

NEW SEC SOFT DOLLAR GUIDANCE

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To Our Clients and Friends:

Last week, the SEC issued proposed new interpretative guidance concerning soft dollars. The proposed interpretation addresses a number of the SEC's concerns regarding the use of soft dollars in light of changes in technology and industry practices that have occurred since the time it last provided guidance in 1986.

It is noteworthy that the SEC now prefers to use the term "client commissions" rather than soft dollars because it wants to emphasize the basic fiduciary principles of best execution and limits on the use of client assets for the benefit of a money manager. In most respects, the new guidance is consistent with the SEC's prior views, although in some areas the types of items that money managers can acquire within the soft dollar safe harbor are narrowed. Documenting thoroughly the basis upon which a money manager has determined that a soft dollar arrangement complies with applicable law will be a key compliance issue. In addition, money managers can expect to make more disclosures to clients about the use of client commissions.

First, some background. Section 28(e) of the Securities Exchange Act of 1934 provides a "safe harbor" that permits money managers to use client commissions to acquire "brokerage and research services" as specified in the statute. Since its enactment in 1975, the SEC has issued a number of interpretations seeking to define the types of brokerage and research services that fall within Section 28(e). In the new guidance, the SEC confirms its 1986 statement that "the controlling principle to be used to determine whether something is research is whether it provides lawful and appropriate assistance to the money manager in the carrying out of his investment decision-making responsibilities." The SEC also lays to rest questions about whether third-party research can be obtained with client commissions, stating plainly that the safe harbor applies to such research if it is provided by a broker "involved" in the transaction.

What are "research services" under the proposed interpretation? Can I pay for computer equipment with client commissions?

Under the proposed interpretation, in order for a particular product to constitute research services, the money manager must conclude that it constitutes "advice," "analysis" or "reports" (the precise terms used in Section 28(e)). In reaching its conclusion, the money manager must determine (1) that the research product "reflects substantive content – that is, the expression of reasoning or knowledge" and (2) that the content meets the substantive

standards described in Section 28(e)(3). For example, if a commercial mass market publication, whether published in print or via internet, meets these standards, it would qualify for the safe harbor, although additional disclosure requirements may make certain mass publication products difficult to justify.

<u>Meets the Standard</u>	<u>Does Not Meet the Standard</u>
Traditional research reports	Physical items, including computer hardware, cabling and accessories (even if they assist in the delivery of research)
Data services, such as quotation equipment, last sale price and trading volume data	Telephone lines; internet service; web design; e-mail software
Newspapers, financial newsletters and trade journals as long as they satisfy the standard and relate to the subject matter covered by the statute	Rent, office furniture and other overhead, including utilities
Quantitative analytical software; software that provides analysis of securities portfolios or account performance	Software assisting with administrative or back-office functions; performance analysis for marketing purposes
Certain seminars and conferences	Travel expenses, entertainment and meals associated with attending a seminar or conference
Consultants providing advice with respect to portfolio strategy	Consultants providing advice with respect to the manager's internal management or operations, or marketing
	Salaries (including salaries of research staff); legal fees; marketing expenses

The SEC emphasized that the money manager must use the product in making investment decisions and must make a good faith determination that the commissions paid are reasonable in relation to the value of the services received. For example, a permitted product that is used for marketing purposes rather than to assist in performing investment decision-making responsibilities would not be within the safe harbor. Money managers should be prepared to demonstrate that the service acquired was used appropriately and that the commission paid was reasonable in relation to the value of the product. *The money manager has the burden of demonstrating that it has made this determination.*

What are brokerage services? What about post-trade services?

“Brokerage services” under the safe harbor “relate to execution of securities transactions.” In addition, clearance and settlement services are also eligible. Recognizing the technological explosion in recent times, the SEC has become increasingly concerned that money managers were using soft dollars to pay for computer “overhead” expenses. To provide guidance, the SEC proposes a “temporal standard” with respect to brokerage products or services. Brokerage products or services “integral” or “related” to the execution of securities transactions begin “when an order is transmitted to a broker-dealer and end at the conclusion of clearance and settlement of the transaction.”

