COMMISSION PUBLISHES INTERPRETIVE GUIDANCE AND SEEKS ADDITIONAL COMMENTS ON "SOFT DOLLARS" SAFE HARBOR

Introduction

On July 18, 2006, the Securities and Exchange Commission ("Commission" or "SEC") published interpretive guidance ("Release")[1] with respect to asset managers' use of client commissions to pay for brokerage and research services under the "soft dollars" safe harbor set out in Section 28(e) of the Securities Exchange Act of 1934 ("Exchange Act"), and certain client commission arrangements under Section 28(e). At the Open Meeting held on July 12, 2006 to consider the interpretation, a number of the Commissioners expressed antipathy for Section 28(e). Nevertheless, they voted to publish an interpretation clarifying the range of products and services that are eligible for safe harbor protection, with a goal of providing "maximum flexibility" for asset managers to use client commissions to seek best execution of trades while obtaining valuable research. The Release significantly expands upon the proposed interpretation published last October, and contains important interpretive statements on research, brokerage, third-party services, and other aspects of the safe harbor.

In many areas, the Release reiterates the proposed interpretive guidance that the Commission published in October 2005 ("Proposal"),[2] which is summarized in our Client Memorandum dated October 28, 2005.[3] The Release does, however, modify the proposed guidance in a number of important ways. Most significantly, the Commission substantially altered the approach to "commission sharing arrangements" for providing third-party research as described in the Proposal. The new interpretation calls them "client commission arrangements" and permits them to operate in a more flexible manner than the Proposal would have allowed.

Advisers, broker-dealers and research providers may wish to begin to review and negotiate any required or permitted changes to their arrangements at the earliest opportunity. Parties to client commission arrangements may wish to take the opportunity to comment on the new interpretation.

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1 *Interpretation of Client Commission Practices Under Section 28(e)*, Exchange Act Release No. 54165 (July 18, 2006), *available at* http://www.sec.gov/rules/interp/2006/34-54165.pdf.

2 *Proposed Interpretation of Client Commission Practices Under Section 28(e)*, Exchange Act Release No. 52635 (Oct. 19, 2005), 70 Fed. Reg. 61700 (Oct. 25, 2005), *available at* http://www.sec.gov/rules/interp/34-52635.pdf.

3 See Willkie Farr & Gallagher LLP Client Memorandum, *Commission Issues Proposed Interpretive Guidance on the Scope of Section 28(e)*, (Oct. 28, 2005), *available at* http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/2220/Section_28(e).pdf.

Effective Date; Comment Due Date

The Release will become effective upon its publication in the Federal Register, which is expected to occur this week, but market participants may elect to rely on either the Release or the Commission's previous guidance on Section 28(e)[4] for a period of *six months* following publication. The Commission requested comments on the guidance provided in the Release concerning client commission arrangements under Section 28(e), and imposed a comment due date of 45 days after publication.

Interpretive Guidance

An asset manager's role as a fiduciary includes the duty to obtain "best execution" in connection with client transactions. Best execution requires the manager to "execute securities transactions for clients in such a manner that the client's total cost or proceeds in each transaction are the most favorable under the circumstances."[5] Section 28(e) of the Exchange Act can provide a safe harbor from liability for a breach of fiduciary duty when the manager causes a client to pay more than the lowest available commission for effecting a securities transaction.

Third-Party Research and Client Commission Arrangements

Most importantly in connection with third-party research, the Commission reiterated its long-standing position that independent research providers are accorded equal treatment with proprietary research providers, and that the Section 28(e) safe harbor encompasses third-party research and proprietary research on equal terms. The most dramatic difference reflected in the Release is a widening of the safe harbor as it applies to methods of providing third-party research under "client commission arrangements."

