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# SEC Releases New Interpretive Guidance on Soft Dollar Arrangements

At an open meeting of the Securities and Exchange Commission (the "SEC" or the "Commission") on July 12, 2006 (the "Open Meeting"), the Commission approved an Interpretive Release (the "2006 Interpretation") regarding the soft dollar safe harbor under Section 28(e) of the Securities Exchange Act of 1934 (the "Exchange Act").[1] The 2006 Interpretation focuses new light on the scope of "brokerage and research services" and on the permissibility of commission-sharing arrangements.[2]

In his opening remarks at the Open Meeting, SEC Chairman Christopher Cox expressed some concerns with the concept of soft dollars, noting that:

> *The purpose of [the 2006 Interpretation] is to better circumscribe the use of soft dollars, which are really inflated brokerage commissions, to ensure that they are used only for research and not for other things...*
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> *As a result of this provision of the Exchange Act, brokers can compete not only on the basis of their execution services, but also their provision of research. But Section 28(e) wasn't meant to create conflicts of interest, by permitting commission dollars to be spent in ways that benefit investment managers instead of their investor clients. So the Commission has to take great care in interpreting Section 28(e) so that soft dollars don't distort the normal market incentives to money managers to seek best execution.*
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> *At the same time, we want to ensure that the legitimate use of soft dollars for research doesn't interfere with the full disclosure of actual management costs.*[3]

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1 The Commission issued the release on July 18, 2006. Rel. No. 34-52635 (July 18, 2006); 71 Fed. Reg. 41978 (July 24, 2006). Because of perceived confusion over the term "soft dollars," the 2006 Interpretation uses the term "client commission practices or arrangements" rather than soft dollars. For ease of reference and understanding, this Update continues to use the soft dollar terminology.

2 The 2006 Interpretation became effective upon publication in the Federal Register on July 24, 2006. Managers may rely on either the 2006 Interpretation or prior guidance for the next six months to give them time to unwind any inconsistent soft dollar arrangements and adapt to the new regime. After January 27, 2007, managers may no longer rely on prior inconsistent interpretations. Of course, because Section 28(e) is a safe harbor, managers need to resort to Section 28(e) only where actions taken would otherwise violate a fiduciary or legal obligation.

Therefore, under certain circumstances (and assuming sufficient disclosure has been provided to satisfy the manager's fiduciary obligations), managers can continue to acquire products and services outside the safe harbor with soft dollars, unless doing so would violate legal requirements otherwise applicable to the manager such as those under the Employee Retirement Income Security Act of 1974 ("ERISA"), or the Investment Company Act of 1940 (the "1940 Act").

3 Opening Statement of Christopher Cox, Chairman, SEC at the Open Meeting ("Cox Statement at the Open Meeting").

The 2006 Interpretation largely reflects the Commission's October 2005 proposal.[4] However, we note that the Commission departed from the Proposed Guidance in several important respects.

## Executive Summary

Under the 2006 Interpretation, a money manager may rely on the safe harbor to acquire products or services only upon satisfaction of each part of a three part test:

- Does the product or service meet the eligibility criteria of Section 28(e)(3)?[5]
- Does the eligible product or service provide lawful and appropriate assistance in the performance of relevant responsibilities?[6]
- May the money manager properly conclude, in good faith, that the commissions paid are reasonable in relation to the value of the research and brokerage products and services provided by the broker[7] (either in relation to the particular transaction or the money manager's overall responsibilities with respect to discretionary accounts)?[8]

The 2006 Interpretation also is relevant to broker-dealers who may receive soft dollars. Under Section 28(e), a money manager can pay soft dollars only to broker-dealers who "provide" research or brokerage services and "effect" transactions.[9] Under the 2006 Interpretation, the circumstances under which broker-dealers will be seen as "providing" services and "effecting" transactions will be interpreted more broadly than under past interpretations, allowing brokers and money managers greater flexibility to structure soft dollar and commission-sharing arrangements in a manner that will better serve the interests of investors.[10]

Following a brief discussion of the history of soft dollars, this update will describe, in greater detail, relevant aspects of the 2006 Interpretation.[11]

## I. A Brief History of Soft Dollars

On May 1, 1975 ("May Day"), the SEC ended the nearly 200-year-old practice of fixed brokerage commission rates. Prior to May Day, brokers and dealers competed for brokerage business not by offering lower priced executions (an impossibility under the fixed commission structure) but instead by providing additional services, such as research. Following May Day, Congress enacted Section 28(e) to address fears that, under competitive commission rates, if a money manager caused an account to pay anything more than the lowest possible commission rate for a particular transaction, the money manager might be seen to have violated state or federal fiduciary duties.[12]

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4 *See* Rel. No. 34-52635 (October 19, 2005) (the "Proposing Release"). In drafting the Proposing Release, the SEC consulted not only market participants, but also the NASD Mutual Fund Task Force and foreign regulators such as the United Kingdom's Financial Services Authority ("FSA"), and other sources. In prior issues of *Dechert OnPoint*, we discussed the SEC's proposed guidance. *See Dechert OnPoint* legal update Issue 20 (October 2005). *Dechert OnPoint* legal update Issue 23, (November 2005).

5 *See infra* §II.A.1–2.

6 *See infra* §II.B. Prior to the 2006 Interpretation the SEC explicitly applied the "lawful and appropriate assistance" standard only to research, the 2006 Interpretation extends this same standard to brokerage services. 2006 Interpretation at 41985.

7 In order to qualify for the safe harbor, the product or service must be "provided by a broker-dealer" to which the soft dollars were paid. 2006 Interpretation at 41994. As discussed below, the 2006 Interpretation may represent a significant liberalization of the circumstances under which products or services are considered to be "provided by a broker-dealer."

8 *See infra* §II.C.

9 2006 Interpretation at 41993–41994. *See infra* §II.A.2.

10 The 2006 Interpretation included a request for further comments on, among other things, commission-sharing arrangements. The comment period ends on September 7, 2006. 2006 Interpretation at 41995.

11 For a more thorough and detailed summary of the background of Section 28(e) of the Exchange Act, *See* the following *Dechert OnPoint* legal updates: Issue 20 (October 2005) and Issue 23 (November 2005) *supra* note 4.

12 Under traditional fiduciary principles, when purchased with soft dollars, even research which benefited the account whose commissions produced the soft dollars was also deemed to benefit the adviser by relieving it of the obligation to purchase such research directly. Despite SEC statements that use of client assets to obtain research is justified in appropriate circumstances, money managers were concerned about their fiduciary responsibility in the absence of a safe harbor.

Market participants believed that, absent a safe harbor:

- Brokers who provided research might be forced out of business, reducing overall market liquidity and competition
- New or small advisers might be unable to obtain research useful (and in some cases necessary) for managing their clients' accounts
- The quality and quantity of research would diminish, increasing volatility and decreasing efficiency
- Existing fee schedules developed under the old, fixed commission regime might not provide enough resources for managers to develop in-house research capabilities or to acquire outside research with "hard dollars"

Section 28(e) allows money managers to "pay up" (*i.e.*, cause an account to pay more than the lowest available execution costs) for eligible brokerage and research services, under certain circumstances.[13] A money manager may not be held liable for failing to pay the lowest possible commission provided that the money manager has determined that "paying up" resulted in the receipt of valuable, eligible brokerage services or research.[14]

In the over thirty years since Section 28(e)'s enactment, the SEC has issued a number of releases which have expanded and contracted the contours of the safe harbor.

