The Securities and Exchange Commission (“SEC”) has issued interpretative guidance on soft dollars (the “2006 Release”) that limits, in important respects, the scope of the safe harbor in Section 28(e) of the Securities Exchange Act of 1934 (“Section 28(e)”) for both research and brokerage services and provides a new interpretation with respect to the applicability of the Section 28(e) safe harbor to third party commission sharing arrangements. The 2006 Release follows the SEC’s issuance of proposed interpretative guidance (the “Proposed Release”) on October 19, 2005 and takes into account the comments received by the SEC during the comment period. The 2006 Release was developed after substantial industry input and follows the adoption of new standards in the United Kingdom by the Financial Services Authority (the “FSA Policy Statement”).

The 2006 Release retains, in substantial form, the eligibility of brokerage and research services for the Section 28(e) safe harbor, particularly as set forth in the SEC’s 1986 interpretative release on Soft Dollar Arrangements, Rel. No. 34-23170, April 23, 1986 (the “1986 Release”). The 2006 Release, however, in general, limits the availability of the safe harbor in two respects. First, with respect to research, the availability of the safe harbor extends only to “advice, analyses and reports” (thereby precluding its availability for items like computer hardware and overhead). Second, the 2006 Release establishes a new temporal test for determining the availability of the safe harbor for brokerage services. Pursuant to this test, only products and services relating to the execution of a trade, determined from the time that the money manager communicates with the broker for purposes of transmitting an order through the conclusion of clearance and settlement of the transaction, may be considered to fall within the safe harbor.

The 2006 Release also sets forth a conceptual framework, or “checklist,” which the SEC believes should be followed in analyzing whether a particular product or service falls within the safe harbor. Money managers would be wise to review all of their soft dollar practices through the prism of the SEC’s analytical framework and document how each product or service satisfies the standards of the Final Release. Finally, the 2006 Release adopts a new interpretation relating to commission sharing arrangements, abandoning its former interpretation which required that (i) in order for research to be considered to be “provided by” the commission broker-dealer (and therefore eligible for the Section 28(e) safe harbor), the commission broker-dealer must have the direct legal obligation to pay for the research, and (ii) requiring that in order for a broker-dealer to be deemed to be “effecting” a transaction (and therefore eligible for the Section 28(e) safe harbor), each broker-dealer must play a role in effecting securities transactions that goes beyond the mere provision of research services to money managers. Instead, the 2006 Release sets forth a set of factors to be considered when determining whether the requirements relating to the “providing” of research and “effecting” transactions are met.

The 2006 Release is effective upon its publication in the Federal Register (most likely in August). Market participants may however continue to rely on the SEC’s prior interpretations of Section 28(e) until 6 months after the publication of the 2006 Release in the Federal Register. While the new guidance relating to third party commission sharing arrangements is also final, the SEC is soliciting comment on its new interpretation. Comments must be received on or before 45 days of the publication of the 2006 Release in the Federal Register.
Background

Section 28(e) establishes a safe harbor that allows money managers to use client assets, in the form of brokerage commissions, to purchase brokerage and research services for their managed accounts without breaching their fiduciary duty to their clients. Absent the safe harbor provided by Section 28(e), the use of client commissions to purchase brokerage or research services may have been deemed to be a breach of fiduciary duty if the money manager paid more than the lowest commission rate available to execute a trade. The Section 28(e) safe harbor was enacted in 1975, and for more than thirty years now Congress and the SEC have recognized the value of research to money managers in managing client accounts and the appropriateness of using client commissions to pay for that research. Through various interpretative releases issued over the years, the parameters of the Section 28(e) safe harbor have expanded and contracted from time to time. The market for soft dollar products has also developed and grown, resulting in a far greater array of products and services available today than was the case in 1975.

The 2006 Release - The Analytical Framework for Applying Section 28(e)

The 2006 Release retains the standard first adopted by the SEC in the 1986 Release requiring that in order for a product or service to satisfy the safe harbor of Section 28(e), the product or service must provide "lawful and appropriate assistance to the money manager in the carrying out of his responsibilities." The 2006 Release makes clear that this standard applies not only to research services but also to brokerage services. The 2006 Release also sets forth a three prong test for both research and brokerage that the SEC believes money managers should follow in determining whether a product or service falls within the Section 28(e) safe harbor.

A. Test 1 – Does the product or service fall within the specific statutory limits of Section 28(e)(3)(A), (B), or (C). This prong of the test must be analyzed separately for research and brokerage services.

