

## SEC Releases Interpretation of Soft Dollar Usage by Money Managers

On October 19, 2005, the Securities and Exchange Commission ("SEC" or the "Commission") published for comment a proposed interpretive release (the "2005 Release") 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 of 1934, as amended (the "Exchange Act").<sup>1</sup> The Commission established a 30-day comment period which expires on November 25, 2005.<sup>2</sup>

The 2005 Release aims to clarify the SEC's position on investment advisers' use of client commissions to obtain research and brokerage services within the Section 28(e) safe harbor. In recognition of changing market conditions, the 2005 Release provides a proposed framework under which advisers may determine which items constitute eligible "research" and "brokerage" products and services.

If the SEC adopts the 2005 Release as proposed, research items, which reflect the "expression of reasoning or knowledge," 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 consistent with the safe harbor. Any items not meeting this standard would fall outside the safe harbor. As a result, managers who use soft dollar credits to pay for overhead expenses such as order management systems and computer hardware would be unable to rely on the safe harbor.

Additionally, the 2005 Release would create a temporal standard that limits the scope of brokerage services within the safe harbor. Under this standard, 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. The safe harbor would not protect services outside of this time frame. The 2005 Release also addresses the use of third-party research and certain commission-sharing arrangements. The 2005 Release also discusses recent regulatory changes made by the Financial Services Authority ("FSA") in the United Kingdom concerning the use of soft commissions.

At an open meeting held on September 21, 2005, (the "Open Meeting") approving the publication of the 2005 Release, individual Commissioners stressed that the 2005 Release is the first step toward developing a robust framework governing the use of soft dollars.<sup>3</sup> Although there is no specific timetable for further action, the Commission has stated its intent to press forward by developing disclosure and recordkeeping requirements with respect to soft dollars.

For a chart summarizing the 2005 Release, including examples of eligible research and brokerage products and services, please refer to Appendix A at the end of this document.

<sup>1</sup> Rel. No. 34-52635 (October 19, 2005) (the "2005 Release").

<sup>2</sup> The 2005 Release was published in the Federal Register on October 25, 2005. 70 Fed. Reg. 61699 (Oct. 25, 2005).

<sup>3</sup> See "SEC to Release Guidance for Use of Soft Dollars by Money Managers," *Dechert OnPoint*, Issue No. 20 (October 2005) (summarizing the Commissioners' discussion at the Open Meeting).

## Background

Congress enacted Section 28(e) of the Exchange Act as part of the Securities Acts Amendments of 1975 in connection with the abolition of fixed commission rates. The section provides a safe harbor to money managers who use client commission dollars to obtain investment research and brokerage services.<sup>4</sup> 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.<sup>5</sup> Therefore, as a general matter, when a manager uses client commissions to pay for research, the manager does not violate his fiduciary duty under any federal or state law so long as the value of the research is reasonable in relation to the amount paid.<sup>6</sup>

<sup>4</sup> §28(e)(3) of the Exchange Act states, in relevant part, that:

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.

<sup>5</sup> Rel. No. 34-12251, at 2 (March 24, 1976) (the “1976 Release”).

<sup>6</sup> Advisers using soft dollars face a conflict of interest between their need to obtain research and their clients’ interest in paying the lowest commission rate available and obtaining the best possible execution. Without the protection of the Section 28(e) safe harbor, paying for research and brokerage with the use of client commissions could be deemed to be a violation of an adviser’s fiduciary duty as the lowest commission rate available would not be charged. See Office of Compliance Inspections and Examination, U.S. Securities and Exchange Commission, *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds* (September 22, 1998) (the “OCIE Report”), available at <http://www.sec.gov/news/studies/softdollar.htm>.

In 1976, the Commission issued an interpretive release concerning Section 28(e) (the “1976 Release”). The 1976 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 commercial basis.”<sup>7</sup> It excluded such items as office supplies and airline tickets from protection under the safe harbor, but did little to clarify the scope of permissible “research products and services.”

In 1980, the Commission issued a report following an investigation of Investment Information, Inc.’s (“III”) client commission arrangements with several money managers (the “III Report”).<sup>8</sup> Pursuant to these arrangements, III would direct a money manager to a particular broker-dealer whose involvement was limited solely to the execution of trades. III would then retain and manage, on behalf of the money manager, half of the commissions paid to the broker-dealer.<sup>9</sup>

In the III Report, the Commission found that these arrangements did not fall within the Section 28(e) safe harbor because the broker-dealers that were “effecting” the transactions “in no significant sense provided the money managers with research services.”<sup>10</sup> The III Report concluded that, although Section 28(e) does not require a broker-dealer to produce research services “in-house,” the services must nevertheless be “provided by” the broker-dealers (*i.e.*, the payment obligation must fall on the broker-dealer rather than on the money manager).