For example, communications services related to the execution, clearing and settlement of securities transactions and other related incidental functions would fall within the safe harbor. Items considered “overhead” do not meet the standard.

<u>Meets the Standard</u>	<u>Does Not Meet the Standard</u>
Connectivity service between the money manager and the broker and other relevant parties, such as a custodian	Internal order management systems used by money managers to manage their orders
Dedicated lines between the broker and the money manager’s order management system; dedicated lines providing direct dial-up service between the money manager and the broker’s trading desk	Hardware, such as telephones and computer terminals
Lines between the broker and order management systems operated by a third party vendor	Trade analytics
Algorithmic trading software	Surveillance systems or compliance mechanisms
Message services used to transmit orders for execution	Error correction trades or related error correction services
Trading software to route orders to market centers	

Post-trade matching; message exchanges among broker, custodian and manager; allocation instructions; routing settlement instructions	
Services required by SEC or SRO rules, such as electronic confirms or trade affirmations	

Can I still obtain mixed-use products?

Yes. The SEC confirms that mixed-use is appropriate, as long as it meets the SEC’s standards. As in the past, the money manager is responsible for making a reasonable allocation of the cost of the product according to its use. The proposed interpretation emphasizes the importance of keeping adequate books and records concerning the allocations. The records should provide a basis for a good faith showing of the reasonableness of the allocation.

The SEC cautions that a money manager may not “camouflage” payment of higher commissions for ineligible functions, such as marketing or paying for “shelf space.”

Can I still use soft dollars to acquire products from third-party research firms?

Yes. The SEC’s guidance on this issue is unchanged.

Can I acquire third-party research from a broker in a commission-sharing or “step-out” arrangement?

If more than one broker is involved in a commission-sharing or step out arrangement, the SEC requires that each broker-dealer “must play a role in effecting securities transactions that goes beyond the mere provision of research services to money managers.” The arrangement must be part of a normal and legitimate correspondent relationship in which the broker 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. The SEC reminds broker-dealers that nothing in the safe harbor rules or proposed interpretation alters a broker-dealer’s best execution obligation to its customers.

In order to fall within the Section 28(e) safe harbor, an introducing broker must

- be financially responsible to the clearing broker-dealer for all customer trades until the clearing broker-dealer has received payment or securities
- make and/or maintain records relating to its customer trades required under applicable rules and regulations
- monitor and respond to customer comments concerning the trading process

- generally monitor trades and settlements
- be legally obligated to the third-party producer of the service to pay for the service if not providing the research and brokerage services directly

The broker must also consider whether the commission-sharing arrangement contributes to a violation of law, taking into account factors such as whether the involvement of multiple broker-dealers is necessary to effect the trade, beneficial to the client and appropriate in light of all applicable duties.

I have a U.K. affiliate that is subject to the new Financial Services Authority client commission rules. Are there special differences between the SEC's soft dollar views and those of the FSA that I should be aware of?

The SEC believes that the two regimes are compatible in most respects. For example, the FSA requires custody not incidental to execution, computer hardware, telephone lines and portfolio measurement and valuation services to be paid for with hard dollars. Unlike the SEC, the FSA determined that raw market data does not meet the requirements of a "research service" but the FSA concluded that it may be an execution service. In addition, the FSA rules do not permit client commissions to be used to pay for seminars.

Will the SEC be providing more guidance?

Yes. This interpretative guidance is issued as a proposal. The SEC requests comment on a number of issues related to soft dollars, including whether its guidance is sufficiently clear and what economic impact its interpretation might have on present arrangements. In addition, the SEC is also considering additional rulemaking initiatives related to the disclosure of soft dollar arrangement to clients, mutual fund boards and beefed up record-keeping requirements.

The Proposed Guidance may be found at <http://www.sec.gov/rules/interp/34-52635.pdf>.

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