

INVESTMENT FUNDS ALERT

SEC PUBLISHES FINAL GUIDANCE ON USE OF “SOFT DOLLARS”



On July 18, 2006, the Securities Exchange Commission (the Commission) published final interpretative guidance regarding the use of “soft dollars” (the Release).¹ The Release clarifies the circumstances under which money managers may use client commissions to pay for brokerage and research services under the soft dollars safe harbor in Section 28(e) of the Securities Exchange Act of 1934 (the Safe Harbor) and specifically addresses four issues: (1) when do “brokerage or research services” fall within the Safe Harbor, (2) what constitutes “eligible research,” (3) what constitutes “eligible brokerage services” and (4) what is the appropriate treatment for “mixed-use” items. The Release affirms most of the positions taken by the Commission in the proposed release issued in October 2005 (the Proposed Release) and is intended to replace Sections II and III of the Commission’s 1986 interpretive release (the 1986 Release) but is not intended to replace any other section of the 1986 Release.

This Client Alert summarizes the differences between the Proposed Release and the Release and discusses the framework for determining whether brokerage or research services fall within the Safe Harbor.

WHAT ARE THE DIFFERENCES BETWEEN THE PROPOSED RELEASE AND THE RELEASE?

The Release does not diverge from the Proposed Release on most points; however, the Commission varied its stance on the following issues:

- The Release clarifies that “mass marketing publications” are not eligible research products under and therefore do not fall within the Safe Harbor.
- The Release takes a less-restrictive approach to commission-sharing arrangements.
- The Release eliminates the requirement that a broker-dealer be contractually obligated to pay a third-party research provider.
- The Release treats order management systems as mixed-use products.

¹ The term “soft dollars” refers to client commissions used by money managers to pay for research and other services. The Safe Harbor allows such use of client commissions paid to a broker-dealer for effecting a securities transaction if the money manager determines, in good faith, that the amount of the commission is reasonable in relation to the value of the brokerage and research services provided by the broker-dealer.

WHEN DO “RESEARCH SERVICES” FALL WITHIN THE SAFE HARBOR?

The Three-Part Test. The Release sets forth a three-part test to determine whether brokerage and research services fall within the Safe Harbor. They must: (1) acquire “eligible” research products and brokerage services, (2) use those products and services lawfully and appropriately and (3) make a good-faith determination that the commissions they are paying are reasonable in light of the value of the products and services they are receiving.

What Constitutes Eligible Research? Research services fall within the Safe Harbor if they (1) provide advice, either directly or through publications or writings, as to the value of securities, the advisability of buying or selling securities, and the availability of securities or (2) furnish analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy and the performance of accounts.

Traditional research reports analyzing the performance of a particular company or stock continue to be eligible. Other eligible research items may include financial newsletters and trade journals, computer software that provides securities or quantitative analysis, and seminars or conferences where the content relates to making decisions about investing.

Third-Party Research. The Release also addressed third-party research. It specified that the Safe Harbor is available when a money manager does business with a broker-dealer that is involved in “effecting” the money manager’s trades and “provides” research. The Commission determined that it is a benefit to investors when money managers are able to functionally separate trade execution from access to valuable research. Accordingly, the Commission concluded that the statutory requirement that the broker-dealer “effect” the trade is met if the broker-dealer performs one of the following four functions: (1) takes responsibility for customer trades, (2) maintains records relating to customer trades, (3) monitors and responds to customer comments concerning the trading process and (4) monitors trades and settlements and takes reasonable steps to ensure that the other functions have been allocated to another broker-dealer. The proposal had required that all four functions be performed by the introducing broker-dealer.

Mass-Market Publications. The Release clarified that “mass-market publications” are not eligible research under the Safe Harbor. “Mass-market publications” are defined as publications intended for and marketed to a broad public audience such as daily or monthly periodicals. Publications that are expensive, narrowly tailored and directed at readers with specialized interests, such as trade journals and financial newsletters, may fall within the Safe Harbor.

WHEN DO “BROKERAGE SERVICES” FALL WITHIN THE SAFE HARBOR?

What Constitutes Eligible Brokerage Services – The Temporal Standard. Brokerage services fall within the Safe Harbor if they relate to the execution of a trade from the point at which the Adviser communicates with the broker-dealer for the purpose of transmitting orders for execution through the point at which funds or securities are delivered or credited to the advised accounts. Eligible brokerage services include functions incidental to effecting securities transactions, such as clearance, settlement, custody and related communications services. Trading software operated by a broker-dealer to route orders to market centers and algorithmic trading software are also considered eligible brokerage services.

Overhead. The Commission determined that products and services that are part of a money manager’s cost of doing business (overhead) are ineligible for protection under the Safe Harbor. Hardware, such as computers, is considered overhead and therefore ineligible under the Safe Harbor because it is not sufficiently related to execution. Money managers are also prohibited from using client commissions for products or services that assist them in meeting

compliance responsibilities, such as compliance tests to analyze the quality of brokerage executions. Error correction trades or related services are also outside of the Safe Harbor.

Order Management Systems. In the Release, the Commission clarified that order management systems may be treated as mixed-use items. Specifically, elements of an order management system that related to eligible research or brokerage services may be eligible under the Safe Harbor. This differs from the Proposed Release, which stated that all order management systems were ineligible.

WHAT IS THE APPROPRIATE TREATMENT FOR “MIXED-USE” ITEMS?

Treatment of mixed-use items remains largely unchanged under the Release. Managers are required to allocate costs with respect to mixed-use items among their research and non-research uses. The allocation must be reasonable and documented.

WHAT IS LAWFUL AND APPROPRIATE ASSISTANCE?

The Safe Harbor requires money managers to determine that the research and brokerage services provide “lawful and appropriate assistance” in the performance of the money manager’s decision-making responsibilities. This means that even if a product or service falls within the definition of brokerage or research, it will not qualify under the Safe Harbor if it does not provide the money manager with lawful and appropriate assistance in meeting the money manager’s obligations to the client. This requirement remains unchanged under the Release.

WHAT IS A GOOD-FAITH DETERMINATION AS TO REASONABLENESS?

The Safe Harbor requires money managers to make a good-faith determination that the commissions paid are reasonable in relation to the value of the brokerage and research services received, either in terms of the specific transaction or the money manager’s overall responsibilities for discretionary accounts. This requirement remains unchanged under the Release.

WHAT IS THE EFFECTIVE DATE?

The Commission’s interpretation of Section 28(e) is not retroactive and becomes effective six months following the publication of the Release in the *Federal Register*. Money managers may rely on either the 1986 Release or the Release during that period.

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