In 1986, the Commission issued a second, more comprehensive interpretive release which attempted to clarify the actual scope of what research products and services were covered under Section 28(e) (the “1986 Re-

<sup>7</sup> The 1976 Release, *supra* note 5, at 6.

<sup>8</sup> Report of Investigation in the Matter of Investment Information, Inc. Relating to the Activities of Certain Investment Advisers, Banks, and Broker-Dealers, Rel. No. 34-16679, 19 SEC Docket 926 (March 19, 1980) (the “III Report”).

<sup>9</sup> Specifically, from the half of the commissions that it received, III retained a service fee for managing the money manager’s client commission account. The remaining amount was then credited to the money manager’s account with III. Money managers could then elect to receive this credit in cash or apply it toward the purchase of research services from persons other than the executing broker-dealer.

<sup>10</sup> *Id.* at 931-932.

lease”).<sup>11</sup> The 1986 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.” This standard was more flexible than that established under the 1976 Release, which had proven to be rigid and unworkable.

In addition to providing a more flexible standard for classifying products and services as “research,” the 1986 Release also permitted money managers to allocate reasonably expenses associated with mixed-use items (*i.e.*, those items that are used for both research and non-research functions) 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 under the circumstances.

After the examination of approximately 355 broker-dealers, advisers, and funds, the SEC published a report in 1998 which described the range of products and services that advisers obtained with soft commissions (the “OCIE Report”).<sup>12</sup> Although the OCIE Report generally found that the vast majority of products and services obtained by advisers with the use of client commissions fell within the Section 28(e) safe harbor, it highlighted concerns about the nature of certain products and services that advisers treated as “research,” the purchase of mixed-use items, and recordkeeping. The OCIE Report made several recommendations for improving soft dollar practices, including that the Commission provide further guidance on the scope of the safe harbor and require enhanced disclosure of client commission arrangements.<sup>13</sup>

In 2001, the Commission issued a release that modified the view that the safe harbor of Section 28(e) was available only for research and brokerage services obtained in relation to commissions paid to a broker-dealer acting in an agency capacity (the “2001 Release”).<sup>14</sup> Until

the 2001 Release, money managers could not rely on the safe harbor for research and brokerage services obtained in relation to fees charged by market makers when they executed transactions in a “principal” capacity. The Commission noted that the prior “interpretation prevented money managers from relying on the safe harbor for research and brokerage services obtained in relation to fees charged by market makers when they executed transactions in a ‘principal’ capacity.”<sup>15</sup> In the Commission’s view, fees on principal transactions were not quantifiable and fully disclosed in a way that permitted a money manager to determine that the fees were reasonable in relation to the value of research and brokerage services rendered.<sup>16</sup>

However, in response to changes in Nasdaq trading, the SEC modified its interpretation of the safe harbor for fees paid for riskless principal transactions in which both legs of the transaction are executed at the same price and where the transactions are reported under the National Association of Securities Dealers’ (“NASD”) trade reporting rules. According to the SEC, the Section 28(e) safe harbor applies to fees 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 (“SRO”) oversight.<sup>17</sup> Under the terms of the 2001 Release, research and brokerage products and services that the dealer pays for with these fees may be eligible for the safe harbor provided that the products and services meet the applicable criteria.

## SEC Task Force

The 2005 Release is partly the result of work carried out by the SEC’s soft dollar task force (the “Task Force”). In February 2004, then-Chairman William Donaldson created the Task Force, which is comprised of senior SEC Staff members, to consider revisions to the scope of Section 28(e), as well as to study and make recommendations for enhancing soft dollar transparency within the

<sup>11</sup> Rel. No. 34-23170 (April 23, 1986) (the “1986 Release”).

<sup>12</sup> See OCIE Report, *supra* note 6.

<sup>13</sup> *Id.* at 4-5.

<sup>14</sup> Rel. No. 34-45194 (December 27, 2001) (the “2001 Release”). Managers may not, therefore, use client funds to obtain brokerage and research services under the safe harbor in connection with fixed income trades that are not executed on an agency basis or other instruments traded

net with no explicit commissions. 2005 Release, *supra* note 1, at n. 20.

<sup>15</sup> 2001 release, *supra* note 14.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

industry. Although the Task Force was created in early 2004, it took the SEC several months to prepare and issue the 2005 Release regarding the scope of the Section 28(e) safe harbor. As mentioned earlier, the 2005 Release will be held open for a 30-day comment period.

