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SEC Issues Final Interpretive Guidance Regarding Client Commission Practices

©2006 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [20215] July 28, 2006 TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 33-06 EQUITY MARKETS ADVISORY COMMITTEE No. 14-06 INVESTMENT ADVISER MEMBERS No. 21-06 SEC RULES MEMBERS No. 65-06 SMALL FUNDS MEMBERS No. 53-06 RE: SEC ISSUES FINAL INTERPRETIVE GUIDANCE REGARDING CLIENT COMMISSION PRACTICES The Securities and Exchange Commission has published an interpretive release on the scope of brokerage and research services and client commission arrangements under Section 28(e) of the Securities Exchange Act of 1934.¹ The Release provides guidance with respect to: (1) the appropriate 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 discusses a money manager’s statutory requirement to make a good faith determination that the commissions paid are reasonable in relation to the value of the brokerage and research services received. Finally, the Release includes guidance on third-party research and client commission arrangements and seeks further comment relating to client commission arrangements.² The effective date of the interpretive release is July 24, 2006, although market participants may continue to rely on the SEC’s prior interpretations of Section 28(e) until January 24, 2007. The Release makes several changes to the SEC’s proposed interpretive release³ based on comments received on the proposal. The most significant aspects of the Release, and changes made from the proposed interpretive release, are summarized below. 1 SEC Release No. 34-54165 (July 18, 2006), 71 FR 41978 (July 24, 2006) (“Release”). The Release can be found on the SEC’s website at <http://www.sec.gov/rules/interp/2006/34-54165.pdf>. 2 Comments on this aspect of the interpretive release must be filed with the SEC on or before September 7, 2006. 3 SEC Release No. 34-52635 (October 19, 2005), 70 FR 61700 (October 25, 2005). 2 Framework for Analyzing the Scope of “Brokerage and Research Services” The Release states that the analysis of whether a particular product or service falls within the Section 28(e) safe harbor should involve three steps. First, the money manager must determine whether the product or service is eligible under Section 28(e)(3) (i.e., whether it is eligible “research” under Section 28(e)(3)(A) or (B) or eligible “brokerage” under Section 28(e)(3)(C)).⁴ Second, the manager must determine whether the eligible product or service provides “lawful and appropriate assistance” in the performance of its investment decision-making responsibilities. Third, the manager must make a good faith determination that the amount of client commissions paid is reasonable in light of the value of products or services provided by the broker-dealer. Eligibility Criteria for “Research Services” In determining

that a particular product or service qualifies as “research services” under the safe harbor, the money manager must conclude that it constitutes “advice,” “analyses,” or “reports” within the meaning of Section 28(e) and that its subject matter falls within the categories specified in Section 28(e)(3)(A) and (B). The Release states that, in evaluating whether a product or service qualifies as “research,” an important common element among “advice,” “analyses,” and “reports” is that each reflects substantive content, i.e., the expression of reasoning or knowledge. Therefore, in determining whether a product or service is eligible as “research” under Section 28(e), the money manager must conclude that it reflects the expression of reasoning or knowledge and relates to the subject matter identified in Section 28(e)(3)(A) or (B). Examples of eligible “research” delineated in the Release include: (1) traditional research reports analyzing the performance of a particular company or stock; (2) discussions with research analysts; (3) meetings with corporate executives to obtain oral reports on the performance of a company; (4) seminars or conferences (if they provide substantive content relating to the subject matter in the statute, such as issuers, industries, and securities); (5) software that provides analyses of securities portfolios; and (6) corporate governance research (including corporate governance analytics) and corporate governance rating services (if they provide reports and analyses about issuers, which can have a bearing on the companies’ performance outlook).

4 Section 28(e)(3) states 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 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.

3 Mass Marketed Publications In response to comments received on the proposed interpretive release, including the Institute’s, the Release clarifies that the safe harbor does not protect the money manager’s purchase of publications that are mass-marketed, i.e., those publications that are intended for and marketed to a broad, public audience. Indicia of mass-marketed publications include, among other things, that they are circulated to a wide audience, intended for and marketed to the public, and have low cost.

Tangible Products and Services The Release clarifies that products or services that do not reflect the expression of reasoning or knowledge, including products with inherently tangible or physical attributes (such as telephone lines or office furniture), are not eligible as research under the safe harbor. Examples of such products or services include expenses for travel, entertainment, and meals associated with attending seminars. Travel and related expenses associated with arranging trips to meet corporate executives, analysts, or other individuals who may provide eligible research orally also are not eligible under the safe harbor. Similarly, salaries (including for research staff), rent, accounting fees, internet service, legal expenses, 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), and professional licensing fees are some examples of overhead items delineated in the Release that the SEC believes would not meet the statutory criteria for “research” and therefore are not eligible under the safe harbor.

