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## SEC Soft Dollar Release Impacts Money Managers and Broker-Dealers

Section 28(e) of the Securities Exchange Act of 1934, as amended (“Section 28(e)”), allows money managers to pay brokers more than the lowest commissions available to obtain research and brokerage services without the money manager violating any law imposing a duty upon the money manager to obtain the lowest commission if certain conditions are met. The Securities and Exchange Commission (“SEC” and “Commission”) has issued its most recent interpretive release giving guidance on client commission practices under Section 28(e) (“2006 Release”).<sup>1</sup> The Commission stated that this interpretive guidance revokes Parts II (Definition of Brokerage and Research Services) and III (Third Party Research) of an interpretation it issued in 1986.<sup>2</sup>

The 2006 Release explains what the SEC views as Research and Brokerage Services and how the duties imposed by Section 28(e) can be discharged and suggests duties for money managers and broker-dealers wishing to rely upon Section 28(e)’s safe harbor. The SEC stated that it may adopt normative and disclosure rules in the future. The SEC also indicated that money managers for mutual funds and ERISA Plans that do not meet the SEC’s guidance may be acting in violation of Section 17(e) of the Investment Company Act of 1940, as amended, or of ERISA.

### Summary

**Research Services:** The SEC defines research services as advice, analyses or reports that furnish advice as to the value of securities or investing, purchasing or selling securities, and analyses and reports concerning issuers, industries, securities and economic factors and trends, portfolio strategy and performance of accounts. This includes: research related to markets (trade analytics, advice on market color and execution strategies); and market, financial, economic and similar data; but does not include mass-marketed publications.

**Brokerage Services:** The SEC defines brokerage services as relating to the execution of a trade from the moment the trade is entered to the time when the securities are delivered to the buyer and the proceeds to the seller.

**Lawful Assistance:** Each brokerage and research service that is to come within Section 28(e) must provide lawful and appropriate assistance to the money manager in discharging its duties.

**Mixed Use Items:** Many mixed use items may be partially paid for with soft dollars if they can be and are reasonably allocated between eligible and ineligible uses, and the manager keeps adequate books concerning these allocations to enable the manager to make a good faith determination of the reasonableness of the commissions paid in relation to the value of the brokerage and research services.

**Good Faith Determination:** The money manager must make a good faith determination that the commissions being paid are reasonable in light of each of the brokerage and research services being provided.

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<sup>1</sup> Securities Exchange Act Release No. 54165 (July 18, 2006).

<sup>2</sup> Securities Exchange Act Release No. 23170 (April 28, 1986).

**Broker Provided Services and Execution:** The broker must provide the research, be financially obligated to pay for the research or, if it is not financially obligated to pay, the arrangements must have certain attributes. The broker-dealer party to the arrangement must either execute, clear or settle the customer's trades or perform one of the four following functions: (i) take financial responsibility for the customer trades, as is customary in a fully disclosed clearing arrangement; (ii) maintain records relating to the customer trades; (iii) monitor and respond to customer comments concerning the trading process; or (iv) monitor customer trades and settlements.

## **Commission Analysis**

**Research Services:** The SEC said that research is deemed to be research, reports or analyses if it reflects substantive content. It must be an expression of reasoning or knowledge. Within this parameter are research reports, meetings with securities analysts and meetings with corporate executives to obtain information on the issuer.

**Mass-Marketed Publications:** Mass-marketed publications, i.e., publications intended for and marketed to a broad public audience, are not considered to be research under Section 28(e). Trade and technical journals, and publications marketed to a narrow audience with specialized interests in particular industries, products or issuers and that have high costs are not mass-marketed publications.

**Tangible Products and Services:** Things such as telephone lines, office furniture, office equipment, meal and travel expenses to attend a seminar or meet with an issuer's officers, business supplies, accounting fees and software, staff salaries, personnel management, marketing, utilities, and overhead items of the money manager are not deemed to be research.

**Market Research:** Items such as order management systems and trade analytical software, including pre- and post-trade analytics software and related products that depend on market information to generate market research, including best execution tracking, may be considered to be research if the money manager can make the necessary determinations as to lawful assistance and reasonable commissions.

**Data:** Data services, such as those that provide market data or economic data, may be considered research if they meet the lawful assistance and reasonable commission tests. However, software used to evaluate performance for marketing purposes would not be considered research services.