Although the work of the Task Force with respect to the scope of the safe harbor is partially visible through the 2005 Release, its work concerning soft dollar transparency has not yet been reflected in any regulatory changes. The SEC, through the Task Force, has been looking to address its concerns about the disclosure challenges presented by soft dollars, and whether the disclosure as currently required adequately informs investors about the use of soft dollars and the benefits received.<sup>18</sup> In addition to conducting its own analysis of the use of soft dollars by money managers, the Task Force considered a report issued by the NASD Mutual Fund Task Force in November 2004, which, included several recommendations with respect to the scope of the safe harbor as well as associated disclosure and transparency requirements.<sup>19</sup> The 2005 Release is generally consistent with the report's recommendations regarding the scope of protected research and brokerage products and services.<sup>20</sup>

The Task Force also looked at soft commission regulatory regimes in foreign countries. It particularly monitored the changes made by the United Kingdom's Financial Services Authority ("FSA") with respect to the use of soft commissions. The FSA had initially ad-

<sup>18</sup> Paul Roye, Director, Division of Investment Management, U.S. Securities and Exchange Commission, *Remarks Before the ICI 2004 Securities Law Developments Conference* (December 6, 2004).

<sup>19</sup> Regarding disclosure, the NASD Mutual Fund Task Force recommended, among other things: (a) ensuring that fund boards obtain information about a fund adviser's brokerage allocation practices and client commission services received; (b) mandating enhanced disclosure in fund prospectuses to improve investor awareness; (c) applying disclosure requirements to all types of commissions; and (d) enhancing disclosure to investors about portfolio transaction costs. See NASD, *Report of the Mutual Fund Task Force, Soft Dollars and Portfolio Transaction Costs* (November 11, 2004), available at [http://www.nasd.com/web/groups/rules\\_regs/documents/rules\\_regs/nasdw\\_012356.pdf](http://www.nasd.com/web/groups/rules_regs/documents/rules_regs/nasdw_012356.pdf) ("NASD Report"). The SEC has not yet adopted any such disclosure requirements.

<sup>20</sup> Although the NASD Report recommends that commercial or mass media publications and online news services be excluded as eligible research products, the SEC has not taken a definitive position with respect to such materials. See *infra* "Research."

ressed issues related to soft commissions in a consultation paper it issued in April 2003. The FSA subsequently refined its approach to regulating soft commissions with its subsequent issuance of two policy statements in May and November 2004. In March 2005, the FSA issued a revised set of proposed rules, and in July 2005 adopted the final version. The new rules become effective in January 2006.<sup>21</sup> The length of the process and the number of released papers indicate the substantial deliberation undertaken by the FSA to arrive at its final rules.<sup>22</sup>

## The 2005 Release

In line with the prior SEC interpretations of the Section 28(e) safe harbor discussed earlier, the 2005 Release reiterates the Commission's position that to determine whether research or brokerage products and services fall within the safe harbor, money managers must determine that:

- The products or services fall within the specific eligibility and definitional criteria of Section 28(e)<sup>23</sup>
- The products or services provide "lawful and appropriate assistance" to the investment manager in carrying out its decision-making responsibilities<sup>24</sup>
- In good faith, the amount of client commissions that the investor pays is reasonable in relation to the value of the products and services provided by the broker-dealer<sup>25</sup>

<sup>21</sup> U.K. Financial Services Authority, *Policy Statement 05/9, Bundled Brokerage and Soft Commission Arrangements: Feedback on CP 05/5 and Final Rules* (July 2005) ("FSA Release").

<sup>22</sup> See *infra* "The U.K. Financial Services Authority and Soft Commissions Reform."

<sup>23</sup> See *supra* note 4 for the specific eligibility and definitional criteria under Section 28(e).

<sup>24</sup> 1986 Release, *supra* note 11.

<sup>25</sup> The 2005 Release specifies that the burden of proof for this determination rests on the money manager. The 2005 Release also cautions that a money manager may not obtain eligible products to camouflage the payment of higher commissions to broker-dealers for ineligible services, such as shelf-space. In such a situation, a money manager would not be able to demonstrate in good faith that the

Although largely consistent with the Commission’s earlier positions, the 2005 Release notably discusses the “lawful and appropriate assistance” standard as it applies to brokerage services. Initially, the 1986 Release discussed the standard only with respect to research products and services. The 2005 Release, however, would expressly apply this standard to both research and brokerage products and services.

Under the 2005 Release, it would remain true that, if the conditions of the safe harbor are met, a money manager would not breach his fiduciary duties solely on the basis that he uses client commissions to pay a broker-dealer more than the lowest available commission rate for a bundle of products and services.