5 Market Research Consistent with the Institute’s comments on the proposed interpretive release, the Release states that the SEC believes that technology now permits managers to obtain research related to the market for securities from many sources and products, and through many delivery mechanisms, including order management systems and trade analytical software. The Release therefore clarifies that market research may be eligible under the safe harbor

if it otherwise satisfies the standards for “research.” For example, market research that may be eligible under Section 28(e) can include pre-trade and post-trade analytics, software, and other products that depend on market information to generate market research, including research on optimal execution venues and trading strategies. In addition, advice from broker-dealers on order execution, including advice on execution strategies, market color, and the availability of buyers and sellers (and software that provides these types of market research) may qualify as “research” under the safe harbor.

5 The Release notes that, although certain tangible products and services may not qualify as “research” under Section 28(e), they may be eligible under the safe harbor as brokerage products if they relate to trade execution and satisfy the other requirements for brokerage.

4 Data The Release states that data services, such as those that provide market data or economic data, could fall within the scope of the safe harbor as eligible “research” provided that they satisfy the subject matter categories identified in Section 28(e) and provide lawful and appropriate assistance in the investment decision-making process. Examples of market data include stock quotes, last sale prices, trading volumes, and other data reflecting substantive content related to the subject matter identified in the statute (e.g., company financial data and economic data such as unemployment and inflation rates or gross domestic product figures). Proxy Services Based on comments received on the proposed interpretive release, including the Institute’s, the Release clarifies that proxy services may be treated as mixed-use items, as appropriate. For example, reports and analyses on issuers, securities, and the advisability of investing in securities that are transmitted through a proxy service may fall within Section 28(e). Nevertheless, the Release notes that products or services offered by a proxy service provider that handle the mechanical aspects of voting, such as casting, counting, recording, and reporting votes, would be administrative overhead expenses of the manager and are not eligible under Section 28(e).

Eligibility Criteria for “Brokerage” Under Section 28(e)(3)(C), eligible brokerage products and services include not only activities required to effect securities transactions but also functions “incidental thereto” and functions required by SEC or SRO rules (such as electronic confirmation or affirmation of institutional trades in connection with settlement processing). The Release discusses this standard and provides additional guidance to assist money managers in determining whether items are eligible as “brokerage services” under the safe harbor. Temporal Standard The Release states that “brokerage” services under the safe harbor must relate to the execution of securities transactions. Specifically, for purposes of the safe harbor, brokerage begins when the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution and ends when funds or securities are delivered or credited to the advised account or the account holder’s agent. By establishing such a temporal standard, the SEC believes it can properly distinguish between “brokerage” services that are eligible under Section 28(e) and those products and services, such as overhead, that are not eligible. The Release clarifies that under this temporal standard, eligible “brokerage” services include communications services related to the execution, clearing, and settlement of securities transactions and other functions incidental to effecting securities transactions, i.e., connectivity service between the 5 money manager and the broker-dealer and other relevant parties such as custodians (including dedicated lines between the broker-dealer and the money manager’s order management system and lines between the broker-dealer and order management systems operated by a third-party vendor).⁶ In addition, trading software used to route orders to market centers, software that provides algorithmic trading strategies, and software used to transmit orders to direct market access (“DMA”) systems are within the temporal standard and therefore are eligible “brokerage” under the safe harbor. Ineligible Overhead The Release discusses several products and services that should be categorized as “overhead,” i.e., part of the manager’s cost of doing business, and that do not qualify as

“brokerage” under Section 28(e). Specifically, the Release clarifies that hardware, such as telephones or computer terminals, including those used in connection with order management systems and trading software, are not eligible for the safe harbor because they are not sufficiently related to order execution and fall outside the temporal standard. In addition, 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 for portfolio modeling (whether or not provided through order management systems) do not qualify as “brokerage” because they are not integral to the execution of orders by the broker-dealers. The Release also states that managers may not use client commissions under the safe harbor to meet their compliance responsibilities, such as: (1) performing compliance tests that analyze information over time in order to identify unusual patterns; (2) creating trade parameters for compliance with regulatory requirements, prospectus disclosure, or investment objectives; or (3) stress-testing a portfolio under a variety of market conditions or to monitor style drift. Finally, trade financing, such as stock lending fees, and capital introduction and margin services, as well as error correction trades or related services in connection with errors made by money managers, are not eligible “brokerage” services under the safe harbor.