In the first decade following the enactment of Section 28(e), SEC guidance generally sought to rein in perceived abuses of the safe harbor. In a 1976 SEC interpretive release, the Commission took the position that the safe harbor did not protect "products and services that are readily and customarily available and offered to the general public on a commercial basis."[15] In 1980, following an investigation of certain soft dollar arrangements among Investment Information, Inc. ("III") and several money managers and broker-dealers, the Commission issued a report (the "III Report")[16] specifying that, while the safe harbor does not require broker-dealers to produce research "in house," the research services must be "provided by" the broker-dealer. Under the III Report, where the broker-dealer that executed the transaction "in no significant sense provided the money managers with research services," the safe harbor is not available.[17]

By contrast, during the period from 1986 through 2001, SEC guidance has generally had the effect of expanding the safe harbor. In 1986, the SEC concluded that the guidance provided in the 1976 Release was "difficult to apply and unduly restrictive in some circumstances" and that "uncertainty about the standard may have impeded money managers from obtaining" certain useful soft dollar items. Consequently, the SEC determined to replace the 1976 Release with a more flexible and comprehensive inter-

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13 Among the principal objectives of Section 28(e) was to ensure "the future availability and quality of research and other services." Report of the Comm. on Banking, Housing and Urban Affairs, S. Rep. 94-75 (1975). Section 28(e)(1) states, in relevant part:

> *No person . . . in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty . . . solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion.*

14 The 1986 Release makes clear that Section 28(e) "only excuses paying more than the lowest available commission and does not shield a[n adviser] from charges of violations of the antifraud provisions of the federal securities laws or from allegations, for example, that he churned an account, failed to seek the best price, or failed to make required disclosures."

15 Rel. No. 34-12251 (March 24, 1976), (the "1976 Release").

16 In these arrangements, III designated certain broker-dealers to which the money managers were instructed to direct transactions. The broker-dealers would effect these transactions on an execution-only basis and remit half of the commissions earned to III. From this portion of commissions, III retained a fee and allowed the money manager to recapture the remaining amount in either cash or to purchase services which would be paid for by III. III was not a registered broker-dealer nor did it perform any brokerage functions. *See*, Rel. No. 34-16679, 19 SEC Docket 926 (March 19, 1980) (the "III Report").

17 *Id.* at 931-932.

pretive release, intended to clarify the scope of what research and brokerage products and services were covered under Section 28(e) (the "1986 Release").[18]

Under the 1986 Release, research would be eligible for protection under the safe harbor if it provided "lawful and appropriate" assistance to the money manager in making investment decisions.[19] Additionally, the 1986 Release introduced the concept of a "mixed-use" item—*i.e.*, an item a portion of which constitutes eligible research or brokerage and a portion of which does not.[20] Payment for such items must be reasonably allocated between soft dollars and direct, cash payment by the money manager. However, the flexibility of the 1986 Release may have led to abuses.[21]

In 2001, the Commission issued a release that extended the safe harbor beyond commissions paid to a broker-dealer acting in an agency capacity (the "2001 Release").[22] Under the 2001 Release, certain 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 trade reporting rules of the National Association of Securities Dealers (the "NASD"), are now considered "commissions" for purposes of the safe harbor.[23]

In 2005, the U.K. FSA adopted final rules relevant to the use of soft dollars by FSA regulated entities. Under the FSA rules, money managers may use client commissions only to acquire eligible "execution" and "research" products and services while specified "non-permitted" services must be paid for with hard dollars.[24] Because money managers may operate in a global market (and therefore be subject to, among others, SEC and FSA requirements), the SEC sought to take "the FSA's work into account in developing our position in this release, while recognizing the significant differences in our governing laws and rules."[25] As a result, the 2006 Interpretation is "generally consistent with the FSA rules, with a few exceptions."[26]

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18 Rel. No. 34-23170 (April 30, 1986) (the "1986 Release"). Chairman Cox summarized these developments in his opening remarks at the Open Meeting, noting that:

> *Since the adoption of Section 28(e) in 1975, the Commission has issued two interpretive releases. The first, issued contemporaneously with the enactment of the law, stated that the safe harbor did not protect "products and services which are readily and customarily available and offered to the general public on a commercial basis." Among the products excluded from the safe harbor were newspapers, magazines, office supplies, off-the-shelf software, and airline tickets.*
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> *The second release was issued ten years later, in 1986, and it went the other way from the original release. It provided greater flexibility to make judgments about how to treat products and services, and it opened the door to potentially overbroad readings of the safe harbor.*

19 Section II and III of the 1986 Release define "brokerage and research services" and "third party research." These sections have been superseded by the 2006 Interpretation. 2006 Interpretation at 41983. The remainder of the 1986 Release (including sections discussing: legal and disclosure obligations under the 1940 Act and the Investment Advisers Act of 1940; best execution; and directed brokerage arrangements), to the extent not inconsistent with the 2006 Interpretation, remains valid. *Id.*

20 1986 Release, at n. 13 and accompanying text. *See infra* §III.

21 In 1998, the SEC staff examined a number of broker-dealers, advisers, and funds, and found that many expenses paid for by money managers with soft dollars were not research or brokerage services for purposes of the safe harbor (*e.g.*, the purchase of mixed-use items solely with soft dollars and the use of soft dollars to pay for recordkeeping expenses). *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"). Although the 1998 report highlighted instances of abuse, it did not alter the circumstances under which money managers could rely on the safe harbor.

22 Rel. No. 34-45194 (December 27, 2001) (the "2001 Release").

23 *See id.*

24 Non-permissible services include: custody not incidental to execution; computer hardware; telephone lines; and portfolio measurement and valuation services. 2006 Interpretation at 41983.

25 *Id*.

26 *Id.* Among the exceptions cited by the SEC are that (i) the FSA does not allow raw market data as a "research service" although such data, under certain circumstances, may fall within the FSA's definition of "execution services" and (ii) the FSA has identified publication subscriptions and seminar fees as "non-permitted" services. *Id.* For further information about the FSA's soft dollar rules, *See Dechert OnPoint* legal update (March 2, 2006).

The 2006 Interpretation makes clear that, as has been the case since the enactment of Section 28(e), "[t]oday, it remains true that, if the conditions of the safe harbor of Section 28(e) are met, a money manager does 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 provided by the broker-dealer (*i.e.*, anything more than 'pure execution')."[27] As with prior guidance, the 2006 Interpretation represents a reevaluation not of whether soft dollars should be available as a general matter but, instead, the circumstances under which the use of soft dollars is consistent with the legal and fiduciary obligations applicable to money managers.[28]

## II. The Three Part Test: Use of Soft Dollars to Pay for Products and Services Under the Safe Harbor

As indicated above, the 2006 Interpretation introduces a three-part test applicable whenever a money manager wishes to rely on the safe harbor to acquire products or services from a broker in exchange for soft dollars. In some cases, it may not be clear whether a particular item might be brokerage or research. Although the three-part test applies equally to brokerage and research, the results of the test may differ depending on whether the particular item is intended to be treated as brokerage or as research.