## Research

In determining whether a particular research product or service falls within the Section 28(e) safe harbor, the money manager must conclude that it constitutes “advice” under Section 28(e)(3)(A), or “analyses” or “reports” within the meaning of Section 28(e)(3)(B) and that its subject matter falls within the categories specified by the relevant section. The subject matter categories specified in the statute subsume other subjects related to securities and the financial markets (e.g., political factors).<sup>26</sup> The following table summarizes the specific subject matters mentioned in the statute:<sup>27</sup>

Subject Matter Categories Included in Sections 28(e)(3)(A) and (B)	
Type of Research	Subject Matter
Advice <i>Section 28(e)(3)(A)</i>	<ul style="list-style-type: none"> <li>■ Value of securities</li> <li>■ Advisability of investing in, purchasing, or selling securities</li> <li>■ Availability of securities or purchasers or sellers of securities</li> </ul>
Analyses and Reports <i>Section 28(e)(3)(B)</i>	<ul style="list-style-type: none"> <li>■ Issuers</li> <li>■ Industries</li> <li>■ Securities</li> <li>■ Economic factors and trends</li> <li>■ Portfolio strategy</li> <li>■ Performance of accounts</li> </ul>

commissions paid are reasonable in relation to the eligible products and services received.

<sup>26</sup> See 2005 Release, *supra* note 1.

<sup>27</sup> See *supra* note 4 for the text of the statute and the subject areas specifically referenced therein.

In addition to meeting the criteria of Sections 28(e)(3)(A) or (B), eligible research products and services must provide substantive content. The 2005 Release would require that such products and services reflect the “expression of reasoning or knowledge.”<sup>28</sup> This requirement attempts to capture products and services that provide high-quality information to managers while preventing the squandering of client assets.

## Qualifying Research Products and Services

The 2005 Release indicates that the following items would be eligible research products and services:

- Traditional research reports analyzing the performance of a particular company or stock
- Certain financial newsletters and trade journals that relate to the subject matter of the statute
- Quantitative analytical software and software that provides analyses of securities portfolios, provided that such software reflects the expression of reasoning or knowledge and relates to the subject matter of the statute
- Seminars or conferences where the content meets the criteria for eligible research products and services

## Non-Qualifying Research Products and Services

In contrast to the permissible items above, products and services that do not reflect the expression of reasoning or knowledge, including products with inherently tangible or physical attributes (e.g., telephone lines, furniture), would not qualify under the SEC’s new interpretation of the Section 28(e) safe harbor if adopted as proposed. The 2005 Release indicates that the following products and services, among others, would not constitute advice, analyses, or reports eligible for the safe harbor:

- Overhead expenses
- Travel expenses, entertainment, and meals associated with attending seminars or conferences
- Office equipment, furniture, business supplies, salaries (including those of the research staff), rent, accounting fees and software, web site de-

<sup>28</sup> 2005 Release at 28.

sign, e-mail software, internet service, legal expenses, personnel management, marketing, utilities, membership dues, professional licensing fees, software to assist with administrative functions, operating systems, and word processing

- Computer hardware and computer accessories that may assist in the delivery of research
- Delivery mechanisms associated with computer hardware (including telecommunications lines, transatlantic cables, and computer cables)<sup>29</sup>

Under the framework put forth in the 2005 Release, data services, such as those providing market data or economic data, could fall within the Section 28(e) safe harbor if, among other things, the data provided by such services meets one or more eligibility criteria described above. For example, market data (e.g., stock quotes, last sales prices, and trading volumes) contains substantive content and constitutes “reports concerning... securities” within the meaning of Section 28(e)(3)(B). Therefore, such market data would be eligible as “research” under the safe harbor provided that all other elements of the safe harbor are met.

In addition to satisfying the specific criteria, research products and services must provide the money manager with “lawful and appropriate assistance ... in the performance of [the manager’s] investment decision-making responsibilities” to be eligible under the Section 28(e) safe harbor. This standard focuses on how a manager uses the eligible research. For example, research that would otherwise qualify for protection under the safe harbor would be ineligible if used for marketing purposes. Furthermore, the money manager must determine, in good faith, that the amount of client commissions paid by investors is reasonable in relation to the value of the research products and services received by the money manager.

The 2005 Release does not provide any definitive guidance as to the eligibility of commercial and mass media publications under the safe harbor. At the Open Meeting, the Commission Staff indicated that the 2005 Release would not include a specific standard applicable to commercial and mass media publications because of the difficulty in creating a clear division between specialized and mass-targeted publications. In the absence of such a standard, managers must continue to determine,

<sup>29</sup> These services are outside the “research services” safe harbor, but may qualify under the “brokerage services” safe harbor. See *infra* “Brokerage.”

on an item by item basis, whether a publication is eligible for the Section 28(e) safe harbor by utilizing the framework provided in the 2005 Release. According to Commissioner Cynthia Glassman, the Commission would consider implementing a well-articulated standard governing mass media publications if it receives comments that suggest an appropriate standard during the comment period.

