The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 19290

October 24, 2005

PROPOSED SEC SOFT DOLLARS GUIDANCE

 [19290] October 24, 2005 TO: BOARD OF GOVERNORS No. 52-05 CLOSED-END INVESTMENT COMPANY MEMBERS No. 58-05 INVESTMENT ADVISER MEMBERS No. 19-05 SEC RULES MEMBERS No. 115-05 SMALL FUNDS MEMBERS No. 89-05 RE: PROPOSED SEC SOFT DOLLARS GUIDANCE The Securities and Exchange Commission has published for comment an interpretive release concerning client commission practices under Section 28(e) of the Securities Exchange Act of 1934.1 The Release is summarized below. Comments on the Release are due 30 days after its publication in the Federal Register. The Release states that Section 28(e) establishes a safe harbor that allows money managers to use client funds to purchase “brokerage and research services” for their managed accounts under certain circumstances without breaching their fiduciary duties to clients. The Release explains that the SEC is proposing to provide further guidance in this area in light of its experience with Section 28(e) and in recognition of changing market conditions. By way of background, the Release briefly summarizes (1) the history of Section 28(e), (2) previous SEC guidance on the scope of Section 28(e), (3) a 1998 report of the Office of Compliance Examinations and Inspections (OCIE) on examination findings regarding the range of products and services that advisers obtain under their client commission arrangements, (4) the 2004 recommendations of the NASD Mutual Fund Task Force concerning client commission practices and portfolio transaction costs, and (5) the United Kingdom Financial Services Authority’s recently adopted client commission rules. Proposed Interpretive Guidance The Release indicates that the SEC has revisited its previous guidance as to the meaning of the phrase “brokerage and research services” in Section 28(e) and is proposing a revised interpretation that would replace some of the guidance it provided in a 1986 interpretive 1 SEC Release No. 34-52635 (Oct. 19, 2005) (“Release”). The Release is available on the SEC’s website at: http://www.sec.gov/rules/interp/34-52635.pdf. 2 release.2 The revised interpretation addresses (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. It also discusses a money manager’s statutory requirement to make a good faith determination that client commissions paid are reasonable in relation to the value of the brokerage and research services received, and provides guidance on third-party research and commission-sharing arrangements. Framework for Analyzing the Scope of the “Brokerage and Research Services” under Section 28(e) According to the Release, 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)(A), (B), or (C).3 Second, the manager must determine whether the eligible product or service provides “lawful and appropriate assistance” in the performance of his 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” To qualify as research services under the safe harbor, a product or service must constitute “advice,” “analyses,” or “reports” within the meaning of Section 28(e) and its subject matter must fall within the categories specified in Section 28(e)(3)(A) or (B). The Release notes that some of these categories subsume other topics and thus, for example, a report containing political factors that are interrelated with economic factors could fall within the scope of the safe harbor. The Release states that in determining whether a product or service is eligible as “research,” a 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). In addition 2 The proposed guidance would replace Sections II and III of the 1986 release; it would not replace other sections of that release. 3 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 to traditional research reports analyzing the performance of a particular company or stock, examples of items that could be eligible include: • financial newsletters and trade journals if they relate to the subject matter of Section 28(e)(A) or (B); • quantitative analytical software and software that provides analyses of securities portfolios if they reflect the expression of reasoning or knowledge relating to subject matter included in Section 28(e)(3)(A) and (B); and • seminars or conferences where the content satisfies the above-mentioned “expression of reasoning or knowledge” and subject matter criteria. Products that do not reflect the expression of reasoning or knowledge, such as operational overhead expenses, are not eligible “research services.” Examples of ineligible items include: • travel expenses, entertainment, and meals associated with attending seminars; • office equipment, office furniture and business supplies, telephone lines, salaries (including research staff), rent, accounting fees and software, website design, e-mail software, internet service, legal services, 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; and • computer hardware and accessories, and the “peripherals” and delivery mechanisms associated with computer hardware (e.g., telecommunications lines, transatlantic cables, and computer cables). 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 if they satisfy the subject matter criteria. Thus, under the proposed interpretation, market data such as stock quotes, last sale prices, and trading volumes, and other data reflecting substantive content, such as company financial data and economic data (e.g., unemployment and inflation rates or gross domestic product figures) would be eligible as “research services.” The Release notes that to be within the safe harbor, a product or service not only must satisfy the specific criteria of Section 28(e), but also must provide the money manager with lawful and appropriate assistance in making