Research Services – The “Advice, Analyzes and Reports” test. Section 28(e) defines the nature of permitted research services as either (i) "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 (ii) "analyzes and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts...". In determining whether research satisfies the “advice, analyses and reports” test, the 2006 Release states that the research must reflect “expressions of reasoning or knowledge” and that the reasoning or knowledge must relate to the subject matter identified in Section 28(e). The content may be original research or a synthesis, analysis or compilation of the research of others. The 2006 Release states that products and services with inherently tangible and physical attributes (and without research content) do not satisfy this test.

Products or Services That Satisfy the Advice, Analyzes and Reports Test

• traditional research reports analyzing a company or stock,
• discussions with research analysts,
• meetings with corporate executives to obtain oral reports on an issuer,
• certain financial newsletters and trade journals relating to the subject matter of Section 28(e) that are not mass-marketed (see discussion below regarding mass-marketed publications),
• quantitative analytical software, order management systems, and software that provides analysis relating to the subject matter of Section 28(e) (see discussion below relating to market research reports),
• corporate governance research (including corporate governance analytics) and corporate governance rating services if they reflect the expression or reasoning or knowledge and they relate to the subject matter of Section 28(e),
• market data reports, including
  • stock quotes, last sale price reports, trading volume – whether or not the data has been analyzed or manipulated by the provider,
• company financial data,
• economic data such as unemployment reports, inflation rates or gross domestic product figures,
• certain proxy services that provide reports and analysis on issuers, securities and the advisability of investing in securities if it relates to the investment function, and
• seminars and conferences where the content satisfies the above requirements.
Products or Services That Do Not Satisfy the Advice, Analyses and Reports Test

- office equipment, including
  - office furniture, business supplies, telephone lines, salaries (including research staff), rent, accounting fees and software, website design, e-mail software, internet service, legal expenses, personnel management, marketing, utilities, membership dues (including 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), professional licensing fees, software to assist with the administrative function (such as managing back-office functions, operating systems and word processing) and equipment maintenance and repair services,

- operational overhead, including
  - travel expenses, entertainment, meals associated with attending conferences or seminars or associated with arranging trips to meet corporate executives, analysts or other individuals who may be providing research orally,

- computer hardware (including computer terminals) and computer accessories, including
  - telecommunication lines, transatlantic cables and computer cables,

- Mass-marketed publications (see discussion below), and

- Proxy services relating to the mechanical aspects of voting, such as casting, counting, recording, and reporting votes or services that provide research that assist the manager in determining how to vote a proxy.

Market Research. The 2006 Release provides that market research may fall within the Section 28(e) safe harbor even if provided through order management systems and trade analytical software. For example, the 2006 Release notes that such research may include pre-trade analytics, software and other products that depend on market information to generate research, including research on optimal execution venues and trading strategies. In addition, advice from broker-dealers on order execution, including advice on trading strategies, market color, and the availability of buyers and sellers (and software that provides this information) may be eligible.9

Mass-marketed publications. With respect to mass-marketed publications, the 2006 Release states that the Section 28(e) safe harbor is not available because the cost of these publications should be considered to be overhead. Mass-marketed publications are defined as those publications that are intended for and are marketed to a broad public audience, as opposed to publications that are designed to serve a specialized group (these latter publications can be considered research). The method of distribution is not relevant so that, for example, the fact that a trade journal is available over the internet to the general public does not make it mass-marketed. The 2006 Release states that the test is whether the trade magazine or technical journal, for example, is marketed to, and intended to serve the interests of, a narrow audience rather than the general public. Obviously this definition leaves ample room for factual interpretation and is likely to be a source of some difficulty in certain circumstances.

As we discussed above, in each case it is not enough that the product or service constitute “advice, analyses and reports” to satisfy the first prong of the test. In addition, the product or service must relate to the “the value of securities, the advisability of investing in, purchasing or selling securities, the availability of securities or purchasers or sellers of securities” or concern “…issuers, industries, economic factors and trends, portfolio strategy, and the performance of accounts.” So, for example, a consulting service with respect to portfolio strategy would satisfy the first prong of the test, but a consulting service relating to the money manager’s administration or operations would not.

Brokerage Services – The Temporal Test. Under this test, only brokerage services that relate to the execution of securities transactions and that occur between the time an order is transmitted to a broker-dealer and the end of the clearance and settlement of the transaction are eligible for the safe harbor.10 This test is designed to distinguish between brokerage services that are eligible for the safe harbor and overhead-related services which are not. Eligible brokerage products and services include not only products and services required to effect securities transactions, but also products and services that are incidental to these functions and products and services relating to functions required by the SEC or by the rules of a self-regulatory body (“SRO”).