## Brokerage

The 2005 Release states that money managers may rely on the safe harbor to use soft dollars to pay for brokerage services only if these services conform to Section 28(e)(3)(C). Under this section, a person provides brokerage services insofar as he effects securities transactions or performs functions incidental thereto (e.g., clearance, settlement, custody). These services also include functions required by either the Commission or the SROs.

In addition to clearance and settlement, the 2005 Release lists certain post-trade brokerage services that would fall within the statutory safe harbor. This list includes:

- Post-trade matching
- Exchange of messages among broker-dealers, custodians, and institutions
- Electronic communication of allocation instructions between institutions and broker-dealers
- Routing instructions to custodian banks and broker-dealers’ clearing agents

The SEC believes that Congress intended brokerage services under Section 28(e) to relate only to the execution of securities transactions. To effectuate this intent, the 2005 Release would, if adopted, establish a new “temporal” standard to determine if a particular item is an eligible brokerage service under the safe harbor. Under the temporal standard, 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.<sup>30</sup> Any service or product outside this time frame

<sup>30</sup> See *Id.*

would not be protected under the Section 28(e) safe harbor.

### Qualifying Brokerage Products and Services

Qualifying brokerage products and services generally include 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. The 2005 Release cites the following examples of items which would be eligible under the safe harbor:

- 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
- Message services used to transmit orders to broker-dealers for execution
- Trading software operated by a broker-dealer to route orders to market centers
- Algorithmic trading software

### Non-Qualifying Brokerage Products and Services

On the other hand, order management systems (whether developed in-house or obtained from third-party vendors) and hardware, such as telephones or computer hardware, would not be eligible for the safe harbor's protection because they are not sufficiently related to order execution. Such systems and hardware are not seen as falling within the temporal standard.

Additional items that would not qualify under the safe harbor include trade analytics, surveillance systems, compliance mechanisms, and error correction functions. According to the 2005 Release, these items are not integral to the execution of orders by broker-dealers because they are in place to correct the manager's own errors and not to benefit an advised account. As with research, eligible brokerage products and services must also provide lawful and appropriate assistance to the money manager in carrying out his responsibilities. Furthermore, the manager must make a good faith deter-

mination that the amount of commissions paid is reasonable in relation to the value of the eligible products and services received.

### Mixed-Use Items

The SEC continues to believe that money managers may use soft dollars to pay for the eligible portion of a mixed-use item. The 2005 Release reiterates the SEC's position set forth in the 1986 Release that money managers who wish to use soft dollars to pay for a portion of a mixed-use item must allocate costs among the item's research and non-research uses. The mixed-use allocation must be reasonable and adequately documented. For example, 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.

### Third-Party Research and Commission Sharing

The 2005 Release would continue to allow money managers to use client commissions to pay for research produced by someone other than the executing broker-dealer, provided that the broker-dealer retains the direct legal obligation to pay for the research.<sup>31</sup>

Commission sharing arrangements would also be permissible, provided that the arrangement complies with SEC guidance. 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.<sup>32</sup> Furthermore, the 2005 Release would require that "each broker-dealer ... play a role in effecting securities transactions that goes beyond the mere provision of research services to money managers."<sup>33</sup> In such arrangements, the introducing broker-dealer must:

<sup>31</sup> See 1986 Release, *supra* note 11.

<sup>32</sup> *Id.*

<sup>33</sup> 2005 Release, *supra* note 1, at 44.

- Be financially responsible to the clearing broker-dealer for all customer trades until the clearing broker-dealer has received payments or securities
- Make and/or maintain records relating to its customer trades required by SEC and SRO rules
- Monitor and respond to customer comments concerning the trading process
- Generally monitor trades and settlements
- Be capable of adding value to investment or trading decisions by providing new insights that inform the investment manager when making such decisions about customers' portfolios
- Represent original thought in critical, careful consideration and assessment of new and existing facts, and not merely repeat or repackage what has been presented before
- Have intellectual rigor and not merely state what is commonplace or self-evident
- Involve analysis or manipulation of data to reach meaningful conclusions

A broker-dealer effecting the trade must also be legally obligated to pay for third-party research or brokerage service. According to the 2005 Release, so long as a commission-sharing arrangement meets the elements discussed above, research and brokerage services provided pursuant to that arrangement would be eligible for the Section 28(e) safe harbor.<sup>34</sup>

### The U.K. Financial Services Authority and Soft Commissions Reform

In drafting the 2005 Release, the Commission Staff consulted market participants, the NASD Mutual Fund Task Force, and foreign regulators, notably the FSA in the United Kingdom, among other sources. In the 2005 Release, the Commission noted that its proposed position regarding the use of soft dollars is generally consistent with that of the FSA. At the Open Meeting, Commissioner Annette Nazareth lauded the Commission Staff's consultation with the FSA and noted that the SEC anticipates a greater convergence of standards as firms conduct transactions globally and incur further costs in complying with widely disparate standards.