Custody The Release clarifies that short-term custody related to effecting particular transactions and clearance and settlement of those trades is included within the statute because it is tied to processing the trade between the time the order is placed and settlement of the trade. In contrast, custodial services, such as long-term custody and custodial recordkeeping, provided in connection with accounts after clearance and settlement of transactions, are not incidental to effecting securities transactions and are not included under the safe harbor.

“Mixed-Use” Items The Release reaffirms the SEC’s belief that the guidance provided in the SEC’s 1986 interpretive release on “mixed-use” items continues to be appropriate. Specifically, the mixed-use 6 The Institute, in its comment letter on the proposed interpretive release, recommended expanding the temporal standard on the front end to include order management systems. 6 approach requires a money manager to make a reasonable allocation of the cost of a product between research and non-research functions. A money manager also must keep adequate books and records concerning allocations so as to be able to make the required good faith showing that the amount paid for the mixed-use item in client commissions was reasonable in relation to the value of the research product or service received. As an example related to the “reasonable allocation” requirement, the Release notes that an allocable portion of the cost of portfolio performance evaluation services or reports may be eligible as research, but that money managers must use their own funds to pay for the allocable portion of such services or reports that is used for marketing purposes.

Good Faith Determination as to Reasonableness Under Section 28(e) The Release reaffirms a money manager’s “essential obligation” under Section 28(e) to make a good faith determination that the commissions paid are reasonable in relation to the value of the brokerage and research services received, and adds that the burden of proof in demonstrating this determination rests on the money manager. The Release cautions that a money manager may not obtain eligible products, such as market data, to camouflage the payment of higher commissions to broker-dealers for ineligible services, such as shelf space. It explains that in this instance, the money manager could not make the determination, in good faith, that the commission rate was reasonable in relation to the value of the Section 28(e) eligible products because the commission would incorporate a payment for the non-Section 28(e) services.

Third-Party Research and Commission-Sharing Arrangements Section 28(e) is available only where a broker-dealer that receives commissions “effects” the money manager’s trades and “provides” the research. The Release discusses the functions an executing broker-dealer must provide in order to “provide” the research and what services an introducing

broker-dealer must provide in order to “effect” the money manager’s trade. The Release also reiterates the SEC’s position that the safe harbor applies equally to arrangements involving client commissions paid for proprietary research and to third-party research arrangements where the research services and/or products are developed by third parties and “provided by” a broker-dealer that participates in “effecting” the transaction. The Release states that comments received on client commission arrangements highlighted the considerable variety of arrangements under Section 28(e) that the industry has developed. Based on the additional information regarding current industry practices provided by these comments and consideration of congressional intent behind Section 28(e), the Release states that the SEC is revising its interpretation of the safe harbor to permit the industry to structure arrangements that are consistent with the statute and that best serve investors in a more flexible manner. The SEC also is requesting additional comment on whether the guidance in this area is sufficient to address the many variations and complexity of these arrangements.

7 “Effecting” Transactions Requirement The proposed interpretive guidance identified four minimum functions that an introducing broker-dealer must satisfy in order to be “effecting” transactions. The four functions are: (1) taking financial responsibility for all customer trades until the clearing broker-dealer has received payment (or securities); (2) making and/or maintaining records relating to customer trades required by SEC and SRO rules; (3) monitoring and responding to customer comments concerning the trading process; and (4) generally monitoring trades and settlements. The Release modifies the “effecting” transactions requirement by clarifying that, in order for the money manager to use the safe harbor, a broker-dealer that is “effecting” the trade must perform at least one of four minimum functions and take steps to see that the other functions have been reasonably allocated to another broker-dealer in a manner consistent with its obligations under SEC and SRO rules.

“Provided by” Requirement The Release reiterates the SEC’s view that broker-dealers “provide” research if they (1) prepare the research or (2) are financially obligated to pay for the research. The Release clarifies, however, that the safe harbor also is available in situations where a broker-dealer pays for eligible research and brokerage for which it is not directly obligated to pay if the broker-dealer pays the research preparer directly 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. Such steps include: (1) reviewing the description of the services to be paid for with client commissions under the safe harbor for red flags that indicate the services are not within Section 28(e) and agreeing with the money manager to use client commissions only to pay for those items that reasonably fall within the safe harbor; and (2) developing and maintaining procedures so that research payments are documented and paid for promptly.

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