While the Commission reiterated that the statute requires that a broker-dealer in a client commission arrangement must be involved in the process of "effecting" trades for the asset manager and must "provide" the research products and services, the Release broadens the scope of what would be permitted under the Proposal in order to provide greater flexibility in using client commissions to seek best execution for trades and obtain research. In part in response to comments on the Proposal that introducing brokers, who do not execute trades, would perhaps be precluded from providing valuable third-party research, the Release now provides that a broker will be deemed to have effected a trade, and thus be eligible to share in commissions protected under Section 28(e), if it performs at least *one* of seven functions and has taken steps to see that the other functions have been reasonably allocated to one or another broker-dealers in the arrangement in a manner that is fully consistent with the obligations under self-regulatory

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4 Securities Exchange Act Release No. 23170 (Apr. 23, 1986), 51 Fed. Reg. 16004 (Apr. 30, 1986) ("1986 Release"). The Release notes that it replaces Sections II and III of the 1986 Release but does not replace other sections.

5 *Id.* at 16011.

organization (SRO) and SEC rules.[6] The Proposal had provided that a broker that did not execute, clear, or settle a trade must perform *all* of the other four functions.

The Commission also has departed from its historical position that, to satisfy the "provided by" requirement, the broker-dealer must have the direct legal obligation to pay for the brokerage or research product or service requested by the asset manager. The new interpretation provides that a broker "provides" the product or service if it: (i) has the direct legal obligation to pay; *or* (ii) is not directly obligated to pay, but 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, as described below. The Release noted that the following attributes "will help determine whether the broker-dealer that is effecting transactions for the advised accounts has satisfied the 'provided by' element," *i.e.*, the broker-dealer: (1) pays the research preparer directly; (2) reviews the description of the services to be paid for with client commissions under the safe harbor to determine whether red flags indicate that the services are not within Section 28(e) and agrees with the asset manager to use client commissions to pay only for those items that reasonably fall within the safe harbor; and (3) develops and maintains procedures so that research payments are documented and paid for promptly. (As noted above, the Release requests that comments with respect to this topic be provided within 45 days of the publication of the Release in the Federal Register.)

Research and Brokerage Services

One Commission's objective in publishing the Release was to clarify the scope of "brokerage and research services" for purposes of Section 28(e), in light of evolving technologies and industry practices. The Release sets out a three-step analysis that an asset 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 asset 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 adviser'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. The burden of proof rests on the asset manager to prove that the manager made a good-faith determination in selecting a broker-dealer.

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[6] Under the Release, a broker-dealer is involved in effecting a trade for purposes of Section 28(e) if it performs one of the following three functions -- executes, clears, or settles the trade -- *or* performs one of the following four specified functions and allocates the other functions to another broker-dealer: (1) taking financial responsibility for customer trades; (2) maintaining records relating to customer trades; (3) monitoring and responding to customer comments concerning the trading process; or (4) monitoring trades and settlements.

Research Services. The Commission also concluded that "research services" are restricted to advice, analyses, and reports relating to the subject matter areas in Section 28(e)(3). The Commission attempted to draw a line between products and services that have substantive content (*i.e.*, the expression of reasoning or knowledge), which are eligible as research, and those that have "inherently tangible" characteristics, which are not eligible. Examples of products or services that are **eligible** include the following:

- "raw" market data,
- pre-trade and post-trade analytics available through an order management system,
- data services with which an investment adviser can use raw data to prepare its own research analytics,
- conferences and seminars (but not meals or transportation),
- meetings with corporate executives to obtain oral reports on the performance of a company,
- publications targeted at a narrow audience,
- certain reports transmitted through a proxy service (such as analyses on the advisability of investing in a security),
- governance research,
- software that provides analyses of securities portfolios, and
- computer software that assists an asset manager in making investment decisions.

A research service or product is covered by the Section 28(e) safe harbor only to the extent that the service or product constitutes advice, an analysis or a report *and* provides lawful and appropriate assistance in the investment decision-making process (as opposed to, for example, the use of account performance analyses for marketing purposes). The Release provides that the form of the research (*e.g.*, electronic, paper or oral) does not affect the availability of the safe harbor.

