

Financial Research Associates, LLC  
Investment Adviser Compliance Forum  
January 23, 2006

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

# Soft Dollars Never Die: Current Perspectives for 2006

---

**J. Christopher Jackson**  
Hansberger Global  
Investors

**Gerald Lins**  
ING Investment  
Management

**Steven W. Stone**  
Morgan, Lewis &  
Bockius LLP

# *Soft Dollar Developments*

---

- SEC proposal
  - October 19, 2005 - proposed interpretation
  - November 25, 2005 - Comment period closed
  - Comments still trickle in
- 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

# *At a Glance - Research*

---

- Reaffirms past guidance in most respects
  - Research must be used for investment decision-making
  - Third-party research is okay if broker providing it is responsible for paying the fees
- Research *includes* (in contrast to FSA stance)
  - Market data
  - Mass market publications
  - Seminars and conferences
- Research *excludes* products and services
  - That do not reflect “the expression of reasoning or knowledge” or
  - With inherently tangible or physical attributes (e.g., computer hardware & accessories)

# *What is “Research”?*

---

- 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*

---

- 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

# *At a Glance - Brokerage*

---

- Brokerage services to include only products and services that relate to the execution of a trade from when a money manager transmits an order through settlement
- Brokerage services *includes*
  - Post-trade matching
  - Algorithmic trading software
  - Exchange of messages among brokers, custodians, and institutions
  - Electronic communication of orders, allocation instructions between institutions and brokers
  - Routing settlement instructions to custodians and clearing agents
- Brokerage services *excludes*
  - Order management systems

# *What is “Brokerage”?*

---

- 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*

---

- 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 execution, clearing, and settlement of trades would constitute brokerage, including
  - Dedicated lines between the broker-dealer and the money manager's OMS
  - Lines between the broker-dealer and OMS's 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*

---

- 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*

---

- 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*

---

- 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*

---

- “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*

---

- CSAs must be part of a normal and legitimate correspondent relationship in which each firm engages in securities activities beyond mere receipt of commissions
- The introducing broker-dealer must
  - Be financially responsible to the clearing broker for customer trades
  - Make or maintain required records relating to customer trades
  - Monitor & respond to customer comments about the trading process
  - Generally monitor trades and settlements
- These requirements will
  - Force the restructuring of some research arrangements where the brokers providing research play a more nominal role
  - Complicate cross-border transactions and arrangements

# *“Provided By” Requirement*

---

- 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*

---

- 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

# *Upcoming SEC Initiatives*

---

- SEC did not propose to force unbundling, but is expected to propose rules to increase the transparency of soft dollar use
- The SEC is expected to propose rulemaking to specify
  - Reports the manager needs to make to clients, especially fund boards
  - Recordkeeping obligations related to soft dollar products and services

# *Enter “Hard Dollar” Research?*

---

- As reported, one major fund group will pay brokers hard dollar fees for U.S. stock research plus a specified amount (¢/share) for equity trades
- Implications for brokers following suit
  - Will result in the brokers being deemed adviser/fiduciaries – and subject to heightened liability – absent regulatory relief
  - May subject brokers to burdensome restrictions on principal and agency-cross trades involving “advised” accounts

# *Enter “Hard Dollar” Research?*

---

- Implications for money managers following suit
  - May limit the field of eligible brokers, as some brokers will not wish to license or function as advisers
  - Will need to reasonably conclude that their “hard dollar” payments fully pay the cost of any research or brokerage obtained
    - Difficulties inhere in this judgment, especially with proprietary research
    - Money managers may still need to rely on Section 28(e) if they cannot confirm that commissions have not subsidized research or brokerage

Financial Research Associates, LLC  
Investment Adviser Compliance Forum  
January 23, 2006

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

# Soft Dollars Never Die: Current Perspectives for 2006

---

**J. Christopher Jackson**  
Hansberger Global  
Investors

**Gerald Lins**  
ING Investment  
Management

**Steven W. Stone**  
Morgan, Lewis &  
Bockius LLP