### A. Does the product or service meet the eligibility criteria of Section 28(e)(3)?

A threshold question in determining whether a money manager can rely on the safe harbor to acquire a product or service pursuant to the safe harbor is whether that product or service is "research" or "brokerage" as each is defined by Section 28(e)(3). Although this is a statutory requirement, prior to the 2006 Interpretation, the SEC had not provided detailed guidance or significant analysis as to how a money manager would determine whether a particular product or service passed this threshold consideration. Additionally, prior guidance failed to keep pace with developing technology. This was particularly true with respect to whether a product or service was eligible brokerage under the safe harbor where guidance was sparse at best.[29]

Although, as discussed below, the test to determine whether a product or service meets the eligibility criteria for research differs from that used to determine whether a product or service meets the eligibility criteria for brokerage, the aim of each is the same—to separate legitimate brokerage and research items which may be paid for with soft dollars, provided that the use of and payment for those items otherwise conforms to the safe harbor, from "overhead" items which should more properly be paid out of the money manager's own resources.

*1. "Research" – Section 28(e)(3)(A) and (B)*

Under Section 28(e)(3), "research" includes:

- Advice, which may be provided either directly or through publications or writings, as to:
  - The value of securities
  - The advisability of investing in, purchasing, or selling securities; or
  - The availability of securities or purchasers or sellers of securities
- Analyses or reports concerning:
  - Issuers
  - Industries
  - Securities
  - Economic factors and trends
  - Portfolio strategy; or
  - The performance of accounts

Based on the language of Section 28(e) and its legislative history, the SEC now takes the view that eligible "research" products and services must reflect sub-

27 2006 Interpretation at 41984.

28 Because the soft dollar safe harbor is statutory, an act of Congress would be required to ban soft dollars outright.

29 The 1998 OCIE Report specifically recommended that the Commission consider further guidance as to eligible brokerage citing "an increasing use of soft dollars to purchase state-of-the-art computer and communication systems that may facilitate trade execution."

stantive content—*i.e.*, "the expression of reasoning or knowledge."[30] Substantive content is not necessarily "original" research. A product or service which synthesizes, analyzes, or compiles the research of others may meet the eligibility criteria.[31] In addition to meeting the substantive content requirement (and, thus, qualifying as "advice," "analyses," or "reports"), "research" products and services must address one or more of the subjects set forth in the statute. Thus, a consultant's report as to portfolio strategy would be eligible research, but a report from the same consultant as to the money manager's internal management or operations would not.[32]

The SEC noted, however, that the enumerated subject matter "categories expressly listed in Section 28(e)(3)(A) and (B) also subsume other topics related to securities and the financial markets."[33] Advice, analyses or reports which express reasoning or knowledge with respect to those subsumed topics (*e.g.*, "a report concerning political factors that are interrelated with economic factors") would also be eligible research.[34] Importantly, the 2006 Interpretation makes clear that "[t]he form (*e.g.*, electronic, paper, or oral) of the research is irrelevant to the analysis of eligibility" for purposes of the first prong of the three-part test.[35]

In addition to providing general guidance, the 2006 Interpretation specifically addressed whether certain items or types of items could be eligible research for purposes of the safe harbor.

(a) Certain Traditional Soft Dollar Items

The SEC demonstrated the application of the first prong of the three part test by concluding that certain expenses traditionally paid for with soft dollars continue to be eligible research. Among these were:

- Traditional research reports analyzing a particular company's performance or securities
- Discussions with research analysts as to the advisability of investing in securities
- Meetings with corporate executives to obtain oral reports on a company's performance
- Attendance at seminars or conferences which relate to one or more of the subject matter categories set forth above
- Portfolio analysis software
- Corporate governance research, analytics, and rating services, to the extent they include substantive content related to a subject matter category[36]
- Consultant services which result in the delivery of advice, analyses, or reports relating to one or more of the subject matter categories[37]

However, the SEC cautioned that, with respect to meetings and conferences, while the costs of attending the meeting may be eligible research, travel and related expenses (*e.g.*, meals and entertainment) are not.

(b) Publications

(i) Mass Market vs. Specialized

In a departure from the 1986 Release, money managers must cease using soft dollars to acquire mass

30 The SEC's view is that such substantive content is "an important common element among 'advice,' 'analyses,' and 'reports.'" 2006 Interpretation at 41985.

31 However, as discussed below, where such an item "simply copied, repackaged, or aggregated" the money manager would be required to "make a good faith determination that the determination that any additional commissions paid in respect of such copying, repackaging or aggregation" are reasonable.

32 2006 Interpretation at 41986.

33 *Id.* at 41985.

34 *Id.*

35 *Id.*

36 In this regard, the 2006 Interpretation noted that corporate governance "can have a bearing on the companies' performance outlook". 2006 Interpretation at 41986. However, as is the case with proxy voting services, discussed below, corporate governance research, analytics and ratings services may fail under the second prong of the three-part test (*i.e.*, lawful and appropriate assistance) when used to make voting as opposed to investment decisions.

37 However, a money manager cannot use soft dollars to pay the salary of internal research staff—even where those personnel perform exactly the same functions.

market publications, such as subscriptions to *The Wall Street Journal*, by January 24, 2007. However, other publications, such as trade magazines and technical journals, remain eligible research items.

How a publication is marketed, rather than its method or form of distribution, is the driving factor in a money manager's determination of whether the publication is eligible research. So long as the publication meets the indicia of a specialized publication, rather than those of a mass market publication (as described below), the fact that it is available through the internet does not render it ineligible.

(ii) Factors to Consider

The 2006 Interpretation provides guidance for money managers who may be unsure as to whether a particular publication is "mass market" (and thus ineligible) or specialized (and thus eligible).

Mass market publications are:

- Circulated to a wide audience
- Intended for and marketed to the public, rather than intended to serve the specialized interests of a small readership
- Low cost

By contrast, publications which are eligible research are:

- Marketed to a narrow audience
- Directed to readers with specialized interests in particular industries, products, or issuers
- High cost

(c) Inherently Tangible Items

Inherently tangible items generally will not be eligible research. These items do not reflect the expression of reasoning or knowledge and, consequently, are not "advice," "analyses," or "reports" as contemplated by Section 28(e)(3)(A) and (B). Whereas under prior guidance, certain tangible items could be deemed to be research to the extent that those items assisted in the delivery of research, under the 2006 Interpretation, such items are seen as "overhead [outside] the statutory criteria . . . and not eligible for the safe harbor."[38] Among the items specifically cited by the SEC as being outside the safe harbor as a result of their failure to meet the eligibility criteria for research were:

- Telephone lines and utilities
- Office furniture, equipment, supplies, and rent;
- Meals, travel, and entertainment
- Salaries (including research staff)[39]
- Accounting fees and administrative software
- Legal expenses[40]
- Marketing
- Membership dues[41] and professional licensing fees
- Computer terminals, peripherals, delivery mechanisms, and accessories[42]

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38 *Id*. at 41987.

39 As noted above, consultant fees may be eligible. *See supra* note 37.

40 The 2006 Interpretation discusses legal expenses in the context of "a money manager's operational overhead." In doing so, the SEC cited to an enforcement action in which an adviser was cited for improper use of soft dollars "to pay for undisclosed non-research business expenses such as legal . . . services." Rel. No. 34-44600 (July 27, 2001). To the extent that a money manager incurs non-research legal expenses that relate to the money manager's business or operations, those services would be overhead and should be paid for with "hard" dollars. However, where an adviser acquires legal advice or analyses or reports that relate to the permissible subject matters set forth in Section 28(e)(3)(A) and (B), in a manner which is otherwise consistent ith the safe harbor, it is arguable that those items are third-party "research" rather than overhead and thus may be protected under the safe harbor.

