

SEC Issues Final Guidance on the Use of Soft Dollars

On July 12, 2006 the Securities and Exchange Commission (the “Commission”) approved an interpretive release (“Interpretive Release”) that provides guidance regarding a money manager’s use of client commissions to pay for brokerage and research services under Section 28(e) of the Securities Exchange Act of 1934. The Interpretive Release largely reiterated the guidance on Section 28(e) provided in a proposed release dated October 19, 2005.¹

The Interpretive Release provides additional guidance on the three-part test for determining whether a money manager may rely on the safe harbor in Section 28(e). The following three elements comprise that test:

- the brokerage and research services must meet the eligibility requirements under Section 28(e);
- the brokerage and research services must serve a lawful and appropriate use; and
- the money manager must determine in good faith that the commissions paid are reasonable in light of the value of the services received.²

I. Determining Whether a Service is Eligible as Brokerage or Research Under Section 28(e)

Brokerage. The Interpretive Release uses a temporal limitation when defining eligible brokerage services under Section 28(e). Eligible “brokerage” services under Section 28(e) only include those products and services that relate to the execution of a trade and are rendered from when the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution, until funds or securities are delivered or credited to the advised account or the account holder’s agent. Eligible “brokerage services” under Section 28(e) include the following: short-term custody related to effecting particular transactions and clearance and settlement of those trades, dedicated lines or connectivity service between the money manager and the broker-dealer and other parties such as custodians, and trading software used to route orders to market centers. Eligible brokerage services do not include long-term custody, compliance testing, computer hardware, telephones or computer terminals, including those used in connection with trading software because they are not sufficiently related to order execution and fall outside the temporal standard for “brokerage” under the safe harbor.

Research. The Interpretive Release reiterates that “research services,” as specified in Section 28(e)(3), are limited to “advice,” “analyses” and “reports” — and that those three terms contain an important common element: the expression of reasoning or knowledge. Thus, in order to qualify as “research” under Section 28(e), the service must reflect the expression of reasoning or knowledge and relate to the subject matter identified in Section 28(e)(3)(A) or (B) (e.g., the value of securities, economic factors or portfolio strategy).³ As a result, traditional research reports analyzing a company or stock or a discussion with research analysts may be eligible under Section 28(e), while items such as computer

¹ Section 28(e) protects money managers from liability for a breach of fiduciary duty on the basis that they caused a client to pay more than the lowest commission rate in order to receive “brokerage and research services” provided by a broker-dealer, if the managers determined in good faith that the amount of the commission was reasonable in relation to the value of the brokerage and research services received.

² The Interpretive Release states the Commission’s view that the prudent way for a money manager to meet its burden of showing eligibility for the safe harbor is to document fully its use of client commissions.

³ The Interpretive Release states that the Commission believes that the Section 28(e) safe harbor encompasses third-party research and proprietary research on equal terms.

hardware, computer terminals, travel expenses, meals and mass-marketed publications would be ineligible as research under Section 28(e).⁴ Market and economic data may fall within the safe harbor as research if the data satisfy the subject matter criteria of Section 28(e) and provide lawful and appropriate assistance in the investment decision-making process. Finally, the Interpretive Release cautions that the same service could be either eligible or ineligible as research under Section 28(e) depending on its use. For example, a consultant's services may be eligible for the safe harbor if the consultant provides advice with respect to portfolio strategy, but not if the advice relates to the money manager's internal management or operations.

Mixed-Use Items. The expense associated with mixed-use items (*i.e.*, items that have uses that are both within and outside the safe harbor provided by Section 28(e)) must be reasonably allocated between eligible and ineligible uses, and the manager must keep adequate books and records concerning allocations to enable the manager to make the required good faith determination of the reasonableness of commissions in relation to the value of brokerage and research services. In allocating part of the expense of mixed-use items to itself, a money manager may consider, among others, the following factors: the relative benefits of the eligible and ineligible uses, the amount of time the product or service is used for eligible versus ineligible purposes and the extent to which the product is redundant with other products employed by the firm for the same purpose.⁵ The Interpretive Release cites proxy services as an example of a mixed-use item, as these services could assist managers in the investment decision-making process as well as in the mechanical aspects of voting.

II. Lawful and Appropriate Assistance

The Interpretive Release reiterates that although a brokerage or research service may fit within the meaning of "research" or "brokerage" under Section 28(e) that alone does not mean that the service is eligible for the Section 28(e) safe harbor. To qualify under Section 28(e), a brokerage or research service must provide "lawful and appropriate assistance" to the money manager in the performance of its management responsibilities. For example, an analysis of the performance of accounts may be eligible as a research item because it reflects the expression of reasoning or knowledge regarding subject matter included in Section 28(e)(3); however, the same item would not qualify for the safe harbor if the research were used by the money manager for marketing purposes.

III. Determining in Good Faith that the Amount of Client Commissions Paid is Reasonable in Light of the Value of Products or Services Provided by the Broker-Dealer

Whenever a commission is paid in reliance on Section 28(e), the money manager must make a good faith determination that commissions paid are reasonable in relation to the value of the products and services provided by the broker-dealer. The burden of proof in demonstrating this determination rests on the money manager. The Interpretive Release notes that where a broker-dealer offers its research for an unbundled price, that price should inform the money manager as to its market value.

IV. Third Party Research

In the Interpretive Release, the Commission recognized the value of third party research and industry developments that have resulted in the functional separation of execution and research services. The Interpretive Release discussed the Commission's position that Section 28(e)(1) requires the broker-dealer *effecting* the trade to be involved in *providing* the research. To "effect" a trade, a broker-dealer must either execute, clear or settle the trade or perform one of the four following functions: (i) taking financial responsibility for customer trades until the clearing broker-dealer has received

⁴ Certain financial newsletters or trade journals aimed at a narrow audience may be eligible research under the safe harbor.

⁵ The Interpretive Release notes that the conflicts of interest associated with mixed-use items should be disclosed to clients.

payment (or securities), (ii) making and/or maintaining required records, (iii) monitoring and responding to customer comments concerning the trading process and (iv) monitoring trades and settlements.⁶ The Interpretive Release provided additional guidance on what it means for a broker-dealer to “provide” research where the broker-dealer effecting the trade is not preparing the research. Under the revised guidance in the Interpretive Release, a broker-dealer “provides” research if it either (a) prepares the research itself or (b) pays the research preparer directly (or is legally obligated to pay for the research) 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 (*e.g.*, by reviewing descriptions of such services for “red flags” and maintaining procedures so that research payments are documented and paid for promptly).

V. Compliance Date

The Interpretive Release’s guidance went effective on July 24, 2006; however, market participants may continue to rely on the Commission’s prior interpretations until January 24, 2007.

Contact Information

If you have any questions or would like to learn more about these rules, please contact the Ropes & Gray lawyer who normally advises you.

⁶ If a broker-dealer meets the “effecting” requirement under Section 28(e) by performing one or more of the four numbered functions, it must take steps to see that the other functions have been reasonably allocated to one or another of the broker-dealers in the arrangement in a manner that is fully consistent with applicable rules promulgated by self-regulatory organizations.