

SEC UPDATES ITS GUIDANCE ON USE OF CLIENT COMMISSIONS

July 25, 2006

To Our Clients and Friends:

In October 2005, the SEC proposed issuing new interpretive guidance concerning soft dollars.¹ On July 18, 2006, the SEC issued the final version of the new interpretive guidance. The new guidance 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.

In most respects, the new guidance is consistent with the SEC's prior views and those contained in the prior draft of the interpretive guidance. The SEC did make some significant changes in response to industry comments.

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" for their managed accounts under certain circumstances without breaching their fiduciary duties to clients.

The new interpretive guidance accomplishes a number of things. As an initial matter, it provides a three-step analytical framework that it will expect a money manager to apply in determining whether it may use client commissions to acquire a particular product or service. The money manager will, in effect, be asked if he can document its response to three questions:

- Is the product or service eligible for the safe harbor?
- Does the product or service actually provide "lawful and appropriate" assistance to the money manager in making investment decisions?
- Has the money manager made a good faith determination that the client commissions paid are reasonable in relation to the value of the brokerage and research services received?

¹ Our memorandum on the initial proposal is available at <http://www.debevoise.com/SECSoftDollars>

The interpretive guidance also clarifies whether certain types of products and services fall within the safe harbor, particularly with respect to a broker's services, and the circumstances under which a broker that is *not directly involved* in the execution of a securities transaction may provide services to money managers that are relying on the safe harbor.

This memorandum answers a number of the questions that are raised by the new interpretive guidance. In addition, for your convenience, we have prepared charts attached at the end of this memorandum comparing items that meet these standards and those that do not, based on the interpretive guidance.

RESEARCH SERVICES

Under the new interpretation, in order for a particular product or service to be eligible for the safe harbor, the money manager must conclude that it constitutes “advice,” “analysis,” or “reports”—the precise terms used in Section 28(e). For a research product or service to be eligible for the safe harbor, the money manager also must conclude (1) that the research product “reflects substantive content—that is, the expression of reasoning or knowledge” (the “content criteria”) and (2) that the content relates to the value of securities, the advisability of investing in, purchasing, or selling securities, the availability of securities or purchasers or sellers of securities or contains an analysis or report concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts (the “subject matter criteria”).

What research services or reports are eligible for the safe harbor? Can the firm still pay for computer equipment or software with client commissions? What about the firm's *Wall Street Journal* subscription?

Traditional research reports. Clearly, traditional research reports have always been eligible under Section 28(e). Discussions with research analysts and corporate executives about the performance of a company or its stock are also eligible because they meet the content and subject matter criteria standards. Corporate governance research and rating services may also be eligible if they meet both the content and the subject matter criteria.

Under this standard, products that have no substantive content—such as computers, computer terminals, peripherals, and other tangible assets—fall outside of the safe harbor because they do not reflect substantive content related to investment decisions. However, a product or service that is delivered via a computer may be eligible for the safe harbor if the product or service meets the content and subject matter criteria.

Mass market publications. The new interpretation explicitly places “mass-market” publications outside the scope of Section 28(e). Mass-marketed publications are those publications that

are intended for and marketed to a broad, public audience rather than intended to serve the specialized interests of a small readership, and have low cost. According to the SEC, these mass-marketed publications are more appropriately considered as overhead expenses of money managers. (The SEC did not explicitly identify mass-marketed publications but it quoted statements of commentators and SEC Commissioners that were made shortly after Section 28(e) was enacted to the effect that it was not intended to cover subscriptions to *The Wall Street Journal* or *Fortune*.) Publications that are not mass-marketed include financial newsletters and other financial and economic publications that are marketed to a narrow audience, directed to readers with specialized interests in particular industries, products, or issuers, and have high cost. The method of distribution (print vs. electronic) is irrelevant to a determination of whether a publication is “mass-marketed.” Therefore, a publication that targets a narrow audience of professionals may be eligible even though it is easily accessed over the Internet.

What about market data and market research?

Market research and data may fall within the safe harbor if they meet the content and subject matter criteria. Market research, in this context, includes 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 be eligible “research” under the safe harbor.

The SEC also reaffirmed that data services, including market data, such as stock quotes, last sale prices, and trading volumes, fall within the safe harbor. Economic data services may also fall within the safe harbor if the data satisfies the subject matter criteria.

