

Investment Adviser Association  
Compliance Workshop  
October 26, 2005

**Morgan Lewis**  
C O U N S E L O R S   A T   L A W

# *Soft Dollar Developments*

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# *Soft Dollar Developments*

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- October 19, 2005 proposed interpretation
- Comments due 30 days after publication
- SEC's proposal followed
  - 2004 NASD Mutual Fund Task Force recommendations
  - FSA's 2005 rulemaking initiatives
- Many of the SEC's proposals had been anticipated by commentators, but there were a few unexpected items

# *What is “Research”?*

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- SEC’s proposed interpretation
  - Relies more heavily on the specific terms in the statute than previous interpretations
  - Involves a three step analysis

# *SEC's 3-Step Analysis*

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- The money manager must determine
  - Whether the product or service falls within the specific statutory limits of Section 28(e)(3)(A), (B), or (C) (*i.e.*, whether it is an eligible product or service under the safe harbor)
  - Whether the eligible product or service actually provides lawful and appropriate assistance in the performance of his investment decision-making responsibilities
  - In good faith that the amount of client commissions paid is reasonable in light of the value of products or services provided by the broker-dealer

# *Examples of Research*

- Research (if satisfy subject matter requirements)
  - Traditional research reports that analyze the performance of a particular company or stock
  - Financial newsletters and trade journals
  - Quantitative analytical software and software that provides analyses of securities portfolios
  - Seminars or conferences
- Not Research
  - Products and services that do not reflect “the expression of reasoning or knowledge”
  - Products and services with inherently tangible or physical attributes
    - Computer hardware & Accessories
    - Office furniture
    - Travel expenses & entertainment
    - Meals associated with attending seminars
    - Website design, E-mail software & Internet service
    - Legal expenses
    - Membership dues

# *What is “Brokerage”?*

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- New focus on whether a service constitutes brokerage
- Proposed a temporal standard, under which brokerage services would include
  - Products and services that relate to the execution of a trade,
  - from the point at which the money manager transmits an order to a broker-dealer for execution,
  - through the point at which funds or securities are delivered or credited to the advised account

# *Examples of Brokerage*

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- Post-trade matching
- Exchange of messages among broker-dealers, custodians, and institutions
- Electronic communication of allocation instructions between institutions and broker-dealers
- Routing settlement instructions to custodian banks and broker-dealers' clearing agents

# *Communications Services aren't “Research” but might be “Brokerage”*

- Information delivery mechanisms (e.g., telecommunications lines and computer cables) would not constitute research
  - Because they do not reflect substantive content related in any way to investment decision-making
- But, communications services related to the execution, clearing, and settlement of securities transactions would constitute brokerage, including
  - Dedicated lines between the broker-dealer and the money 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 money manager and the trading desk at the broker-dealer
  - Message services used to transmit orders to broker-dealers for execution

# *Order Routing Systems are In, but Order Management Systems are Out*

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- Order routing software and algorithmic trading software would constitute brokerage
- Order management systems used by money managers to manage orders, along with related hardware such as telephones or computer terminals, would not constitute brokerage
  - because they are not sufficiently related to order execution and fall outside the temporal standard for brokerage

# *Market Data Constitutes Research*

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- Stock quotes, last sale prices, and trading volumes would be “reports concerning securities”
- Company financial data and economic data (e.g., unemployment and inflation rates or gross domestic product figures)
- Contrast FSA -- market data that has not been analyzed or manipulated does not constitute research
  - But money managers may justify using raw data feeds as brokerage services

# *Good Faith Determination*

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- Money managers bear the burden in making “good faith determinations” that the amount of commissions paid is reasonable in relation to the value of brokerage & research services received
- The SEC left unaddressed, for now, the issues of what
  - Information about the costs of brokerage and research services the money manager must obtain
  - Reports the manager needs to make to clients

## *Give-Ups are Out, Step-Outs are In*

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- “Give ups” would not qualify for the safe harbor
- “Step outs” would qualify for the safe harbor if each broker performs substantive functions in effecting trades (e.g., clearance and settlement)

# *Commission-Sharing Arrangements*

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- Commission-sharing arrangement must be part of a normal and legitimate correspondent relationship in which each firm engages securities activities beyond mere receipt of commissions
- The introducing broker-dealer must
  - Be financially responsible to the clearing broker for customer trades until the clearing broker has received payment or securities
  - Make or maintain records relating to its customer trades required by SEC and SRO rules
  - Monitor and respond to customer comments concerning the trading process
  - Generally monitor trades and settlements

# *“Provided By” Requirement*

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- A broker-dealer effecting a trade that is not providing research and brokerage services directly must be legally obligated to a third-party producer of research or brokerage services to pay for the product or service ultimately provided to the money manager

# *Mixed Use Allocations Permitted*

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- The NASD's Mutual Fund Task Force expressed skepticism about the use of mixed-use allocations
- SEC reiterates 1986 guidance
  - A money manager must keep adequate books and records concerning mixed-use allocations to make the required good faith showing

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