investment decisions. According to the Release, this standard focuses on how the manager uses the eligible research. For example, while analyses of performance of accounts are eligible research items, they are not within the safe harbor if used for marketing purposes. 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 self-regulatory organization (SRO) rules (such as electronic confirmation or affirmation of institutional trades in connection with settlement processing). The Release states that, in addition to clearance and settlement services, the following post- trade services are examples of incidental functions that are eligible as “brokerage services”: 4 • post-trade matching; • exchange of messages among broker-dealers, custodians, and institutions; • electronic communication of allocation instructions between institutions and broker- dealers; and • routing settlement instructions to custodian banks and broker-dealers’ clearing agents. The Release notes that the 1998 OCIE Report recommended that the SEC provide further guidance on the scope of the safe harbor concerning the use of items that may facilitate trade execution. It also mentions a potential risk that, in the absence of such guidance, the proposed narrowing of the scope of eligible research under the safe harbor could lead to inappropriate reclassification of services and products as brokerage that previously were classified as research. For these reasons, the Release provides additional guidance to assist money managers in determining whether items are eligible as “brokerage services” under the safe harbor. The Release proposes a new “temporal standard” to distinguish between “brokerage services” that are eligible under Section 28(e) and those products and services, such as overhead, that are not eligible. According to the Release, 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 contrast, the Release points out, research services include services provided before the communication of an order. Under the proposed temporal standard, eligible “brokerage services” include: • communications services related to the execution, clearing, and settlement of securities transactions and other incidental functions, i.e., connectivity service between the 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; lines between the broker-dealer and order management systems operated by a third-party vendor; dedicated lines providing direct dial-up service between the money manager and the trading desk at the broker-dealer; and message services used to transmit orders to broker-dealers for execution); • trading software operated by a broker-dealer to route orders to market centers; and • algorithmic trading software. Items properly characterized as “overhead” and not eligible as “brokerage services” include: • order management systems used by money managers (whether developed in-house or obtained from third party vendors); • hardware, such as telephones or computer terminals; • trade analytics,4 surveillance systems, or compliance mechanisms; and 4 The Release notes that trade analytics may be used both for research and to assist a money manager in fulfilling contractual obligations to a client or to assess compliance with regulatory or fiduciary obligations. In this case, the trade analytical software is a mixed-use product and the money manager must use its own funds to pay for the allocable portion of the cost of the software that is not within the safe harbor. 5 • error correction trades or related services in connection with errors made by money managers. The Release reiterates that in order to obtain safe harbor protection for products or services that are eligible brokerage services, the money manager must (1) be able to show that the product or service provides lawful and appropriate assistance to the manager in carrying out his or her responsibilities and (2) make a good faith determination that the amount of

commissions paid is reasonable in relation to the value of the research and brokerage product or service received. “Mixed-Use” Items The SEC’s 1986 interpretive release introduced the concept of “mixed use” and stated that where a product has a mixed use, a money manager should make a “reasonable allocation” of the cost of the product according to its use. It also emphasized that the money manager must keep adequate books and records concerning allocations in order to make the required good faith determination. The Release states that the SEC continues to believe that the mixed use approach is appropriate, and reiterates the mixed-use standard in the 1986 release (i.e., “The money manager must keep adequate books and records concerning allocations so as to be able to make the required good faith showing.”). 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 used for marketing purposes. Similarly, according to the Release, if the money manager receives both eligible and ineligible products and services for a bundled commission rate, the manager must use his own funds to pay for the allocable portion of the cost of products and services that are not within the safe harbor. The Release mentions that the SEC may further address the documentation of mixed-use items at a later time. 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. 6 Third-Party Research and Commission-Sharing Arrangements The Release states that third-party research arrangements can benefit advised accounts by providing greater breadth and depth of research. Noting that Section 28(e) requires that the broker-dealer receiving commissions must “provide” brokerage or research services, the Release reiterates the SEC’s position that money managers may use client commissions to pay for research produced by someone other than the executing broker-dealer (i.e., third-party research), provided that the broker-dealer has the direct legal obligation to pay for the research. As the SEC has previously indicated, third-party research is eligible even if the money manager participates in selecting the research services or products that the broker-dealer will provide, and the third party may send the research directly to the broker-dealer’s customer, so long as the broker-dealer has the obligation to pay for the services. The Release reminds money managers and broker-dealers that arrangements whereby broker-dealers pay for research or brokerage services for which money managers are obligated to pay a third party are not eligible for the Section 28(e) safe harbor. The Release discusses Section 28(e)’s requirement that the broker-dealer providing the research also be involved in “effecting” the trade, noting that it is principally intended to preclude the practice of paying “give-ups.”5 Although Section 28(e) does not apply if a money manager makes payment to one broker-dealer for the services provided by another broker dealer, the SEC’s 1986 interpretive release clarified that payment of a part of a commission to a broker-dealer who is a “normal and legitimate correspondent” of the executing or clearing broker-dealer would not necessarily be outside the safe harbor. The Release describes certain commission-sharing arrangements.6 It reiterates the SEC’s view that where more than one broker-dealer is involved in a