On July 22, 2005, the FSA adopted final rules governing the use of client commissions to pay for research and execution services.<sup>35</sup> The rules also acknowledge that some products and services may or may not be permitted depending on how the money manager uses them.

Under the FSA's rules, eligible research goods or services must:

With respect to the provision of research, the FSA provides examples of those goods or services that do not meet the required standard. These goods or services include price feeds or historical price data that have not been manipulated to reach meaningful conclusions.

The rules also specify a temporal standard for determining whether particular goods or services sufficiently relate to execution and are therefore eligible to be paid for with client commissions. Under the FSA rules, eligible execution services must be linked to the arranging and conclusion of a specific investment transaction (or series of related transactions) and must be provided between the point at which the investment manager makes an investment or trading decision and the point at which the investment transaction is concluded. The rules list a number of non-permitted execution services. These non-permitted services include custody not incidental to execution, computer hardware, telephone lines, and portfolio performance measurement and valuation services.<sup>36</sup>

In addition to defining the scope of eligible research and execution services, the FSA's rules require managers to make certain disclosures to customers regarding their use of client commissions to obtain these services. The disclosures must include details of the goods or services that relate to the execution of trades and, wherever appropriate, separately identify the details of the goods or services that are attributable to the provision of research.

<sup>34</sup> The 2005 Release's treatment of third-party research suggests that the Commission has rejected a suggestion from the Investment Company Institute ("ICI") that third-party research be banned altogether. The ICI had made this suggestion, in addition to other suggestions, regarding the use of soft dollars, in December 2003.

<sup>35</sup> See FSA Release, *supra* note 21.

<sup>36</sup> See *Id.* at Annex 8-9. Additional examples of non-permitted goods or services with respect to execution are (a) seminar fees; (b) subscriptions for publications; (c) travel, accommodation or entertainment costs; (d) membership fees to professional associations; and (e) employees' salaries.

According to the FSA's policy statement, the FSA's new rules, together with the industry proposals in the United Kingdom, will:

- Require investment managers to disclose to their customers details of how commission payments have been spent and what services have been acquired with them ("enhanced disclosure")<sup>37</sup>
- Limit investment managers' use of dealing commission to the purchase of "execution" and "research" services
- Embed in the commercial relationship between investment managers and brokers incentives to secure value for clients for execution and research spend
- Promote competition between those who produce investment research by removing the regulatory distinction between research services provided by brokers along with execution (*i.e.*, bundled services) and research services provided by third parties (*i.e.*, softed services)

The FSA's rule on the use of client commissions will become effective in January 2006, with a transitional period until June 2006.

With the significant exception of the enhanced disclosure requirement, the 2005 Release is generally consistent with the position taken by the FSA. There are, how-

<sup>37</sup> The amendments to the Conduct of Business sourcebook at 7.18.12 provide that:

- (1) If an *investment manager* enters into arrangements for the receipt of goods or services that relate to the *execution* of trades or the provision of research in accordance with COB 7.18.3R (Use of dealing commission to purchase goods or services), it must in a timely manner make adequate:

(a) prior disclosure; and

(b) periodic disclosure;

to its *customers* of the arrangements entered into.

- (2) The adequate disclosure in (1) must include details of the goods or services that relate to the *execution* of trades and, wherever appropriate, separately identify the details of the goods or services that are attributable to the provision of research. See *Id.* at Annex 10.

ever, two notable differences with respect to the treatment of market data and seminars. The FSA has determined that market data that has not been analyzed or "manipulated" does not meet the requirements of a research service, but does permit managers to justify using client commissions to pay for raw data feeds as execution services.

Additionally, the FSA classifies seminars as non-permitted services.<sup>38</sup> By contrast, the 2005 Release would include market data, in either raw or analyzed form, as an eligible research product so long as the eligibility criteria are met. Similarly, under the criteria of the 2005 Release, seminars would be eligible research services under the Section 28(e) safe harbor so long as the substantive content of the seminars meets the eligibility criteria.

