

SEC Releases Interpretive Guidance on Soft Dollars

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An investment adviser with authority to place brokerage orders for an advisory client has a duty to obtain best execution for its advisory client. Section 28(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), establishes a safe harbor that allows an investment adviser to use client funds to purchase "brokerage and research services" for its managed accounts under certain circumstances without breaching its fiduciary duties to clients. The commissions paid may be higher than those which might otherwise have been paid to another broker if those services had not been provided. This practice is sometimes referred to as using "soft dollars" for research and information. Fund directors have a general fiduciary responsibility to ensure the appropriateness of soft dollar services obtained by an investment adviser through portfolio transactions placed on behalf of the fund.

The SEC recently issued interpretive guidance (the "Release") on the use of client commissions by an investment adviser to pay for brokerage and research services under Section 28(e).¹ The Release generally narrows the scope of research and brokerage products that are covered by the safe harbor. The Release provides guidance on (1) the framework for analyzing whether a particular service falls within the "brokerage and research services" safe harbor, (2) the eligibility criteria for "research," (3) the eligibility criteria for "brokerage," and (4) the appropriate treatment of "mixed-use" items. The Release also reiterated the statutory requirement that an investment adviser must make a good faith determination that the commissions paid are reasonable in relation to the value of the brokerage and research services received. Lastly, the Release provides further interpretive guidance on commission sharing arrangements and third party research.

I. Framework for Analyzing the Scope of the "Brokerage and Research Services" under Section 28(e)²

The analysis of whether a particular product or service falls within the safe harbor involves three steps. First, the investment adviser must determine whether the product or service is eligible

¹ Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 54165 (July 18, 2006), available at <http://www.sec.gov/rules/interp/2006/34-54165.pdf>.

² Over the past 30 years, the SEC has issued several releases interpreting the Section 28(e) safe harbor. In 1986, the SEC issued guidance that provided a broad interpretation of what might constitute eligible brokerage and research products and services under Section 28(e), and introduced the concept of "mixed use" items. In 1998, the SEC published a soft dollar practices report (the "Report") which indicated that investment advisers took an over-broad view of the products and services that fall within the safe harbor. The Report detailed numerous cases where "administrative" or "overhead" goods and services (such as CFA exam review courses, office rent, membership dues and licensing fees, backup generators, office supplies, and legal and travel expenses) were improperly classified as eligible research under Section 28(e). In addition, the Report also noted that improvements in technology had led to difficulties in applying client commission standards. For instance, a single software product may perform several functions, only some of which may be properly classified as "brokerage and research services" under Section 28(e). As a result, the SEC issued a proposed interpretive release regarding client commission practices on October 19, 2005.

“research” under Section 28(e)(3)(A) or (B), or eligible “brokerage” under Section 28(e)(3)(C).³ Second, the investment adviser must determine whether the product or service actually provides lawful and appropriate assistance in the performance of the adviser’s investment decision-making responsibilities. If the product or service has a mixed use, the investment adviser must make a reasonable allocation of the costs of the product according to its use. Finally, the investment adviser must make a good faith determination that the amount of client commissions paid is reasonable in light of the value of the products or services provided by the broker-dealer.

II. Eligible “Research” under Section 28(e)

In determining whether a product or service is eligible as “research,” the investment adviser must conclude that it is “advice,” “analyses” or “reports” that reflect substantive content, i.e., the expression of reasoning or knowledge. In addition, the “advice” must relate 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,” and the “analyses” or “reports” must relate to “issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts.”⁴

Among the services eligible under Section 28(e)(3) are:

- research reports analyzing the performance of a particular company or stock;
- quantitative analytical software, and software that provides analyses of securities portfolios;
- discussions with research analysts relating to the advisability of investing in securities;
- meetings with corporate executives to obtain oral reports on the performance of a company;
- seminars or conferences that provide substantive content relating to a permissible subject matter, such as issuers, industries and securities; and
- financial newsletters and trade journals that are not mass-marketed.