commission-sharing arrangement, the “introducing broker [must be] engaged in securities activities of a more extensive nature than merely the receipt of commissions paid to it by other broker-dealers for ‘research services’ provided to money managers.” It states that while commission-sharing arrangements typically involve clearing agreements pursuant to SRO rules, a clearing agreement that satisfies SRO rules does not necessarily satisfy the criteria of Section 28(e). Further, “[e]ach broker-dealer must play a role in effecting securities transactions that goes beyond the mere provision of research services to money managers,” and the nature of the activities actually performed determines whether the commission-sharing arrangement qualifies for the safe harbor. According to the Release, the following elements are necessary for a commission-sharing arrangement under which research and brokerage services are provided under the safe harbor: 5 The Release explains that when brokerage commissions were fixed before 1975, a “give-up” was a payment to another broker-dealer of a portion of the commission required to be charged by the executing broker-dealer. The broker-dealer receiving the give-up may have had no role in the transaction generating the commission and may not even have known where or when the trade was executed. The SEC found that these arrangements violated the securities laws because the portion of the commission “given up” is a charge above the cost of execution on client accounts and because the broker-dealer receiving the “give up” did nothing in connection with the securities trade to benefit investors. 6 The Release differentiates “step-outs” from commission-sharing arrangements. According to the Release, “[p]rovided that each broker in a step-out performs substantive functions in effecting trades, e.g., clearance and settlement, such arrangements may be eligible for the safe harbor. 7 • The commission-sharing arrangement must be part of a normal and legitimate correspondent relationship in which each broker-dealer is engaged in securities activities of a more extensive nature than merely the receipt of commissions paid to it by other broker-dealers for research services provided to money managers. The SEC believes that, at a minimum, this means that the introducing broker-dealer must: (1) be financially responsible to the clearing broker-dealer for all customer trades until the clearing broker-dealer has received payment (or securities); (2) make and/or maintain records relating to its customer trades required by SEC and SRO rules; (3) monitor and respond to customer comments concerning the trading process; and (4) generally monitor trades and settlements; and • a broker-dealer effecting the trade (if not providing research and brokerage services directly) must be legally obligated to a third-party producer of research or brokerage services to pay for the service ultimately provided to a money manager. Request for Comments The SEC seeks comment generally on its proposed interpretive guidance, including whether the proposed guidance has accurately identified the industry practices for which guidance would be most useful, and whether the guidance would significantly affect the level and distribution of costs among industry participants and, if so, whether these effects would be beneficial to investors or otherwise serve the public interest. The Release also includes a list of specific questions on which the SEC solicits comment. These questions address, among other topics, whether there are types of products or services that are commonly paid for with client commissions for which additional guidance would be useful (e.g., proxy voting services), whether the SEC should provide additional guidance concerning mass-marketed publications, and whether the SEC should afford firms time to implement the interpretation. Regarding the latter, the Release requests specific examples of any potential implementation issues. Frances M. Stadler Deputy Senior Counsel

should not be considered a substitute for, legal advice.