**Proxy Services:** Proxy services that include reports and analyses on issuers, securities and the advisability of investing in securities may be treated as research. However, other services such as handling the mechanical aspects of voting, and casting, counting, recording and reporting votes, are not deemed to be research services. The result is that some proxy services may be treated as mixed-use items.

## **Eligibility Criteria for Brokerage Services**

**Temporal Standard:** Brokerage under Section 28(e) begins with the placement of the order with the broker and continues through to payment to the seller and delivery of the security to the buyer. Services before and after those times will have to qualify as research to be within Section 28(e)'s safe harbor. Services meeting the temporal standard include communications services for execution, clearing and settlement, including communication lines and services to link the money manager, brokerage trading desk and the manager's custodian. Trading software to provide algorithmic trading strategies and software to transmit orders to trading systems are within this standard.

**Ineligible Overhead:** Hardware such as telephones or computer terminals are not within the definition of brokerage services under Section 28(e). Also, soft dollars cannot be used to meet the client's compliance responsibilities. This includes programs to test for best execution, portfolio turnover rates, trading parameters for purposes of compliance with regulatory or offering memoranda disclosures or stress testing of a portfolio under various market conditions.

**Custody:** Long term custody services are outside the safe harbor of Section 28(e).

**Lawful and Appropriate Assistance:** In each instance, where a money manager wishes to rely upon Section 28(e), whether for research or brokerage services, the money manager must make a separate determination that the subject research or brokerage service provides the money manager with lawful and appropriate assistance in making investment decisions.

**Good Faith Determination as to Reasonableness of Commissions Paid:** For each brokerage or research service that the money manager wishes to characterize as within the scope of Section 28(e), the money manager must make a good faith determination that the commissions paid for that service are reasonable in relation to the value of the brokerage or research service received. The money manager needs to be able to demonstrate that it used the item in performing its investment decision-making responsibilities and its belief that the amount of commission paid is reasonable in relation to the value of the research or brokerage received, either in terms of the particular transaction or the manager's overall responsibilities for discretionary accounts. Where research is copied, repackaged or aggregated, the money manager needs to show that any extra commissions paid for such copying, repackaging or aggregation are reasonable.

**Third Party Research:** The SEC reiterated its position that soft dollars may be used to pay for third party research.

## **Commission Arrangements**

**Statutory Linkage Between "Provided by" and "Effecting":** Section 28(e) requires that the broker-dealer providing the research be involved in effecting the trade. This was required to prevent continuation of the practice known as "give ups." The broker-dealer receiving the soft dollar payment must have provided a good or service to benefit the advised accounts.

**Effecting Transactions:** This test is met if the arrangement between the broker-dealer receiving soft dollars and the broker-dealer executing, clearing and settling the trade is a fully disclosed clearing arrangement within the meaning of self-regulatory organization rules. Otherwise, the broker-dealer receiving the soft dollars must provide one of the four functions set forth above.

**Research Services "Provided by" the Broker-Dealer:** If the broker-dealer receiving the soft dollars is legally obligated to pay for research this test will be met. The following tests were posited by the SEC as meeting the "provided by" test: (i) the broker-dealer pays the research preparer directly; (ii) the broker-dealer reviews the description of the services to be paid for with client commissions under the safe harbor for red flags indicating 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; and (iii) the broker-dealer develops and maintains procedures so that research payments are documented and paid for promptly.

**Enhanced Compliance Duties:** Implicit in the 2006 Release is an increase in the duties of both the money manager and the broker-dealer seeking to rely upon Section 28(e). Both need to be able to demonstrate that: (i) the research or brokerage services are within the definition of research or brokerage services; and (ii) that such determination was made and documented at the time of acquisition by the money manager and marketing by the broker-dealer. The money manager needs to memorialize its determination that the research or brokerage service provided lawful assistance in discharging its duties. In the case of mixed-use items the money manager must make an allocation and record it in its books contemporaneously with the purchase/receipt thereof. The good faith determination by the money manager needs to be reasonable and must be documented. Also, the record should reflect that the same goods or services could not reasonably be obtained elsewhere for less, including not only the cost of the service, but also the ratio of soft dollar credits to brokerage needed to pay for it.

Similarly, the broker-dealer will also need to demonstrate that it was involved in providing the research services or met one of the two tests where it does not directly provide the service and keeps records of its payment activities, and either executed, cleared or settled the trades generating the soft dollars or performed one of the four specified functions.

## **We Can Help**

Please contact one of the following Katten Muchin Rosenman LLP attorneys if you wish to discuss the ramifications of the SEC's 2006 Release:

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