Additionally, certain market research and market data may be eligible if it otherwise meets the criteria. Eligible products and services would include pre-trade and post-trade analytics, software

³ Section 28(e)(3) provides that,
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 rules of the SEC 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.

⁴ See Section 28(e)(3)(A), (B) of the Exchange Act.

and other products that depend on market information to generate market research (such as research on optimal execution venues and trading strategies), advice from broker-dealers on order execution (such as advice on execution strategies, market color, and the availability of buyers and sellers, including software that provides these types of market research), stock quotes, last sale prices, trading volumes, company financial data and economic data (such as unemployment and inflation rates or gross domestic product figures).⁵

In contrast, products or services that do not reflect the expression of reasoning or knowledge are not eligible under the safe harbor. These include overhead expenses, travel expenses, entertainment, meals associated with attending seminars, office equipment, office furniture and business supplies, salaries (including research staff), rent, accounting fees and software, website design, e-mail software, internet services, 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), equipment maintenance and repair services. Similarly, computer hardware, computer accessories and the peripherals and delivery mechanisms associated with computer hardware would not be eligible "research services" because they do not reflect substantive content related to making decisions about investing.⁶

III. Eligible "Brokerage" under Section 28(e)

"Brokerage services" within the safe harbor of Section 28(e)(3)(C) include effecting securities transactions and performing functions incidental thereto. The Release clarifies that the safe harbor covers only those products and services that relate to the execution of the trade from the point at which the investment adviser communicates with the broker-dealer for the purpose of transmitting an order for execution through the point at which funds or securities are delivered or credited to the advised account.⁷ The SEC believes that this temporal standard is an appropriate way to distinguish between brokerage services that fall within the safe harbor and those services, such as overhead, that do not. Examples of eligible products and services include:

- trading software used to route orders to market centers;
- software that provides algorithmic trading strategies;
- software used to transmit orders to direct market access systems; and

⁵ According to the Release, market data (such as stock quotes, last sale prices and trading volume) and other data (such as company financial data and economic data) constitute "reports concerning . . . industries, securities, economic factors and trends" and, as such, are eligible as research services under Section 28(e).

⁶ The Financial Services Authority (the "FSA") in the United Kingdom adopted its final rules on the use of client commissions on July 22, 2005, which became effective beginning in January 2006. The Release is generally consistent with the FSA rules, with a few exceptions. The FSA has determined that market data that has not been analyzed or manipulated does not meet the requirements of a "research" service, but permits advisers to justify using client commissions to pay for raw data feeds as "execution" services. The FSA also has identified subscriptions for publications and seminar fees as "non-permitted" services.

⁷ Unlike brokerage services, research services include services provided before the communication of an order.

- communication services related to the execution, clearing and settlement of securities transactions (such as dedicated lines between the broker-dealer and the investment adviser's order management system, lines between the broker-dealer and order management systems operated by a third-party vendor, and message services used to transmit orders to broker-dealers for execution).

Post-trade services that are considered "incidental" to executing a transaction under Section 28(e)(3)(C) and thus eligible for the safe harbor include:

- post-trade matching of information;
- exchanges of messages among broker-dealers, custodians and institutions related to the trade;
- routing settlement instructions to custodian banks and broker-dealers' clearing agents; and
- short-term custody related to effecting particular transactions in relation to clearance and settlement of trades.

In contrast, telephones, computer terminals, software used for recordkeeping or administrative purposes, quantitative analytical software used to test "what if" scenarios for portfolio modeling, services used to assist the investment adviser to meet its compliance responsibilities (such as tests to identify unusual patterns or analyze portfolio turnover), trade financing, and error correction trades or related services are not eligible under the safe harbor because they are not integral to the execution of orders by the broker-dealers. Similarly, long-term custody and custodial recordkeeping provided in connection with accounts after clearance and settlement of transactions are not eligible because they are not incidental to effecting securities transactions.

