SEC Issues Interpretive Release on Soft Dollars

On July 18, 2006, the SEC published formal guidance through an interpretive release that addresses the scope of "brokerage and research services" and client commission arrangements under Section 28(e) of the Securities Exchange Act of 1934 (the "Interpretive Release"). The SEC issued the Interpretive Release with the goal of clarifying the scope of "brokerage and research" taking into account "evolving technologies and industry practice." While the 63-page document clarifies some significant issues pertaining to the use of soft dollars, it is likely that the length and complexity of the SEC’s guidance will continue to present challenges in determining whether a particular arrangement falls within Section 28(e).

Our summary of the major points addressed in the Interpretive Release follows.

A. The Analytical Framework

Section 28(e) provides a safe harbor that allows investment managers with discretionary authority over client accounts to pay more than the lowest available commission to obtain "brokerage and research services" without breaching their fiduciary duties to clients. The Interpretive Release describes a three-step analysis that investment managers must perform to determine whether a particular brokerage or research service falls within the safe harbor. The three-step analysis requires an investment manager to:

1. determine whether a particular product or service is eligible brokerage or research;
2. determine whether the eligible product or service actually provides lawful and appropriate assistance to the manager in the performance of its investment decision-making responsibilities; and
3. make a good faith determination that the amount of the client commissions paid is reasonable in light of the products or services provided by the broker-dealer.

Most of the Interpretive Release focuses on the first step – determining whether or not a particular product or service is eligible research or brokerage.

1. Eligible Research

The Interpretive Release states that the criteria for determining eligible "research services" are set forth in

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Section 28(e)(3)(A) and (B)\textsuperscript{2} and that a research service must therefore constitute “advice,” “analyses,” or “reports.” The Interpretive Release further states that a common theme among the terms “advice,” “analyses,” and “reports” is that they each reflect substantive content or the expression of reasoning or knowledge. Thus, eligible research under the safe harbor must reflect the expression of reasoning or knowledge and relate to the subject matter identified in Section 28(e)(3)(A) or (B). Using this standard, the Interpretive Release identifies a number of examples of “research” services that fall inside or outside the safe harbor, including the following:

**Examples of Eligible Section 28(e) “Research”**

- Traditional research reports analyzing the performance of a particular company or stock;
- Discussions with analysts;
- Meetings with corporate executives to obtain oral reports on performance of a company;
- Seminars or conferences if they truly relate to research, such as about issuers, industries, and securities (but not travel and related expenses);
- Software that provides analyses of securities portfolios
- Research related to the market for securities, such as trade analytics (including analytics available through order management systems (OMS)) and advice on market color and execution strategies; and
- Market, financial, economic and similar data that relate to the subject matter identified in Section 28(e)(3)(A) or (B).

**Examples of Ineligible Section 28(e) “Research”**

- Inherently tangible items such as computer hardware, including computer terminals and computer accessories;
- Telephone lines and office equipment, office furniture, business supplies and salaries (including research staff salaries);
- Mass marketed publications; and

\textsuperscript{2} Section 28(e)(3). For purposes of this subsection a person provides brokerage and research services insofar as he

\begin{itemize}
  \item 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; or
  \item B. furnishes analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts.
\end{itemize}
• Proxy services to the extent that they (1) provide eligible research, but for the purpose of assisting a manager in deciding how to vote proxy ballots or (2) handle the mechanical aspects of voting, such as casting, counting, recording and reporting votes.3

2. **Eligible Brokerage**

The Interpretive Release looks to the language contained in Section 28(e)(3)(C) to determine whether a particular brokerage services falls within the safe harbor.4 The Interpretive Release then endorses a temporal standard to distinguish brokerage services that are related to the execution of securities transactions which are eligible for the safe harbor, from those that are overhead expenses and not eligible. According to the temporal standard, eligible “brokerage” services are those that relate to the execution of a trade from the point at which a money manager 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. Using this standard, the Interpretive Release identifies a number of examples of “brokerage” services that fall inside or outside the safe harbor, including the following:

*Examples of Eligible Section 28(e) “Brokerage”*

• Post-trade services incidental to executing a transaction, including post-trade matching of trade information and exchanges of messages among broker-dealers, custodians, and institutions related to the trade; and

• Communications services related to the execution, clearing and settlement of securities transactions and other functions incidental to effecting securities transactions, such as connectivity service between the money manager and the broker-dealer and other relevant parties, including: dedicated lines between the broker-dealer and the money manager’s OMS and lines between the broker-dealer and an OMS operated by a third party vendor.5

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3 Proxy services may have a mixed use to the extent that they transmit reports and analyses on issuers, securities, and the advisability of investing in securities and provide managers with lawful and appropriate assistance in investment decision-making.

4 Section 28(e)(3). For purposes of this subsection a person provides brokerage and research services insofar as he—

C. effects securities transactions and performs functions incidental thereto (such as clearance, settlement, and custody) or required in connection therewith by rules of the Commission or a self-regulatory organization of which such person is a member or person associated with a member or in which such person is a participant.