## Solicitation of Comments

The 2005 Release is open for a 30-day comment period which ends on November 25, 2005. Although the SEC does not generally request public comment on an interpretive release, the Commission is seeking comment on the 2005 Release to ensure that any guidance ultimately released is fully informed and draws clear lines as to when it is permissible to pay for services with investors' money. The 2005 Release specifically solicits comments and responses to the following questions:

- Does the Commission's interpretation offer sufficient guidance with respect to the types of "advice," "analyses," and "reports" that are eligible as "research services" under Section 28(e)?
- How would investors, money managers, broker-dealers, and others be affected by the Commission's interpretive guidance that client commissions cannot be used to obtain computer equipment as "research" under Section 28(e)?
- Does the Commission's interpretation offer appropriate guidance as to the eligibility of market data and trade analytical software under Section 28(e)?
- Does the Commission's interpretation offer sufficient guidance as to the eligibility of "brokerage" services, functions, and products under Section 28(e)? How would this guidance affect existing arrangements or practices? Is the Commission's

<sup>38</sup> See *Id.* at 2.15.

temporal standard sufficiently clear? Are there types of services that should be excluded from the safe harbor, even though they might appear to satisfy the temporal standard? If so, explain why those services should be excluded—for example, is the service unrelated to execution of transactions?

- Does the Commission’s interpretation offer sufficient guidance about third-party research and commission-sharing arrangements?
- How does the Commission’s interpretive guidance differ from the approaches that other regulators, SROs, market participants, trade organizations, and investor advocacy groups have adopted or recommended with respect to client commission practices?
- Are there types of products or services that are commonly paid for with client commissions for which additional guidance would be useful? If so, please provide facts about these products and services and their components, and how they are used. For example, are client commissions commonly used to pay for proxy voting services?
- Should the Commission provide additional guidance on the allocation and documentation of mixed-use items?
- Concerns have been expressed by some industry participants and others that mass-marketed publications (publications that are widely circulated to the general public and intended for a broad, public audience) are part of a firm’s overhead and should not be paid for with client commissions. To what extent are these types of publications currently being paid for with client commissions? Are the purposes and uses of these types of publications distinguishable from those of traditional research products? Should the Commission provide further guidance in this area?
- Should the Commission afford firms time to implement the interpretation?

## Conclusion

While the 2005 Release seeks to clarify the scope of research and brokerage products and services that fall within the Section 28(e) safe harbor, a number of questions remain. For example, the 2005 Release does not

specifically address the eligibility of commercial or mass media publications. However, it should be noted that the 2005 Release indicates the Commission’s willingness to work with and refine the current soft dollar regulatory regime. The 2005 Release would also draw new lines in a number of places, engendering further debate and, if adopted, raising new questions. Although the Commission narrowed the scope of eligible research and brokerage products and services, it did not take this opportunity to radically change soft dollar regulation or restrict substantially the reach of the Section 28(e) safe harbor. For example, the Commission did *not* urge Congress to repeal or modify Section 28(e).

In addition to the Commission’s actions with respect to soft dollars, the market may itself be moving toward adopting changes to soft dollar practices. For example, Fidelity Investments negotiated an agreement with Lehman Brothers to separate trading costs and research costs.<sup>39</sup> Fidelity has decided to use corporate assets to pay for these separate proprietary research products and services. Currently, Fidelity is in the process of negotiating similar arrangements with other brokerage firms.

The issuance of the 2005 Release is likely the first step in a new round of regulatory changes that would alter soft dollar practices. At the Open Meeting, the Commission expressed concern regarding the lack of transparency with respect to the use of soft dollars by money managers. For example, Chairman Christopher Cox stated that, in the coming months, the Commission will be considering whether to propose requirements for disclosure and recordkeeping of client commission arrangements. Additionally, Commissioner Nazareth remarked 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 investors receive for soft dollars.

■ ■ ■

<sup>39</sup> See Matthew Keenan and Adrian Cox, “Fidelity Presses Brokers to Split Trading Costs From Research,” Bloomberg (October 20, 2005), available at [http://www.bloomberg.com/apps/news?pid=10000103&refer=u&sid=ainh3hbl.\\_To](http://www.bloomberg.com/apps/news?pid=10000103&refer=u&sid=ainh3hbl._To).