41 The 2006 Interpretation specifically cited "initial and maintenance fees paid on behalf of the money manager or any of its employees to any organization or representative or lobbying group or firm." 2006 Interpretation at 41987.

42 Even where such items are associated with the oral or electronic delivery of research (*e.g.*, Bloomberg terminals, T-1 lines, cables) the lack of substantive content renders them outside the eligibility criteria for research. However, certain of these items may be eligible as bro-

(d) Market Research

Market research (*i.e.*, information regarding the market for securities) generally is, and will continue to be, eligible research under the safe harbor, provided that it meets the substantive content requirement. While the SEC noted that market research traditionally was provided directly by broker-dealers, the 2006 Interpretation recognizes that, as a result of technological advancements, these products and services now are available through other means, including trade analytical software and order management systems ("OMS").[43]

Regardless of the delivery mechanism, the 2006 Interpretation generally allows money managers to treat reports, analyses, and advice as to the following as eligible research (whether directly from a broker-dealer or through software and other products that generate such reports, analyses, or advice based on market information):

- Market color
- The availability of buyers and sellers
- Execution or trading strategies
- Optimal execution venues
- Pre-trade and post-trade analytics

The SEC cautioned, however, that where "products and services contain functionality that is not eligible brokerage or research or [are not] used in a way that provides lawful and appropriate assistance" these products may be mixed-use items.[44]

(e) Data

The 2006 Interpretation adopts substantially as proposed the SEC's position that "data services, including market data [that] reflect[s] substantive content related to the subject matter categories identified in Section 28(e)" would be eligible research.[45] The 2006 Interpretation cited the following types of market and economic data and data services as potentially within the safe harbor:

- Stock quotes
- Last sale prices
- Trading volumes
- Company financial data
- Economic data (*e.g.*, unemployment figures, inflation rates, gross domestic product figures)

Because some money managers rely on raw data to create their own research, the SEC believed that inclusion of these sorts of data within eligible research was consistent with the policy underlying the safe harbor and, moreover, would promote innovative research and level the playing field with those managers who purchase finished research into which the relevant data has already been incorporated.[46]

(f) Proxy Services

Proxy voting services encompass "a range of products, some of which may satisfy the standards set forth . . . for eligible 'research' under the safe harbor"[47] and proxy voting service providers may offer these services individually or on a bundled basis. Consequently, money managers will typically be called upon to either determine whether each service is eligible research or to examine the bundled service to determine which aspects are eligible research and which are not.

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kerage, provided they meet associated eligibility criteria, as described below.

43 *See infra* §II.D.1. As discussed more fully below, the SEC's views on the treatment of OMS, as reflected in the 2006 Interpretation, represent a departure from the Proposing Release.

44 2006 Interpretation at 41987. *See infra* §§II.B. and II.C.2.

45 2006 Interpretation at 41987.

46 *Id.* Additionally, because traditional research often includes market data in the finished product, the SEC was concerned that the addition of even a minimal level analysis or functionality would be sufficient to bring raw data within the eligibility criteria and, therefore, excluding such data from eligible research would be a meaningless exercise. By contrast, under FSA rules, "market data that has not been analyzed or manipulated does not meet the requirements of a research service [but may qualify] as execution services." *Id.* at 41983.

47 *Id.* at 41988.

To the extent such services are or include substantive content as to issuers, securities, and the advisability of investing in securities, the 2006 Interpretation would view such content as eligible research. However, those services or items which lack substantive content or otherwise serve a non-research purpose are not eligible research. Consequently, the SEC concludes that, at best, proxy services are mixed-use items and those aspects of a proxy voting service that are not eligible research, or that do not provide lawful and appropriate assistance (as discussed further below), cannot be paid for with soft dollars consistent with the safe harbor.

Proxy services that may be eligible under the safe harbor include:

- Proxy reports and analyses on issuers, securities, and the advisability of investing in securities
- Corporate governance research and ratings

Proxy services that are ineligible under the safe harbor include:

- Proxy services that handle the mechanical aspects of voting
- Administrative expenses
- Research provided to a money manager to determine how to vote[48]

(g) Third-Party Research

For purposes of the eligibility criteria, and generally under the safe harbor, the SEC's treatment of research items does not depend on whether the research is proprietary or provided by a third party. Consistent with the SEC's traditional position, the 2006 Interpretation specifically states that third-party research benefits clients by increasing the breadth and depth of available research as well as providing access to research which is independent from sell side conflicts. As such the SEC confirmed that "the safe harbor encompasses third-party research and proprietary research on equal terms." Moreover, as explained below, the 2006 Interpretation expands the circumstances in which a broker-dealer "effects" transactions for the manager to be eligible for the safe harbor.[49]

*2. "Brokerage – Section 28(e)(3)(C)*

Under Section 28(e)(3), "brokerage" includes:

- Effecting securities transactions

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48 The 2006 Interpretation makes clear that aspects of proxy voting services that are or contain substantive content about issuers, securities or the advisability of investing in securities, are eligible research and thus meet the first prong of the three-part test. Consequently, provided that the amount paid is reasonable in relation to the value of the service, such services will be eligible for the safe harbor if they provide lawful and appropriate assistance. The 2006 Interpretation differentiates between proxy voting services used to make investment (*i.e.*, buy/sell/hold) decisions and those used to make voting decisions based on the SEC's conclusion that reports, analyses or advice obtained from proxy voting services provide lawful and appropriate assistance when used to "consider . . . the advisability of investing in, or retaining a position in, a security" but the same reports, analyses or advice do not provide lawful and appropriate assistance when used to "in deciding how to vote proxy ballots."

This would seem to conflict with the SEC's guidance in the 2003 releases adopting certain rules related to proxy voting by investment companies and investment advisers. *Final Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, Rel. No. 33-8188 (January 31, 2003) (the "Fund Release"). *Final Rule: Proxy Voting by Investment Advisers*, Rel. No. IA-2106 (January 31, 2003) (the "Adviser Release"). In those releases, the SEC strongly suggested that proxy voting is an integral part of the investment adviser's responsibilities. Specifically, the Adviser Release stated that "advisers typically exercise proxy voting authority as a part of their discretionary management" and that this voting power places advisers "in a position to significantly affect the future of corporations and, as a result, the future value of corporate securities held by their clients." The Fund Release was even stronger, stating that "[p]roxy voting decisions . . . can play an important role in maximizing the value of the fund's investments."

Under the plain language of Section 28(e), money managers are permitted to consider their "overall responsibilities with respect to the accounts as to which he exercises investment discretion" and, as discussed more thoroughly below, the 2006 Interpretation, states that the lawful and appropriate assistance standard "focuses on how the manager uses eligible research" and suggests that such research must be used in connection with "making investment decisions." Accordingly, it is reasonable to question whether the conclusion that the use of soft dollars to acquire reports used to make proxy voting decisions is not protected under the safe harbor (though explicitly stated) is consistent with the three-part test, as it has been set forth and explained by the SEC in the 2006 Interpretation.

49 *See infra* §IV.C.1.