My firm devotes a substantial amount of resources to voting my client’s proxies. Is a proxy voting service eligible research that falls within the safe harbor?

Proxy voting services may fall within the safe harbor if the manager determines “after a careful analysis” that the proxy voting service provides reports and analyses on issuers, securities, and the advisability of investing in securities. The SEC does not believe, however, that a service that assists a manager in deciding *how to vote* proxy ballots provides the manager lawful and appropriate assistance in making decisions about investments for his or her clients and, therefore, fall outside the safe harbor. Moreover, proxy services that assist the money manager by addressing the mechanical aspect of the proxy voting process are not within the safe harbor. It appears that the SEC expects that most proxy services will either

fall outside the safe harbor or be treated as mixed-use items (meaning that the money manager will have to pay for a portion of the service with hard dollars).

BROKERAGE SERVICES

It will not escape the industry that the interpretive guidance narrows the scope of eligible research. In part, for that reason, the SEC provides explicit guidance on what constitutes eligible brokerage services so that what might formerly have been deemed “research” does not resurface as “brokerage.”

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

The SEC has adopted a new “temporal standard” with respect to brokerage products or services. Brokerage services relate to the execution of securities transactions which, for purposes of Section 28(e), begin “from the point at which the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution, through the point at which funds or securities are delivered or credited to the advised account or the account holder’s agent.” Under this temporal standard:

- Software that provides algorithmic trading strategies and trade routing or order transmittal software to direct market access (“DMA”) systems are eligible brokerage services. And, as discussed above, advice provided by a broker or trade analytical software that falls outside the temporal standard for brokerage services may fall within the “research” portion of the safe harbor.
- 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. Thus, a money manager’s use of client commissions to acquire products or services that assist it in meeting its compliance responsibilities (such as software that creates trade parameters for compliance with regulatory requirements, prospectus disclosure, or investment objectives) would not fall within the safe harbor.

The SEC also clarified that a short-term custody arrangement that is related to effecting particular transactions, and clearance and settlement of those trades, fits squarely within Section 28(e) because the arrangement is tied to processing the trade between the time the order is placed and settlement of the trade. A long-term custody arrangement, however, would not fall within the safe harbor as it is not incidental to effecting securities transactions. This does not prohibit the *client* from directing brokerage to a broker to obtain credits to pay for long-term custody services.

MIXED USE PRODUCTS; ORDER MANAGEMENT SYSTEMS; CERTAIN DETERMINATIONS

Can I still obtain mixed-use products?

Yes. The SEC confirms that mixed-use products are appropriate as long as a portion of the products' use meets the standards of Section 28(e). 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 money manager, however, must keep adequate books and records concerning the allocations. The records should provide a basis for a good faith showing of the reasonableness of the allocation. Further, the SEC noted that the allocation determination itself poses a conflict of interest that should be disclosed to the client.

Do order management systems fall within the safe harbor?

In the proposed interpretive guidance, the SEC appeared to suggest that order management systems ("OMS") used by the money manager to manage their orders would fall outside of the safe harbor based on the interpretive guidance. The SEC changes this position. OMS may be eligible for the safe harbor, either as research or brokerage services, to the extent that the OMS contains certain functionality that provides services that fall within the safe harbor. These functions include pre-and post-trade analytics (which may be eligible research) or trading software used to route orders, provide algorithmic trading strategies, or transmit orders to direct market access systems or provide connectivity to this software (which may be eligible brokerage).

How does my firm determine whether the service actually provides the firm with lawful and appropriate assistance in making investment decisions?

The money manager must use the item in performing its investment decision-making responsibilities for accounts over which he exercises investment discretion. Thus, for example, a money manager may purchase an eligible item of research with client commissions if he properly uses the information in formulating an investment decision, but another money manager may not rely on Section 28(e) to acquire the very same item if the manager uses the item for marketing.

How does the firm make a good faith determination that the client commissions paid are reasonable in relation to the value of the brokerage and research services received?

As noted above, in order to rely on Section 28(e), the money manager must believe in good faith that the amount of commissions paid is reasonable in relation to the value of the search or brokerage product or service received, either in terms of the particular transaction or the manager's overall responsibilities for discretionary accounts.