5 The Interpretive Release provides that brokerage services, unlike research, can include connectivity services and trading software where these items are used to transmit orders to the broker. The interpretive release also cautions,
Examples of Ineligible Section 28(e) “Brokerage”

- Hardware, including those used in connection with OMS and trading software, such as telephones and computer terminals;
- Software used for recordkeeping or administrative purposes, such as managing portfolios;
- Quantitative analytical software used to test “what if” scenarios related to adjusting portfolios, asset allocation, or for portfolio modeling (whether or not provided through OMS);
- Services used to meet compliance responsibilities; and
- Long-term custody (i.e., custody provided post-settlement and relating to long-term maintenance of securities positions).

3. Lawful and Appropriate Assistance

Assuming that a research service falls within the eligibility criteria established by Section 28(e)(3) as described above, an investment manager must still determine that the service provides lawful and appropriate assistance in making investment decisions. Whether this standard is met depends on how the manager uses the eligible service. To illustrate the point, the Interpretive Release cites the example of account performance analyses, which can provide assistance in making investment decisions, but can also be used for marketing purposes.

4. “Mixed-Use” Items

The Interpretive Release continues to embrace the concept of “mixed use” items (i.e., those services that contain multiple components, only some of which fall within the safe harbor). The Interpretive Release does not appear to provide any new guidance in this area, but reiterates that investment managers must (1) make a reasonable allocation of the cost of the service according to its use and pay for the ineligible portion with hard dollars and (2) keep adequate books and records to make a good faith showing of the reasonableness of the allocations.

5. Reasonableness of Commissions

The Interpretive Release reaffirms an investment manager’s basic obligation under Section 28(e) to make a good faith determination that commissions paid are reasonable in relation to the value of the brokerage however, that ineligible products or services previously classified as research should not be inappropriately reclassified as brokerage services.
and research services received. The reasonableness should be viewed in terms of the particular transaction or the manager’s overall responsibilities for discretionary accounts.

B. Additional Issues: Third Party Research

The Interpretive Release acknowledges that third-party research arrangements can benefit advisory clients by “providing greater breadth and depth of research.” Accordingly, Section 28(e) covers third-party research and proprietary research equally.

1. Arrangements Involving Both Introducing and Clearing Brokers

Section 28(e) states that a broker-dealer providing research must be involved in “effecting” the trades that generate the commissions used to pay for research. The Interpretive Release reviews the original purpose for this requirement – to prevent a practice known as “give ups” – and acknowledges the development of various soft dollar arrangements involving both introducing and clearing brokers. In connection with these arrangements, the SEC had previously taken the position that an introducing broker needed to satisfy at least four minimum criteria in order to be “effecting” transactions. The Interpretive Release, however, notes a change in the SEC’s position and states that an introducing broker is “effecting” transactions if it performs only one of four identified functions and takes steps to see that the other functions are reasonably allocated to one or another of the broker-dealers in the arrangement. 6

2. The “Provided By” Element

Section 28(e) also requires that a broker-dealer receiving commissions for effecting client transactions must also “provide” the brokerage or research. The SEC had previously taken the position that in order for a broker-dealer to be “providing” research produced by a third party, the broker-dealer needed to be legally obligated to pay for the research. In the Interpretive Release, the SEC modified its view with respect to the “provided by” requirement. Specifically, the Interpretive Release states that a broker-dealer need not be legally obligated to pay if the broker-dealer generally (1) pays the research preparer directly; (2) reviews the description of the services for red flags that indicate the services are not within Section 28(e) and agrees with the investment manager to use client commissions only to pay for items that reasonably fall within Section 28(e); and (3) develops and maintains procedures so that research payments are documented and paid for promptly.

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6 The Interpretive Release describes the four functions as: (1) taking financial responsibility for all customer trades until the clearing broker-dealer has received payment (or securities), i.e., one of the broker-dealers in the arrangement must be at risk for the customer’s failure to pay; (2) making and/or maintaining records relating to customer trades required by Commission and SRO rules, including blotters and memoranda of orders; (3) monitoring and responding to customer comments concerning the trading process; and (4) generally monitoring trades and settlements.
C. Next Steps and Compliance Deadlines

We recommend that investment managers take this opportunity to review their soft dollar arrangements and soft dollar compliance policies and procedures. We note that guidance contained in Interpretive Release became effective on July 24, 2006, but market participants may continue to rely on the SEC’s prior interpretations until January 24, 2007.

_In order to assist our clients, we have developed a form of soft dollar policies and procedures that takes into account the guidance contained in the Interpretive Release. We also have compiled an extensive list of brokerage and research services that the Interpretive Release specifically cites as examples of items that fall inside or outside of Section 28(e). We will be glad to provide these materials upon request._

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If you have any questions about this memorandum, want to discuss in more detail the Interpretive Release, or are interested in a copy of our form of soft dollar policies and procedures, please call Terrance O’Malley at (212) 859-8402 or Jessica Forbes at (212) 859-8558, or any of the other partners in the Fried Frank Asset Management Group.

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