

**COMMISSION ISSUES PROPOSED INTERPRETIVE GUIDANCE  
ON THE SCOPE OF SECTION 28(e)**

On October 19, 2005, the Securities and Exchange Commission (the “Commission”) issued a proposed interpretive release (the “Release”) providing guidance and requesting comments on the scope of the brokerage-allocation safe harbor in Section 28(e) of the Securities Exchange Act of 1934 (the “Exchange Act”).<sup>1</sup>

The Release focuses on the scope of the Section 28(e) safe harbor. It does not address soft-dollar arrangements that do not come within the safe harbor.<sup>2</sup> The Release provides additional guidance and reaffirms some of the Commission’s prior positions on the following: (i) the appropriate framework for analyzing “brokerage and research services” under the safe harbor, (ii) eligible research services, (iii) eligible brokerage services, (iv) treatment of mixed-use items, (v) good-faith determinations, and (vi) third-party research and commission-sharing arrangements.

The key elements of the Release are:

- Research must be “an expression of reasoning and knowledge” to qualify as “eligible research” under Section 28(e)’s safe harbor;
- To rely on Section 28(e), an investment manager must differentiate between computer hardware that receives the delivery of the research (non-eligible) and the software applications that are an expression of reasoning and knowledge (eligible);
- “Eligible Brokerage” begins when an order is transmitted to the broker-dealer, and ends at the conclusion of clearance and settlement of the transaction; and
- Prior positions on mixed-use items, third-party research and commission-sharing arrangements are reaffirmed by the Commission.

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<sup>1</sup> SEC Release No. 34-52635 (Oct. 19, 2005), available at: <http://www.sec.gov/rules/interp/34-52635.pdf>. The Commission’s rationale in issuing guidance is to update and clarify prior releases and to address some results in the 1998 Office of Compliance Inspection and Examination staff’s report on soft-dollar practices (the “1998 OCIE Report”). *See id.* at 31-32, where the staff concluded that some investment managers were taking an expansive view of the safe harbor under Section 28(e). The 1998 OCIE Report is available at: <http://www.sec.gov/news/studies/softdoler.htm>.

<sup>2</sup> Section 28(e)(1) provides that the safe harbor “is exclusive and plenary . . . unless otherwise expressly provided by contract. . . .” The Release notes that investment managers “may provide more detailed disclosure when they receive products or services that fall outside the scope of the safe harbor.” Release in text at n.73. The Commission further observed, however, that, regardless of any disclosures made to investors, arrangements by advisers to investment companies registered under the Investment Company Act of 1940 or employee benefit plans subject to the Employee Retirement Income Security Act of 1974 may violate those statutes if they fall outside the safe harbor. Release in text accompanying nn.21-24.

## The Scope of Section 28(e)'s Safe Harbor

### *I. Consideration of Products or Services*

The Release sets forth a three-step analysis that an investment manager should employ when determining whether a product or service falls within the statutory scope of Section 28(e)'s safe harbor. In making a determination, the investment manager should:

1. determine whether the product or service falls within the specific statutory limits of Section 28(e)(3) (*i.e.*, whether it involves an eligible product or service);
2. determine whether the product or service provides lawful and appropriate assistance in the performance of the investment manager's investment decision-making responsibilities; and
3. make a good-faith determination that the amount of client commissions paid is reasonable in light of the value of the products or services provided by the broker-dealer.<sup>3</sup>

### *II. Eligible Research*

In determining whether a product or service qualifies as "eligible research" under Section 28(e), the Release provides that an investment manager must conclude that the product or service reflects an expression of reasoning or knowledge and relates to the following subject matter enumerated in Section 28(e)(3)(A) or (B):

- advice 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, or
- analyses or reports regarding issuers, industries, securities, economic factors or trends, portfolio strategy, or the performance of accounts.<sup>4</sup>

In evaluating the statutory language, the Commission noted that the common nexus of eligible advice, analyses and reports is that each is an expression of reasoning and knowledge.<sup>5</sup>

The Release provides some examples of "eligible research" under the safe harbor of Section 28(e), including:

- consultants advising on portfolio strategy (not the manager's operations),
- market or economic data services satisfying the subject matter in Section 28(e)(3)(A) or (B),

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<sup>3</sup> Release in text accompanying nn.77-78. The Commission believes that this three-step test incorporates Congress's intent to provide a limited safe harbor for conduct that may be considered a breach of the investment manager's fiduciary duty, and also incorporates some of the Commission's prior guidance regarding the safe harbor under Section 28(e).

<sup>4</sup> 15 U.S.C. 78bb(e)(3)(A)-(B).

<sup>5</sup> Release in text accompanying n.81.

- quantitative analytical software and software that provides analyses of securities portfolios, and
- seminars or conferences where the content satisfies Section 28(e)(3)(A) or (B).

Specifically, the Commission stated that a data service could fall within the scope of the safe harbor provided it satisfies the subject matter criteria set forth in Section 28(e).<sup>6</sup>

In the Release, the Commission emphasized that when an investment manager makes a determination, the manager must differentiate between the computer hardware that receives the delivery of the research and the software application that is an expression of reasoning and knowledge. The Commission explicitly states that computer hardware and computer accessories, while assisting in the delivery of research, would not be eligible “research services” because they do not reflect substantive content related to making investment decisions.<sup>7</sup>

In addition, the Commission takes the position that the following products and services are not “eligible research” within the scope of 28(e):

- telecommunications lines,
- transatlantic cables,
- telephone lines,
- office equipment,
- travel expenses, entertainment and meals associated with attending an eligible seminar, and
- other operational overhead.<sup>8</sup>

The final criterion for determining if a product or service falls within the safe harbor of Section 28(e) is whether the product or service provides the investment manager with lawful and appropriate assistance in making investment decisions. The Commission stated that although a product or service might satisfy the criteria set forth in Section 28(e), that product or service would not fall within the safe harbor of Section 28(e) if it were used for marketing purposes.<sup>9</sup>

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<sup>6</sup> The SEC believes that this would include a company’s financial data and economic data (such as unemployment and inflation rates or GDP figures). This position reaffirms the Commission’s position set forth in SEC Release 34-23170 (April 23, 1986) (the “1986 Release”), where the Commission stated that this type of service serves “a legitimate research function of pricing securities for investment and keeping a manager informed of market developments.”