- Performing functions incidental to such transactions, such as:
  - Clearance
  - Settlement
  - Custody
- Performing functions required by rule or regulation in connection with such transactions

To properly distinguish brokerage services from services which, under prior guidance, may have constituted either research or brokerage services and which might "be inappropriately reclassified as brokerage," and to ensure that "services that are related to the execution of securities transactions [remain] eligible as brokerage under the safe harbor [while] those that are overhead expenses [do] not," the SEC sought a standard which would "reflect historical and current industry practices that execution of transactions is a process, and that services related to execution of securities transactions begin when an order is transmitted to a broker-dealer and end at the conclusion of clearance and settlement of the transaction."

Thus, the 2006 Interpretation includes, substantially as proposed, the so-called "temporal standard" for determining whether a product or service meets the eligibility criteria applicable to brokerage for purposes of the safe harbor.

(a) The Temporal Standard

Unlike research products and services, which may be provided and/or used at any time, the 2006 Interpretation requires that eligible brokerage services be provided or used during the period that "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."[50]

In response to commenters who suggested that the temporal standard should be expanded to include, among other things, pre-trade analytics, OMS, and long-term custody, the SEC noted that the temporal standard, as proposed, is an appropriate interpretation of Section 28(e)(3)(C), and includes all aspects of brokerage services as contemplated by the statute (*i.e.*, effecting transactions as well as performing incidental functions and functions required by SEC or self-regulatory organization ("SRO") rules). However, as discussed in the next section, an item that does not qualify as "brokerage" because it falls outside the temporal standard may, if the conditions described above are met, be eligible "research" for purposes of the safe harbor.

(b) Eligible Brokerage

It is important to note that, under the temporal standard for "brokerage," many items that are excluded from the definition of research under the safe harbor may be eligible brokerage services, while other items which, in the past, may have been considered "brokerage" but now fail the temporal standard, meet the eligibility criteria for research products or services, as described above. The 2006 Interpretation lists a number of products and services which are explicitly within the temporal standard including:

- Communications and connectivity services related to execution, clearing, and settlement of securities transactions and other functions incidental thereto
- Trading software used to route orders to market centers
- Software that provides algorithmic trading strategies
- Software used to transmit orders to direct market access ("DMA") systems

Additionally, the following "post-trade services" were explicitly noted as being either incidental to executing a transaction or required by relevant SEC or SRO rules and, therefore, meet the eligibility criteria for brokerage services post-trade matching of trade information:

- Exchanges of messages among broker-dealers, custodians, and institutions related to the trade
- Electronic communication of allocation instructions between institutions and broker-dealers
- Routing settlement instructions to custodian banks and broker-dealers' clearing agents

[50] 2006 Interpretation at 41989.

- Short-term custody related to effecting particular transactions in relation to clearance and settlement of the trade
- Comparison services required by SEC or SRO rules (*e.g.*, electronic confirmation and affirmation of institutional trades in connection with settlement processing)

(c) Ineligible Brokerage

By contrast, the 2006 Interpretation notes that services or products which are not sufficiently related to order execution or fall outside the temporal standard, are not eligible brokerage including:

- Telephones or computer terminals, even where used in connection with OMS and trading software
- Recordkeeping, portfolio management, quantitative analytical and administrative software
- Compliance responsibilities, such as:
  - Compliance tests and analyses to identify unusual patters over time
  - Creating trade parameters for compliance with investment objectives or restrictions
  - Stress-testing a portfolio under a variety of market conditions or to monitor style drift
- Trade financing (*e.g.*, stock lending fees and margin services)
- Capital introduction
- Error correction[51]

Of course, some items that are not eligible brokerage may qualify, in whole or in part, as eligible research for purposes of the Safe Harbor. Examples of such items may include:

- Pre- and post- trade analytics
- OMS
- Market research provided by a broker or trade analytical software prior to order transmission
- Quantitative analytical software used to test "what-if" scenarios

(d) Custody

Although, as indicated above, short term custody in connection with clearance or settlement of transactions is eligible brokerage, the SEC rejected commenters' requests to treat long-term custody as eligible brokerage. The 2006 Interpretation explains that the disparate treatment of custody is a result of the "plain language of the statute [which] limits the scope of the safe harbor to custody that is incidental to effecting securities transactions."[52]

The SEC reiterated that, whereas short-term custody fits neatly within the temporal standard "because it is tied to processing the trade between the time the order is placed and settlement," long-term custody is, by its very nature, provided post-settlement and, therefore, violates the temporal standard. Moreover, because long-term custodial services are often provided by "financial firms that do not execute transactions for the client at all," the SEC believes that long-term custody typically "has no relationship to, and cannot be incidental to, effecting securities transactions."[53]

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51 The 2006 Interpretation notes that "error correction trades or related service in connection with errors made by money managers are not related to the initial trade for a client within the meaning of Section 28(e)(3)(c) because they are separate transactions to correct the manager's error, not to benefit the advised account." 2006 Interpretation at 41990.

52 *Id.*

53 *Id.* However, the SEC pointed out that, as a practical matter, the differential treatment will not have a significant effect on money managers as custody is typically the product of a direct arrangement between the client and the custodian. As a general matter, the SEC views directed brokerage arrangements as being outside the scope of Section 28(e):

> *[T]ransactions for which the client has directed the money manager to a particular broker dealer in order to recapture a portion of the commission for that client or to pay expenses of that client such as sub-transfer agent fees, consultants' fees, or administrative services fees generally do not raise the types of conflicts for the money manager that the safe harbor of Section 28(e) was designed to address. These types of directed brokerage arrangements typically involve the use of a client's commission dollars to obtain services that directly and exclusively benefit the client.*

**B. Does the Eligible Product or Service Provide Lawful and Appropriate Assistance to the Money Manager in the Performance of his Relevant Responsibilities?**

Once the money manager has determined that a particular product or service meets the eligibility criteria of Section 28(e)(3), he must next determine that those products and services also provide "lawful and appropriate assistance" in the performance of his relevant responsibilities to managed accounts. While this analysis has long been applied to the payment of soft dollars for research items, the 2006 Interpretation extends similar treatment to brokerage services.[54]

As with the eligibility criteria, the SEC applies the standard slightly differently to research as opposed to brokerage items. Whereas research items must provide "lawful and appropriate assistance in making investment decisions," brokerage items must provide "lawful and appropriate assistance in carrying out the manager's responsibilities." However, as with the eligibility criteria, the focus remains the same—to determine whether the eligible product or service is used in a manner which is consistent with the safe harbor (*e.g.*, to provide research assistance) as opposed to a manner which disproportionately or exclusively benefits the money manager (*e.g.*, to assist in preparing marketing materials).

Thus, this second prong of the three-part test focuses on the use to which the money manager puts an eligible research or brokerage item—only when the money manager uses products or services for the benefit of his clients can he avail himself of the safe harbor. Whether payment for a particular eligible item with soft dollars will fall within the safe harbor may, therefore, vary from manager to manager (or, indeed, from use to use by a single manager) depending on whether that particular use of the item conforms to the lawful and appropriate assistance standard.

For example, analyses of the performance of accounts are eligible research under Section 28(e)(3)(B) and may be paid for with a reasonable amount of soft dollars when used to make investment decisions. However, if these analyses are used by the money manager for marketing purposes, the "assistance" provided to the money manager is not "lawful and appropriate" because marketing is not done for the benefit of the client's account, regardless of how much or little the manager "paid" for the item.

