with the SEC's Soft Dollar Taskforce on ways to enhance disclosure related to soft dollars and the allocation of fund brokerage. According to Mr. Eisenberg, the Division of Investment Management will proceed as quickly as possible to determine what disclosures should be made to independent directors.

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