IV. "Lawful and Appropriate Assistance" and "Mixed-Use" Items

In order for a product or service to be within the safe harbor, the eligible brokerage or research service must also provide the investment adviser with "lawful and appropriate assistance" in performing the adviser's investment decision-making responsibilities. For example, analyses of account performance used for marketing purposes, as opposed to investment purposes, are not within the safe harbor because they do not assist the adviser in making investment decisions.

"Mixed-use" items must be reasonably allocated between eligible and ineligible uses. "Mixed-use" items include trade analytical software (which may sometimes be put to administrative use), order management systems, and proxy services. For proxy services, eligible uses include reports and analyses on issuers, securities, and the advisability of investing in securities, corporate governance research and corporate governance rating services to the extent they are used for investment decision-making but not in connection with voting. Ineligible uses of proxy services include products or services that handle the mechanical aspects of voting, such as casting, counting, recording and reporting votes. These are considered to be administrative overhead expenses of the

manager. The investment adviser must keep adequate books and records concerning the allocations between eligible and ineligible uses so as to enable the adviser to make the required good faith determination of the reasonableness of commissions in relation to the value of brokerage and research services.

V. Good Faith Determination as to Reasonableness under Section 28(e)

An investment adviser is required to make a good faith determination that the commissions paid are reasonable in relation to the value of the brokerage and research services received. In making such a determination, the adviser should not only consider the commission rate but also consider the range and quality of a broker's services, including the value of the research provided, execution capability, financial responsibility and responsiveness.

For instance, if the service provided was simply copied or repackaged, the adviser would need to make a good faith determination that the additional commissions paid for the copying or repackaging are reasonable. If the higher commission paid for eligible products, such as market data, was used to camouflage the payment for ineligible services such as shelf space, the adviser could not determine in good faith that the commission rate was reasonable.

VI. Commission Sharing Arrangements and Third Party Research

Section 28(e) requires that research be "provided by" a broker-dealer involved in "effecting" the trade. In commission sharing arrangements, there may be more than one broker-dealer involved in the trade, such as an introducing broker and a clearing broker. In third party arrangements, investment advisers obtain research services and products developed by someone other than the broker-dealers effecting the transaction. The SEC has provided additional guidance on the terms "effecting" and "provided by" as used in this context:

- Broker-dealers are "effecting" the trade if they execute, clear or settle the trade, or perform one of four functions (taking financial responsibility for customer trades; maintaining records relating to customer trades; monitoring and responding to customer comments concerning the trading process; and monitoring trade settlements) and allocate the other functions to another broker-dealer.
- Broker-dealers "provide" the research if they (a) prepare the research, (b) are financially obligated to pay for the research, or (c) are not financially obligated to pay for the research but take steps to ensure that the commissions paid are used only for eligible brokerage and research.⁸

⁸ In addition, the SEC outlined three attributes to help determine whether the broker-dealer has satisfied the "provided by" element: (i) the broker-dealer pays the research preparer directly, (ii) the broker-dealer reviews the description of services to be paid for with client commissions for red flags that indicate the services are not within the safe harbor and agrees with the investment adviser to use client commissions only to pay for those items that reasonably fall within the safe harbor, and (iii) the broker-dealer develops and maintains procedures so that research payments are documented and paid for promptly.

While the guidance with respect to commission sharing arrangements and third party research is effective immediately, the SEC will receive and consider any additional comments that are submitted, particularly with respect to whether the guidance is sufficient, and may supplement its guidance further based on additional comments received.

VII. Effective Date

The interpretation set forth in the Release is effective as of July 24, 2006. Investment advisers, however, may continue to rely on the SEC's prior interpretations until January 24, 2007.

If you have any questions about the Release or would like to have a copy of the Release, please contact Sarah E. Cogan (scogan@stblaw.com), Cynthia G. Cobden (ccobden@stblaw.com), or David E. Wohl (dwohl@stblaw.com) of our firm at (212) 455-2000.