Additionally, as discussed more thoroughly below, when an item is used both to benefit clients and to benefit the manager, a mixed-use allocation is necessary.

**C. May the Money Manager Conclude, in Good Faith, that the Commissions Paid are Reasonable in Relation to the Value of the Services Provided?**

Because soft dollars are a client asset, money managers have an obligation under Section 28(e) to determine that commissions paid are reasonable in relation to the value of the research and brokerage products and services received. This determination may be made, in accordance with Section 28(e), in reference either to a particular transaction or to the money manager's "overall responsibilities with respect to accounts as to which he exercises investment discretion."[55]

*1. Duty to Seek Best Execution*

While an investment adviser's duty to seek best execution does not require a determination that the lowest available commission cost be paid, but rather a reasonable belief that the execution yielded total costs and proceeds on the most favorable terms readily available—*i.e.*, that the transaction represents the best qualitative execution available under the circumstances—managers who acquire products or services which benefit the manager in addition to his clients may need to rely on the safe harbor to protect against allegations that he has breached his duties as a fiduciary or under applicable law.

When making execution decisions generally in accordance with the duty to seek best execution for client transactions, money managers are expected to consider "the full range and quality of a broker's services."[56] Moreover, because trades may be executed

*Id.* at 41980 n. 27. Of course, other conflicts of interest may be present in directed brokerage arrangements and advisers entering into such arrangements are expected to make appropriate disclosures with respect to those conflicts. *See In re Mark Bailey*, Rel. No. IA-1105 (February 24, 1988).

54 The lawful and appropriate assistance standard was drawn from the legislative history of Section 28(e). 2006 Interpretation at 41984.

55 Section 28(e)(1).

56 2006 Interpretation at 41991 (citing the 1986 Release).

through numerous channels under most circumstances, and the lowest commission rate may be essentially ephemeral, it may be difficult even to determine what portion of a commission represents "paying up."

Indeed, where an investment adviser uses a full service broker or otherwise receives any product or service beyond pure execution, it may be assumed by the SEC that the adviser is "paying up" with soft dollars. In the 2006 Interpretation, the SEC cautioned that money managers who pay up to obtain both eligible products, such as market data and other ineligible services, would be ineligible for safe harbor protection because the commissions paid would be disproportionate to the value of services received.

*2. Evidences of Cost*

Recently, some money managers have been successful in convincing broker-dealers to unbundle proprietary research from "execution-only" rates. In these circumstances, a manager may pay hard dollars for the proprietary research. To the extent that other money managers are aware of the unbundled rate, that price "should inform the money manager as to [the] market value [of the item] and help the manager make its good faith determination."[57] Similarly, one would expect that, where a manager has entered into a soft dollar arrangement where he is credited a particular amount based on a ratio of commissions generated, the price of the service could be estimated with a reasonable degree of precision.

*3. Considerations of Value*

The 2006 Interpretation noted that the consideration of value depends on the nature of the service (rather than, perhaps, its ultimate use); where, for example, eligible research has 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." In any event, the good faith determination would seem to require that the manager obtain the service at a cost which closely approximates the manager's view of the value received.[58] The value of a soft dollar item may be inferred from the relative benefits that product or service provides to the manager and its clients.[59] This determination is inextricably tied to the utility of the service and whether there may be alternate means of obtaining it at a potentially lower cost.[60]

## III. "Mixed-Use" Items

The 2006 Interpretation reaffirms the SEC's position, first set forth in the 1986 Release, that a particular "soft dollar item" may include both eligible and ineligible components (*i.e.*, portions of the item may not meet the eligibility criteria required to satisfy the first prong of the three part test), or may be used in both an eligible and an ineligible way (*i.e.*, certain uses of the item may not provide "lawful and appropriate assistance" as required to satisfy the second prong of the three part test).

### A. Order Management Systems and other Common Mixed-use Items

The most significant mixed-use item identified in the 2006 Interpretation is OMS. Under the Proposing Release, OMS would have been wholly outside the safe harbor based on the SEC's view that OMS, as a delivery system akin to computer hardware would fail to meet the eligibility criteria for "research" and would also fall outside the temporal standard for "brokerage."[61] Based on numerous comments, the 2006 Interpretation views OMS as a collection of components—some of which may meet one or both of the eligibility criteria, while others of which would continue to fall outside of the safe harbor.

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57 Of course, simply because a particular price has been quoted to a particular manager is not conclusive evidence of its value or demonstrative of other managers' ability to acquire the same service on an unbundled basis or for the same price but on a soft dollar basis.

58 By analogy, with respect to mixed-use determinations, one factor the SEC advised managers to consider was "the relative utility to the firm of eligible versus non-eligible uses." 2006 Interpretation at 41991.

59 This too is similar to the guidance provided for mixed-use allocations. *Id.*

60 Again, an analogy could be drawn to the 2006 Interpretation's treatment of mixed-use items which suggests that managers consider, in making mixed-use allocations "the extent to which the product is redundant with other products employed by the firm for the same purpose." *Id.*

61 *See* Proposing Release.

Consistent with the 2006 Interpretation, a money manager may pay soft dollars for that portion of those components of an OMS that meet the eligibility criteria for either research or brokerage, and provide lawful and appropriate assistance with respect to relevant responsibilities of the money manager, provided that the amount of soft dollars paid is reasonable in relation to the value of those services provided, and subject to a proper and reasonable mixed-use allocation.

The particular uses or components of OMS that are most likely to fall within the safe harbor include:

- Research reports or software which meet the eligibility criteria for "research"
- Trading software or functionality used in a manner consistent with the eligibility criteria for "brokerage"
- Direct lines connecting the OMS with a broker-dealer

By contrast, those functions and components of OMS that do not meet the various eligibility criteria will not fall within the safe harbor, including:

- Compliance functions
- Hardware, peripherals, cables, and accessories
- Administrative, recordkeeping, and other non-research software
- Connectivity for other than trading purposes
- Portfolio analytics/what-if scenarios for other than research purposes

Other specific products and services that are likely to be "mixed-use" include:

- Proxy voting services
- Trade analytical software
- Management information services

### B. Treatment of Mixed-use Items

Money managers who choose to pay for a portion of a mixed-use item with soft dollars must make a reasonable allocation of the cost of the product according to its use and keep adequate books and records concerning allocations in order to make a good faith determination that the commissions paid were reasonable in relation to the value of the eligible products and services. Among the factors which money managers should consider when making and documenting mixed-use allocations are:

- How the manager and its employees use the product or services
- The relative benefits provided to the firm or its clients
- The amount of time the product or service is used for eligible vs. non-eligible purposes
- The relative utility (measured by objective metrics) to the firm of the eligible vs. non-eligible uses
- The extent to which the product is redundant with other products employed by the firm for the same purpose[62]

Because money managers have discretion to allocate costs—paying "hard" dollars for portions that are outside the safe harbor and soft dollars for portions that are within the safe harbor—and an incentive to allocate those costs in such a way as to minimize the amount of out-of-pocket expenses incurred, "mixed-use" allocations create potential conflicts of interest that investment advisers should disclose to clients.[63]

## IV. Soft Dollar Arrangements

### A. Acquiring Soft Dollar Items

Money managers typically obtain soft dollar items either from full service broker-dealers (often on a "bundled" basis) or pursuant to negotiated soft dollar arrangements which typically involve a portion of the commissions generated by a manager being credited to a "soft dollar account" and redeemed for products or services. In either event, these classic soft dollar arrangements allow a money manager to receive brokerage and research services from a broker-dealer, which are used to benefit client accounts. The client

[62] 2006 Interpretation at 41991.