<sup>7</sup> Release in text accompanying n.86.

<sup>8</sup> *Id.* in text accompanying n.85.

<sup>9</sup> *Id.* in text accompanying n.90.

In addition, the Commission stated that the delivery mechanism (e.g., paper or electronic) of the research is not a factor when determining whether a product or service qualifies as “eligible research.”<sup>10</sup>

### *III. Eligible Brokerage*

In addition to eligible research, certain brokerage products and services are also eligible for safe harbor protection under Section 28(e). In implementing a “temporal” standard for what constitutes eligible brokerage, the Commission stated that execution of transactions is a process, and that services related to the execution of securities transactions begin when an order is transmitted to the broker-dealer and end at the conclusion of clearance and settlement of the transaction.<sup>11</sup>

The Release provides the following examples of eligible brokerage under the safe harbor of Section 28(e):

- dedicated lines between the broker-dealer and the investment 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 investment manager and the trading desk of the broker-dealer, and the message services used to transmit orders to broker-dealers for execution,
- software operated by a broker-dealer that routes orders to market centers, and
- algorithmic trading software.

The Release also provides the following list of ineligible brokerage services under Section 28(e)’s safe harbor:

- order management systems and hardware,
- telephones or computer terminals,
- trade analytics,
- surveillance systems,
- compliance programs, and
- error correction trades and related services in connection with errors by investment managers.<sup>12</sup>

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<sup>10</sup> *Id.* in text following n.80.

<sup>11</sup> *Id.* in text following n.96.

<sup>12</sup> *Id.* in text accompanying nn.97-99.

As with research products and services, brokerage services will be eligible for Section 28(e)'s safe harbor only if the services provide the investment manager with lawful and appropriate assistance in carrying out the manager's responsibility, and the manager makes 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.<sup>13</sup>

#### *IV. Mixed-Use Items*

The Release reaffirms the Commission's position taken in its 1986 Release regarding mixed-use items. The 1986 Release stated that where a product has a mixed use, the manager should make a reasonable allocation of the cost in accordance with its uses. In addition, the investment manager should maintain adequate books and records to make and justify its good-faith determination.<sup>14</sup> Finally, the Commission restated its 1986 position that an investment manager relying on the Section 28(e) safe harbor must pay its own hard dollars for the ineligible portion when the manager receives both eligible and ineligible products or services for a bundled commission rate.

#### *V. Good-Faith Determination That Commissions Are Reasonable*

The Commission reaffirmed that an investment manager has an 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. In the Release, the Commission cited its 1986 position that "the determinative factor [in selecting a broker-dealer] is not the lowest possible cost but whether the transaction represents the best qualitative execution for the managed accounts."

The Commission also stated that an investment manager satisfies its good faith obligation under Section 28(e) if the manager can demonstrate that:

- the item is eligible under the language of the statute,
- the manager used the item in performing decision-making responsibilities over accounts as to which the manager exercises investment discretion, and
- in good faith, the manager believes that the amount of commissions paid is reasonable in relation to the value of the research or brokerage product or service received.

In addition, the burden of proof rests on the investment manager to prove that the manager made a good-faith determination in selecting the broker-dealer.

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<sup>13</sup> *Id.* in text following n.99.

<sup>14</sup> In the Release, the Commission stated that "lack of documentation makes it difficult for the manager to make the required good faith showing of the reasonableness of the commissions paid in relation to the value of the portion of the item allocated and also makes it difficult for compliance personnel to ascertain the basis of the allocation." *Id.* in text accompanying n.105.

*VI. Third-Party Research and Commission-Sharing Arrangements*

The Release reaffirmed the Commission's position that Section 28(e)'s safe harbor applies equally to in-house research obtained by a full-service broker-dealer as well as to third-party research provided by an executing broker-dealer.<sup>15</sup> Section 28(e) requires that the broker-dealer receiving commissions must "provide" the brokerage or research services. The Commission continues to permit investment managers to use client commissions to pay for research produced by someone else other than the executing broker-dealer only if the broker-dealer has the direct legal obligation to pay and thus provide for the research.

When relying on Section 28(e)'s safe harbor, a manager must use the same method of analysis in determining whether a product or service is eligible under the safe harbor for third-party research as in-house research. The Commission's rationale in continuing to permit reliance on Section 28(e) for third-party research is to provide an investment manager with (1) a broader universe of available research, and (2) access to specialized research that may not be available from the executing broker.

The Commission reaffirmed its 1986 view of more than one broker-dealer being 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 investment managers."<sup>16</sup>

**Additional Action to Be Considered**

The Commission also recognized that improvements may be necessary regarding disclosure and documentation of client commission practices, but stated that it will evaluate whether further action might be necessary.<sup>17</sup>

**Request for Comments**

The Commission requested comments regarding whether the proposed interpretation has accurately identified the industry practices for which guidance would be most useful, and any other significant issues arising under Section 28(e) that the Release has not addressed. All comments must be received no later than November 25, 2005.

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<sup>15</sup> Release in text following n.61.

<sup>16</sup> 1986 Release, 51 FR at 16007, quoting Data Exchange Securities, No-Action Letter (Apr. 20, 1981).

<sup>17</sup> See Release at n.72.

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