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## Appendix A: Eligible Research and Brokerage Products and Services

	RESEARCH	BROKERAGE
<b>STANDARDS</b>		
<b>Overall Standard</b>	<p>⇒ Eligible products and services must provide a money manager with <b>lawful and appropriate assistance</b> in carrying out investment decision-making responsibilities.</p> <p>⇒ Money managers must make a <b>good faith determination</b> that the amount of commissions paid is reasonable in relation to the value of the research and brokerage product or service received.</p>	
<b>Substantive Standard</b>	<p>⇒ Advice, reports or analyses must reflect the <b>expression of reasoning or knowledge</b>.</p> <p>⇒ The subject matter must relate to the categories identified in Section 28(e)(3)(A) [advice] or (B) [analyses or reports] (<i>i.e.</i>, relate to the securities or financial markets).</p>	<p>⇒ Persons must either <b>effect securities transactions</b> or perform functions <b>“incidental thereto”</b> (e.g., clearance and settlement) and otherwise meet the requirements of Section 28(e)(3)(C).</p> <p>⇒ Functions required by the SEC or SRO rules are included.</p>
<b>Temporal Standard</b>	<p>⇒ No applicable temporal standard.</p> <p>⇒ <b>Note:</b> research services include services provided before the money manager communicates an order.</p>	<p>⇒ 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.</p>
<b>EXAMPLES OF ELIGIBLE AND INELIGIBLE PRODUCTS AND SERVICES</b>		
<b>Eligible Products or Services</b>	<b>Products and Services Related to Research Reports</b>	<p>⇒ Post-trade services:</p> <ul style="list-style-type: none"> <li>▪ Post-trade matching.</li> <li>▪ Exchange of messages among broker-dealers, custodians, and institutions.</li> <li>▪ Electronic communication of allocation instructions between institutions and broker-dealers.</li> <li>▪ Routing instructions to custodian banks and broker-dealer’s clearing agents.</li> </ul> <p>⇒ Services required by SEC or SRO rules, which may include electronic confirmation and affirmation of institutional trades in conjunction with settlement processing (e.g., NYSE Rule 387).</p> <p>⇒ Communications services related to the execution, clearing, and settlement of securities transactions and other incidental functions, <i>i.e.</i>, connectivity service between the money manager and the broker-dealer and other relevant parties such as custodians including:</p> <ul style="list-style-type: none"> <li>▪ dedicated lines between the broker-dealer and the money manager’s order management system;</li> <li>▪ lines between the broker-dealer and order management systems operated by a third-party vendor;</li> <li>▪ dedicated lines providing direct dial-up service between the money manager and the trading desk at the broker-dealer; and</li> <li>▪ message services used to transmit orders to broker-dealers for execution.</li> </ul> <p>⇒ Trading software operated by a broker-dealer to route orders to market centers and algorithmic trading software.</p>

Appendix A: Eligible Research and Brokerage Products and Services (cont'd)

	RESEARCH	BROKERAGE
<b>EXAMPLES OF ELIGIBLE AND INELIGIBLE PRODUCTS AND SERVICES</b>		
<b>Ineligible Products or Services</b>	<b>Products and Services Related to Research Reports</b>	<ul style="list-style-type: none"> <li>⇒ Order Management Systems used to manage orders (whether developed in-house or obtained from third-party vendors) and hardware, such as telephones or computer hardware.</li> <li>⇒ Trade analytics (may be mixed use, to the extent used for research and not for compliance purposes).</li> <li>⇒ Surveillance systems and compliance mechanisms.</li> <li>⇒ Error correction trades or related services in connection with errors by money managers.</li> </ul>
	<ul style="list-style-type: none"> <li>⇒ Overhead expenses.</li> <li>⇒ Travel expenses, entertainment, and meals associated with attending seminars.</li> <li>⇒ Office equipment, office furniture, business supplies, telephone lines, salaries (including research staff), rent, accounting fees and software, website design, email 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.</li> </ul>	
	<b>Computers, Software and Related Services</b>	
	<ul style="list-style-type: none"> <li>⇒ Computers, hardware, accessories, peripherals, delivery mechanisms, including telecommunications lines.</li> <li>⇒ Analyses of account performance that are used for marketing purposes.</li> </ul>	
<b>EXAMPLES OF ELIGIBLE AND INELIGIBLE PRODUCTS AND SERVICES</b>		
<b>Potentially Eligible Products or Services</b>	<b>Products and Services Related to Research Reports</b>	
	<ul style="list-style-type: none"> <li>⇒ Consultant's report: <ul style="list-style-type: none"> <li>▪ would qualify if the consultant provides advice with respect to portfolio strategy;</li> <li>▪ would not be eligible, if the advice relates to the managers' internal management or operations.</li> </ul> </li> <li>⇒ Data Services <ul style="list-style-type: none"> <li>▪ market data such as stock quotes, last sale prices, and trading volumes are eligible.</li> <li>▪ company financial data is eligible.</li> <li>▪ economic data, such as unemployment and inflation rates or gross domestic product figures are eligible.</li> <li>▪ other data would be eligible if it meets the standard.</li> </ul> </li> </ul>	