The interpretive guidance indicates how the money manager could go about making this determination in one context: If a broker offers its research for an unbundled price, that price should inform the money manager as to its market value and help the manager make its good faith determination. In addition, the interpretive guidance describes two practices that would be problematic. First, the money manager may not use client commissions to acquire eligible items, such as market data, in order to camouflage the payment of higher commissions to brokers for ineligible services, such as shelf space or client referrals. Second, if research products or services that are eligible under Section 28(e) have been simply copied, repackaged, or aggregated, the money manager must make a good faith determination that any additional commissions paid in respect of such copying, repackaging, or aggregation services are reasonable.

THIRD-PARTY RESEARCH; COMMISSION SHARING "ARRANGEMENTS"

One of the most "political" items presented by any soft dollar discussion is what constitutes permitted "third-party" research under the safe harbor in Section 28(e). The SEC takes pains in the interpretation to state that independent (or third-party research) providers should be afforded "equal treatment" with proprietary research providers.

In order for a service to fall within the safe harbor, the service must be "provided by" a broker who is involved in "effecting" the transaction. The SEC has modified its prior guidance of the meaning of the terms "provided by" and "effecting" in Section 28(e). The goal of this aspect of the guidance is to afford money managers with greater flexibility to obtain the most efficient trade execution and high quality research. Just as importantly, the SEC specifically seeks additional comment only on this interpretive position and not on the release as a whole.

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 executing a transaction and providing research, 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 SEC took a flexible approach to reconcile the language of the statute with this objective. In order to satisfy the requirement that a broker-dealer is “effecting” a transaction, the broker-dealer must perform at least one of the following four minimum functions:

- be financially responsible to the clearing broker-dealer 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;
- 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; or
- generally monitor trades and settlements.

Of course, a broker-dealer also “effects” a trade if it executes, clears or settles the trade.

In addition, the SEC has significantly modified its interpretation of the meaning of the term “provided by” in Section 28(e). Under the new guidance, a money manager can use client commissions to pay eligible research and brokerage for which such broker-dealer is not directly obligated to pay for 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. The SEC listed three attributes that indicate that the new standard is met:

- The broker-dealer pays the research preparer directly;
- The broker-dealer reviews the description of the services to be paid for with client commissions for red flags that indicate the services are not eligible and agrees with the money manager to use the commissions only to pay for those items that are eligible; and
- The broker-dealer develops and maintains procedures so that research payments are documented and paid promptly.

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." (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. Finally, the FSA allows money managers to use client commissions to pay separately for trade execution by the broker-dealer that can provide the best execution and asks the executing broker-dealer to allocate a portion of the commission directly to an independent research provider without requiring that the executing broker-dealer be legally responsible for the research.

DISCLOSURE

The SEC stressed the importance of the disclosure of a money manager's practices with respect to client commission arrangements. The SEC recognizes that improvements may be necessary in disclosure and documentation of client commission practices and will evaluate whether further action in this regard is necessary.

IMPLEMENTATION

The SEC granted the industry a period of six months following the publication of the guidance in the Federal Register to comply with the interpretation.

The Guidance may be found at www.sec.gov/rules/interp/2006/34-54165.pdf

Please call us if you have any questions.

Kenneth J. Berman
+1 202 383 8050
kjberman@debevoise.com

Marcia L. MacHarg
+49 69 2097 5120
mlmacharg@debevoise.com

Francis S. Kuo
+1 202 383 8132
fskuo@debevoise.com

APPENDIX

The following is a list of services that the SEC concluded may or may not fall within the safe harbor. In connection with the services that meet the Eligibility Standard, the money manager must also determine that the services meet the subject matter criteria, provide “lawful and appropriate” assistance to the money manager in making investment decisions, and allow for a good faith determination that the client commissions paid are reasonable in relation to the value of the services received.