The following products and services, however, are among those that are **not eligible** for commission payments under the safe harbor:

- operational overhead,
- computer hardware,
- software relating to administrative functions,
- compliance-related products or services,
- proxy services relating to the mechanical aspects of voting, and
- newspapers, magazines and other publications marketed broadly to a public audience (as opposed to publications "intended to serve the specialized interests of a small readership").

The Commission determined that such products and services do not reflect the expression of reasoning or knowledge relating to the subject matter identified in Section 28(e).

Brokerage Services. Advisers should apply the same three-step test in connection with brokerage services. The Release, in clarifying the meaning of "brokerage services" under Section 28(e), establishes what the Commission calls a "temporal" standard. Under that standard, brokerage services begin when an adviser communicates with a broker-dealer for the purpose of transmitting an order for execution and ends when funds are delivered or credited to an advised account. The following are some of the non-exclusive examples set out in the Release of brokerage services that may be **eligible** for the safe harbor:

- dedicated lines and message services that connect market participants (the asset manager, broker-dealers, and custodians),
- software used to route orders to market centers or to direct market access systems or that provides algorithmic trading strategies including such software incorporated in order management systems, and
- certain post-trade services incidental to executing a transaction, such as post-trade matching of trade information, electronic communication of allocation instructions, and the use of electronic confirmation and affirmation of institutional trades as required in connection with settlement processing.

The Release, however, provides the following non-exclusive examples of "overhead" items that are **not eligible** for the safe harbor:

- margin services and stock lending fees,
- recordkeeping or administrative software,
- quantitative analytical software to test "what if" scenarios, to adjust portfolios or allocations,
- analysis of the quality of brokerage execution for the purpose of evaluating the manager's fulfillment of its duty of best execution,
- trade error correction functions, and
- aspects of order management systems that provide the above types of functions or other functions outside of the temporal period.

The Release provides that the short-term custody of assets incidental to effecting securities transactions is covered by Section 28(e), but the Commission has determined that long-term custody falls outside of the safe harbor.

Mixed-Use Items

The Release reiterates the Commission's guidance on mixed-use items provided in the 1986 Release and emphasizes that an adviser should keep adequate records to support allocation determinations. The Release highlights certain areas in which an asset manager must make reasonable mixed-use allocations -- such as trade analytical software, account performance analyses, proxy voting services, and order management systems -- to the extent that the manager uses those items for purposes other than investment decision-making. The Release notes that the Commission may, at a later time, address the documentation of mixed-use items.

Disclosure and Documentation

The Release indicates that the Commission will evaluate whether to take further action with respect to additional disclosure and documentation of client commission practices. At the Commission's Open Meeting, the Director of the Division of Investment Management stated that he hoped to make recommendations in this area by the end of this year.

Comparison to Actions in the United Kingdom

The United Kingdom's Financial Services Authority ("FSA") recently has taken measures with respect to commission arrangements similar to those arrangements relating to Section 28(e). The Commission indicated that the guidance set out in the Release was intended to be generally consistent with that of the FSA, and Commissioners at the July 12th Open Meeting expressed an interest in avoiding situations in which an adviser must act inconsistently with one country's guidance in order to act consistently with the other's. The Release, however, highlights certain differences between the Commission's and the FSA's guidance, such as the application of the FSA's guidance only to equity trades and not to fixed-income trades, and the eligibility under the Release (but not under the FSA's guidance) of seminars, publications targeted to a narrow audience, and raw data provided for research purposes.

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If you have any questions regarding this memorandum, please contact Roger D. Blanc (rblanc@willkie.com, 212-728-8206), Larry E. Bergmann (lbergmann@willkie.com, 202-303-1103), Martin R. Miller (mmiller@willkie.com, 212-728-8690), Jesse P. Kanach (jkanach@willkie.com, 202-303-1276), Jane H. Kim (jkim@willkie.com, 202-303-1242), or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office located at 1875 K Street, NW, Washington, D.C., 20006-1238. Our New York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Washington, D.C. telephone number is (202) 303-1000 and our facsimile number is (202) 303-2000. Our website is located at www.willkie.com.

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