Brokerage Services That Satisfy the Temporal Test

- execution clearing and settlement services,
- post trade matching of trade information,
- exchange of messages among broker-dealers, custodians and institutions related to the trade,
- electronic communication of allocation instructions between institutions and broker-dealer,
- routing settlement instructions to custodian banks and clearing agents,
- electronic confirmation and affirmation of institutional trades,
• short-term custody related to effecting particular transactions in relation to clearance and settlement of the trade,

• communication services related to the execution, clearing and settlement of securities transactions and other incidental services (i.e., connectivity service between the money manager and the broker-dealer and other relevant parties such as the custodian), such as
  ■ dedicated lines between the broker-dealer and the money manager’s order management system,
  ■ dedicated lines between a broker-dealer and the order management system of a third party,
  ■ dedicated direct dial lines with the trading desk of a broker-dealer,
  ■ message services used to transmit orders to broker-dealers for execution, or

• trading software to route orders, algorithmic trading software, and software used to transmit orders to direct market access systems.

Brokerage Services Do Not Satisfy the Temporal Test

• order management systems used to manage orders (as noted, such systems may be permitted under the research prong of Section 28(e)),

• hardware, such as telephones and computer terminals (including those used to connect with order management systems and trading software),

• software functionality used for recordkeeping or administrative purposes, such as managing portfolios, and quantitative analytical software used to test “what if” scenarios related to adjusting portfolios, asset allocation or portfolio modeling,

• surveillance systems and compliance mechanisms (such as systems that perform compliance tests to identify unusual trading patterns, analysis of brokerage execution, portfolio turnover rate, analysis of comparative performance of similarly managed accounts, compliance with investment parameters, stress testing or analysis to identify style drift),

• trade financing, such as stock lending fees, capital introduction and margin services,

• long term custody arrangements and custodial recordkeeping provided in connection with accounts after clearance and settlement, or

• error correction services.

B. Test 2 - The Lawful and Appropriate Assistance Test.

Once a product or service has been determined to have satisfied the “advice, analyses and reports” test, for research, or the temporal test, for brokerage, the money manager must review how it uses the product or service to determine if the product or service meets the second test, the “lawful and appropriate assistance” test. For example, with respect to research, in order to satisfy the “lawful and appropriate assistance” test, the research must be used by the money manager in performing its investment decision-making function. So, for example, while software that performs analysis of the performance of accounts satisfies the “advice, analyses and reports” test, if that software is used to generate marketing reports, rather than to manage the account, then it falls outside the 28(e) safe harbor because it fails the lawful and appropriate assistance test.

C. Test 3 – The Cost Test.

The third prong of the analysis is whether the money manager can determine, in good faith, that the amount of client commissions paid for the product or service is reasonable in light of the value of the products or services provided by the broker dealer to the money manager. The 2006 Release states the burden of proof in demonstrating compliance with this test rests with the money manager and provides a number of cautions to money managers, noting that they cannot acquire eligible products, such as market data, to camouflage the payment to broker-dealers for ineligible services, such as self space. In addition, the 2006 Release notes that in performing this cost analysis, the money manager should take into account the reasonableness of the commissions paid for products or services that are merely repackaged, copied or aggregated.

Mixed Use Items

The 2006 Release continues to permit the use of “mixed-use” items first recognized in the 1986 Release. The 2006 Release reiterates the guidance provided in the 1986 Release relating to mixed-use items, emphasizing again that money managers must keep adequate books and records to support the allocation of the cost of mixed use products and notes again that such allocation must be made on the basis of use of such products. For example, portfolio performance evaluation products and services are often mixed-use items, as they are used for both research and marketing purposes. The money manager must document in writing the basis for allocating the cost of these items based on the manager’s use of these services for each function.
Third Party Research and Commission Sharing Arrangements

In a departure from the Proposing Release, the 2006 Release sets forth a new interpretation relating to third party research commission sharing arrangements. The 2006 Release also solicits comment from the public as to whether its new interpretation requires further clarification. As background, Section 28(e) requires that the broker-dealer “providing” the research also be involved in “effecting” the trade. In its 1986 Release, the SEC had established the standard that such research must be “provided by” the commission broker-dealer in order to be eligible for the 28(e) safe harbor. Third party research was considered to be “provided by” the commission broker-dealer if that broker-dealer had the direct legal obligation to pay for the research. The 1986 Release provided that the money manager may participate in selecting the third party research services or products to be provided and that the third party may send the research directly to the money manager so long as the commission broker-dealer had the legal obligation to pay for such research.11

The 1986 Release further provided that the broker-dealer providing the research to the money manager (whether the broker-dealer’s own research or research from a third party) must be involved in some manner in “effecting” the money manager’s trade.12 In the context of commission sharing arrangements involving third party research, the 1986 Release noted that “… the introducing broker must be engaged in securities activities of a more extensive nature than merely the receipt of commissions for research services’ and that “[e]ach broker-dealer must play a role in effecting securities transactions that goes beyond the mere provision of research services to money managers.” The 1986 Release further noted that a clearing agreement that satisfies the SRO rule requirements is not necessarily sufficient to satisfy Section 28(e).13 The Proposing Release had proposed to retain these standards.