Research Product and Services

<u>Meets the Eligibility Standard</u>	<u>Does Not Meet the Eligibility Standard</u>
Quantitative analytical software and software that provides analysis of portfolios or account performance	Software assisting with administrative or back-office functions, operating systems, word processing, equipment maintenance and repair services, and performance analysis for marketing purposes
Data services, market data (such as stock quotes, last sale price, and trading volume), company financial data and economic data (such as unemployment and inflation rates or gross domestic product figures)	Telephone lines, transatlantic cables, computer cables, Internet service, web design, and e-mail software
Traditional research reports	
Certain seminars and conferences	Travel expenses, entertainment and meals associated with attending a seminar or conference, and travel and related expenses associated with arranging trips to meet corporate executives, analysts, or other individuals who may provide eligible research orally
Consultants providing advice with respect to portfolio strategy	Consultants providing advice with respect to the manager’s internal management or operations, or marketing

<u>Meets the Eligibility Standard</u>	<u>Does Not Meet the Eligibility Standard</u>
Discussions with research analysts, meetings with corporate executives to obtain oral reports on the performance of a company	
Corporate governance research (including corporate governance analytics) and corporate governance rating services if they reflect the expression of reasoning or knowledge in the event they meet the subject matter criteria, i.e., if they provide reports and analyses about issuers that can have a bearing on the companies' performance outlook	
Financial newsletters and other financial and economic publications that are not targeted to a wide, public audience, trade magazines and technical journals concerning specific industries (e.g., nano-technology) or product lines (e.g., medical devices) if they are marketed to and intended to serve the interests of a narrow audience (e.g., physicians) rather than the general public	Mass-marketed publications
Pre- 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	
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)	

<u>Meets the Eligibility Standard</u>	<u>Does Not Meet the Eligibility Standard</u>
	Physical items, including computer hardware, computer terminals, computer accessories, cabling, and accessories (even if they assist in the delivery of research)
	Rent, office furniture, office equipment and business supplies, and other overhead, including utilities
	Salaries (including salaries of research staff), legal fees, accounting fees, marketing expenses, personnel management, membership dues and professional licensing fees

DEBEVOISE & PLIMPTON LLP

Brokerage Products and Services

<u>Meets the Eligibility Standard</u>	<u>Does Not Meet the Eligibility Standard</u>
Connectivity service between the money manager and the broker and other relevant parties, such as a custodian	Software used for recordkeeping and administrative purposes, such as managing portfolios, asset allocation, or portfolio modeling (whether or not through OMS)
Dedicated lines between the broker and the money manager’s order management system and dedicated lines providing direct dial-up service between the money manager and the broker’s trading desk	Hardware, such as telephones and computer terminals, including those used in connection with OMS and trading software
Lines between the broker and order management systems operated by a third-party vendor	
Algorithmic trading software	Trade analytics
Message services used to transmit orders for execution	
Trading software used to route orders to market centers, software used to transmit orders to direct market access (“DMA”) systems	Quantitative analytical software used to test “what if” scenarios related to adjusting portfolios, asset allocation, or for portfolio modeling (whether or not provided through OMS)
Post-trade matching, message exchanges among broker, custodian, and manager, allocation instructions, routing settlement instructions, and short-term custody related to effecting particular transactions in relation to clearance and settlement	Error correction trades or related error correction services
Services required by SEC or SRO rules, such as comparison services, electronic confirms, or trade affirmations	Surveillance systems or compliance mechanisms

<u>Meets the Eligibility Standard</u>	<u>Does Not Meet the Eligibility Standard</u>
	Trade financing, such as stock lending fees and capital introduction and margin services
	Performing compliance tests that analyze information over time in order to identify unusual patterns, including, <i>e.g.</i> , an analysis of the quality of brokerage executions, an analysis of the portfolio turnover rate, or an analysis of the comparative performance of similarly managed accounts
	Creating trade parameters for compliance with regulatory requirements, prospectus disclosure, or investment objectives
	Stress testing a portfolio under a variety of market conditions or to monitor style drift
Short-term custody arrangements	Long-term custody arrangements

Mixed-Use Items

<u>Meets the Eligibility Standard</u>	<u>Does Not Meet the Eligibility Standard</u>
Proxy Services: reports and analyses on issuers, securities, and the advisability of investing in securities that are transmitted through a proxy service	Proxy Services: products or services offered by a proxy service provider that handle the mechanical aspects of voting, such as casting, counting, recording, and reporting votes
Trade Analytical Software, <i>e.g.</i> , if used in aiding the money manager in making investment decisions	Trade Analytical software if used for administrative purposes
OMS: the portion that represents services that are eligible, <i>e.g.</i> , research related to the market for securities	OMS: the portion that represents overhead, such as telephones and computer terminals