[63] *Id.*

pays for these services with higher transaction commissions.

*1. Full Service Brokers – Bundled Services*

"Proprietary" or "bundled" research and execution services may be provided by "full service" or "Wall Street" broker-dealers in exchange for executing trades through such broker-dealers.[64] Receipt of proprietary research generally involves paying more than the lowest available commission rate to the providing broker-dealer. However, in most instances, the broker-dealer does not attach a particular value to the "research" or "brokerage" component of any given trade in relation to commission received for "pure execution" or improved service with respect to the trade.

In these instances, most consider the amount of soft dollars expended to be the amount by which the broker's commission exceeds the minimum available commission for such a trade. Isolating the amount of soft dollars paid for "research" or "brokerage" services from the amount paid for "pure execution" or higher quality execution (*e.g.*, maintaining the confidentiality of the manager, executing large blocks) can be difficult and many advisers view higher quality execution to be equally (or even more) important to their decision to trade through that broker.[65]

*2. Soft Dollar Credits and Similar Arrangements*

Soft dollar products and services may also be acquired through soft dollar arrangements pursuant to which money managers receive credit from commissions directed to certain broker-dealers to pay for services offered by third parties for a specific price. The amount of commissions required to cover the hard dollar cost of any given service with soft dollars is calculated according to a ratio determined in advance between the money manager and the broker-dealer. Soft dollar credits may also be redeemed for third party products and services which could otherwise be purchased for cash. Under these arrangements, the cost of the service is quantifiable.

*3. Effects on Eligibility for the Safe Harbor*

Although both "bundling" and "crediting" arrangements generally may qualify for the safe harbor, the manner in which soft dollar items are acquired may have a bearing on how a money manager may use soft dollars to acquire those items in reliance on the safe harbor. For example, when a money manager acquires soft dollar items through a crediting arrangement, the cost of those items is typically transparent to the manager, providing a clearer benchmark against which to analyze the reasonableness of commissions paid. Moreover, as discussed in the next section, the requirement that soft dollar items be "provided by" a broker-dealer who is involved in "effecting" the transaction may dictate the contours of certain soft dollar relationships. Thus, for example, third parties who invoice money managers directly for soft dollar services risk causing that service to lose the protection of the safe harbor, unless the item is paid by the broker-dealer in conformity with the 2006 Interpretation.

**B. Commission-Sharing Arrangements – Paying for Execution and Soft Dollar Services**

The manner in which participating broker-dealers' responsibilities are allocated under commission sharing arrangements can and does vary. In some circumstances, an introducing broker-dealer accepts orders from money managers, executes trades, and provides research, while a second broker-dealer clears and settles the transactions. In other circumstances, the introducing broker-dealer provides research but has little if any role in accepting orders or executing, clearing, or settling trades—those services are provided by a clearing broker-dealer. In either case, the commission is split among all participating broker-dealers.

In still other instances, the introducing broker-dealer is often unaware of daily trading activity and the money manager routes orders directly and exclusively through the clearing broker-dealer's desk. Still others have suggested arrangements, similar to those common in the United Kingdom and acceptable under FSA

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64 Bundled research does involve soft dollars however, in contrast to credit based arrangements, the relative cost of the soft dollar items as opposed to "pure execution" may not be as easily ascertainable.

65 In this regard, the OCIE Report indicated that:

> *[T]he average commission rate on third-party soft dollar trades was six cents per share, the same average rate being paid to firms providing proprietary research. This suggests that, while there is no separately itemized charge for proprietary soft dollar benefits, advisers have placed an equivalent value on these services. Examiners also were told however, that many firms providing proprietary research are used by advisers to execute larger or more difficult trades. Thus, the average commission rate paid to these firms may also reflect payment for the care used in obtaining best execution for these transactions.*

guidance, whereby money managers direct a broker-dealer to collect and pool commissions generated by trades executed through that broker-dealer and periodically direct the broker-dealer to pay for soft dollar items from that pool.

*1. Is Further Guidance Forthcoming?*

As demonstrated above, commission-sharing arrangements vary widely in the industry, but, in addition to the money manager, often involve multiple broker-dealers and/or other third-party research providers, each of which may provide different research and/or brokerage services to the money manager or the client. The transacting broker-dealer is paid commissions, these commissions generate soft dollars which are either pooled to pay for services provided, or are paid directly to providers as transactions occur. Because of the variety of arrangements, the 2006 Interpretation includes both an acknowledgement that further guidance may be required and a solicitation for further comments to help the SEC determine whether such guidance is necessary and, if so, what should be addressed therein.

*2. Responding to Evolving Circumstances*

Prior guidance allowing money managers to pay soft dollars to a broker-dealer and others who are "normal and legitimate correspondent[s]" of the executing or clearing broker-dealer remains valid under the 2006 Interpretation. Moreover, as the financial services industry has become more specialized, concerns about "give-ups"[66] have yielded to a recognition that the industry and financial markets benefit from the functional separation of execution and research. At the same time, there is a continued recognition that client commissions should not be used in a manner "to make concealed payments to a broker-dealer that did not provide any services to benefit the advised accounts."[67]

Nonetheless, the SEC, bound by the statutory requirement that "the broker-dealer providing the research also be involved in effecting the trade,"[68] continues to require that these types of soft dollar arrangements be structured in a manner that "promotes a functional allocation" of the basic responsibilities of a broker-dealer (as described in the next section) among the participating broker-dealers. Such an arrangement is not the equivalent of a give up or inconsistent with the SEC's (and commenters') view that efficient execution and valuable research may not originate with the same provider. Because obtaining both efficient execution and valuable research is beneficial to clients, these types of arrangements are, and will continue to be, permitted within the safe harbor.

### C. Safe Harbor Requirements with Respect to Soft Dollar Arrangements

The 2006 Interpretation (and prior releases) contain valuable guidance as to when a money manager may pay soft dollars to a broker-dealer consistent with the safe harbor's requirements that the services be "provided by" the broker in connection with "effecting" transactions. Soft dollar arrangements may be protected by the safe harbor if the broker-dealer "effects" related transactions, and, with respect to eligible research, the broker-dealer "provides" the research to the money manager.

*1. When Does a Broker "Effect" Transactions?*

The 2006 Interpretation departs from previous SEC positions by permitting greater flexibility in commission-sharing arrangements. Nonetheless, broker-dealers still must provide a minimum level of services in order to be considered to "effect" a transaction within the meaning of Section 28(e).[69] Specifically, each broker-dealer involved must perform at least one of the following services:[70]

- Taking financial responsibility for all customer trades until the clearing broker-dealer has received payment or securities (*i.e.,* being at risk for the customer's failure to pay)
- Making and/or maintaining required records relating to customer trades

66 A "give-up" is an arrangement in which a money manager instructed a broker-dealer to pay another broker-dealer part of a negotiated commission, when the third-party broker-dealer was not a "normal and legitimate correspondent" of the transacting broker-dealer. 2006 Interpretation at 41993.