The 2006 Release departs from these standards. With respect to “effecting” transactions, the 2006 Release provides that in order to be deemed to be “effecting” a trade, the broker-dealer must perform at least one of the following four functions (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 or maintaining records relating to the customer’s trade as required by the SEC or the SRO, (3) monitoring and responding to customer comments concerning the trading process, and (4) generally monitoring trades and settlements. In addition, a broker-dealer is deemed to be “effecting” a trade if it is executing, clearing or settling the trade.

With respect to the “providing” of research, a broker-dealer may be deemed to be “providing” research if it is (1) legally obligated to pay for the research, (2) it is not obligated to pay for the research but (a) it pays the research provider directly, (b) it reviews the description of services to be paid for with client commissions under the safe harbor for red flags that indicate that the service is not eligible for the safe harbor and agrees with the money manager to use client commissions only to pay for those items that reasonably fall within the safe harbor, and (c) the broker-dealer develops and maintains procedures so that research payments are documented and paid for promptly.

Legal Obligations of Parties under Section 28(e)

The 2006 Release reminds market participants that not only money managers, but also broker-dealers may be subject to liability under Section 28(e). The 2006 Release notes that if a broker-dealer knows that a money manager has represented to its client that it will operate solely within Section 28(e) and the money manager asks for products or services that are not within the scope of the safe harbor, then the broker-dealer may be considered to be aiding and abetting a violation of the federal securities laws.

NOTES

3Such input included the NASD’s November 2004 Report of Soft Dollars and Portfolio Transaction Costs.
5For example, the 1986 Release liberalized certain conditions imposed on soft dollars by the SEC in a 1976 release by expanding the availability of the safe harbor to encompass products and services that were readily and customarily available to the general public on a commercial basis. The 1986 Release also introduced the concept of “mislabeled” products. In 2001, the SEC modified its interpretation of “commissions” to encompass certain riskless principal transactions.
6The 2006 Release expressly replaces the guidance provided in Sections II and III of the 1986 Release.
7The 2006 Release makes clear that the form in which the “advice, analyses or reports” are given (e.g., electronic or written) is irrelevant.
8The “subject matter” of Section 28(e) means “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 “issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts...”. These categories may subsume other categories, so that, for example, a report regarding political factors could fall within the scope of these categories if these political factors are interrelated with economic factors. 9Since many of these services are provided outside of the “temporal” test set forth for permissible brokerage services (discussed below), many commentators on the Proposing Release addressed the area. The 2006 Release, while retaining the temporal test for brokerage services, has attempted to address these concerns by clarifying that these types of services may constitute research, which is not subject to a temporal test.
10Unlike brokerage, research services can include services provided before the communication of an order or after settlement and clearance.
11In contrast, a money manager could not rely on Section 28(e) if the broker-dealer merely pays an obligation the money manager has incurred to a third party.
12The 1986 Release notes that this requirement is intended to preclude the practice of “give-ups” where the executing broker-dealer would pay a portion of a commission to another broker-dealer that had no role in the transaction generating the commission.
13Step-out programs – where the money manager directs the executing broker to allocate a portion of a trade to another broker-dealer – are eligible for the Section 28(e) safe harbor provided that each broker involved in the step-out performs substantive functions in effecting the trade.
If you have any questions about the SEC's final guidance, or about investment management matters in general, please do not hesitate to contact any member of our Investment Management Practice Group:

Our Senior Management Team:

Michael R. Rosella 212-318-6800
Chair – Investment Management Practice Group
mikerosella@paulhastings.com

David A. Hearth 415-856-7007
Vice Chair – Investment Management Practice Group
davidhearth@paulhastings.com

Julie Allecta 415-856-7006
julieallecta@paulhastings.com

Robert E. Carlson 213-683-6299
robertcarlson@paulhastings.com

Wendell M. Faria 202-508-9574
wendelfaria@paulhastings.com

Christopher J. Tafone 212-318-6713
christophertafone@paulhastings.com

Michael Glazer 213-683-6207
michaelglazer@paulhastings.com

Jacqueline A. May 212-318-6282
jacquelinemay@paulhastings.com

Mitchell E. Nichter 415-856-7009
mitchellnichter@paulhastings.com

Domenick Pugliese 212-318-6295
domenickpugliese@paulhastings.com

Gary D. Rawitz 212-318-6877
garyrawitz@paulhastings.com

Arthur L. Zwickel 213-683-6161
arthurzwickel@paulhastings.com