67 *Id.*

68 *Id.*

69 Of course, broker-dealers must comply with their obligations under the federal securities laws, including their responsibility regarding best execution.

70 2006 Interpretation at 41994.

- Monitoring and responding to customer comments concerning the trading process
- Generally monitoring trades and settlements
- Executing trades
- Clearing trades
- Settling trades

Additionally, to ensure that all relevant services are performed with respect to each trade, each broker-dealer involved must "see that the other functions have been allocated to one or another of the broker-dealers in the arrangement" consistent with relevant SEC and SRO rules.[71] Furthermore, at least one participant "must be aware of and monitor daily trading activity of customers even where the money manager sends orders directly to (and only to) the clearing broker."[72]

2. *When Does a Broker "Provide" Eligible Products and Services?*

In addition to the requirement that eligible research be obtained from a broker-dealer who "effects" the related transactions, the relevant broker-dealer also must "provide" the eligible research to the money manager in order for the money manager to rely on Section 28(e).[73] Under the 2006 Interpretation, traditional bundled research arrangements (where the broker-dealer provides proprietary research to the money manager) and traditional crediting arrangements (where the broker-dealer is legally obligated to pay for the research) are, and will remain, eligible for the safe harbor. Additionally, in a significant departure from prior guidance, the 2006 Interpretation now considers the "provided by" requirement to be satisfied:

> *[I]n situations where broker-dealers use a money manager's client commissions to pay for eligible research and brokerage for which* ***such broker-dealer is not directly obligated*** *to pay if such broker-dealer pays the research preparer directly and takes steps to assure itself that the client commissions that the manager directs it to use to pay for such services are used only for eligible brokerage and research.*[74]

Under the 2006 Interpretation, where the following attributes are present, "the broker-dealer that is effecting transactions . . . has satisfied the 'provided by' element, and the Section 28(e) safe harbor is available" to the money manager:

- The broker-dealer pays the research preparer directly
- The broker-dealer reviews the description of the services to be paid for with client commissions under the safe harbor for red flags that indicate the services are not within Section 28(e), and agrees with the money manager to use client commissions only to pay for those items that reasonably fall within the safe harbor
- The broker-dealer develops and maintains procedures so that research payments are documented and paid for promptly

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71 For example, under NYSE rules, the following functions must be allocated among participants in a fully-disclosed clearing arrangement: (i) opening, approving, and monitoring of accounts; (ii) extension of credit; (iii) maintenance of books and records; (iv) receipt and delivery of funds and securities; (v) safeguarding of funds and securities; (vi) confirmations and statements; (vii) acceptance of orders and execution of transactions. NYSE Rule 382(b). *See* 2006 Interpretation at 41994.

72 2006 Interpretation at 41994.

73 The 2006 Interpretation replaces and expands prior guidance with respect to the "provided by" requirement, including that set forth in the 1986 Release. *Id.* at 41983.

74 2006 Interpretation at 41994 (emphasis added). As indicated in the Proposing Release at 61710:

> *The essential feature of the "provided by element" is that the broker-dealer has the direct legal obligation to pay for the research.[114] The Commission also has clarified that research provided in third party arrangements is eligible under Section 28(e) even if the money manager participates in selecting the research services or products that the broker-dealer will provide. The third party may send the research directly to the broker's customer so long as the broker-dealer has the obligation to pay for the services. In contrast, a money manager may not rely upon Section 28(e) if he uses the broker-dealer merely to pay an obligation that he has incurred with a third party.*
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> In footnote 114, the Commission cited to "1986 Release, 51 FR at 16007; III Report, 19 SEC Docket at 932." [other footnotes omitted].

## V. Liability and Obligations of Managers and Broker-Dealers

### A. Liability for Activities in Violation of Applicable Legal and Fiduciary Duties

The 2006 Interpretation reiterates the responsibility of money managers and broker-dealers to ensure that soft dollar commission sharing arrangements requiring protection under the safe harbor are structured and effectuated so as to allow reliance on Section 28(e). Money managers face potential liability under federal securities law, ERISA, and state law when they use soft dollars inconsistently with the safe harbor. Additionally, the 2006 Interpretation makes clear that broker-dealers who participate in improper soft dollar arrangements which result in a money manager violating legal or fiduciary obligations in circumstances where the safe harbor is not available may have liability as aiders and abetters of the money manager's violation.

### B. Disclosure Obligations

Money managers who are not (by virtue of their management of ERISA assets or registered investment companies or otherwise) required to rely on the safe harbor are, and will continue to be, permitted to use soft dollars to acquire items which:

- Do not meet the eligibility criteria
- Do not provide "lawful and appropriate assistance"
- Are acquired for a cost in excess of their reasonable value

However, when operating outside the safe harbor, money managers must provide clear and comprehensive disclosure to clients, including a discussion of any relevant conflicts of interest that arise.

Similarly, advisers who disclose that they will comply with the safe harbor are, of course, required to so comply. Moreover, advisers who use mixed-use items should disclose relevant conflicts of interest associated with mixed-use allocations. The SEC is "considering whether at a later time to propose requirements for disclosure" relating to soft dollars.[75]

### C. Recordkeeping Obligations

Money managers are subject to certain recordkeeping obligations in connection with soft dollar activities, including:

- Records relating to the reasonableness determination
- Records relating to mixed-use allocations

Similarly, broker-dealers may be required to maintain:

- Records relating to documentation of research payments
- Records relating to customer trades (if not allocated to another broker-dealer)

The SEC is also considering whether to propose recordkeeping and disclosure requirements for client commission arrangements.[76]

## VI. Implementation Timeline

The 2006 Interpretation is effective immediately. However, the Commission is permitting industry participants to rely on prior soft dollar guidance for a phase-in period of six months following the publication of the 2006 Interpretation in the *Federal Register*—that is, until January 24, 2007.

## VII.Conclusion

The Commission may take additional steps to improve transparency of soft dollar arrangements. Several Commissioners and members of the Staff stated during the Open Meeting that further guidance or rule

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75 *Id.* at 41979. *See also*, Remarks of Andrew Donahue, Director of the Division of Investment Management at the Open Meeting ("Donahue Remarks").

76 *See* 2006 Interpretation at 41979 and 41991 (noting that "[l]ack of documentation makes it difficult for the manager to make the required good faith showing of reasonableness . . . and also makes it difficult for compliance personnel to ascertain the basis for the [mixed-use] allocation.") and Donahue Remarks.

making may be adopted, requiring money managers to disclose additional details about soft dollar arrangements to their clients, including mutual fund boards. Indeed, Commissioner Roel C. Campos stated:

> *I am glad to see that some industry participants have taken a piece of the puzzle into their own hands with the unbundling of commissions (such as Fidelity's and Lehman Brothers' $7 million October 2005 unbundling deal), which requires the sell side to affix a value to each of its research products. The likely outcome of this conduct is to reduce the types of goods and services managers considered legitimate under the safe harbor. Again, the power of transparency and disclosure can be enormous.*[77]

Chairman Cox confirmed that disclosure is of great concern to the Commission, and will likely be the subject of further SEC guidance, noting that soft dollar arrangements "make it more difficult for investors to understand what's going on with their money."[78]

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[77] Remarks of Commissioner Campos at the Open Meeting.

[78] Cox Statement at the Open Meeting, *supra* note 3.

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