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# New SEC Soft Dollar Interpretation

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# New SEC Soft Dollar Interpretation

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# Overview

- New SEC interpretation
  - October 19, 2005 – Proposal
  - July 18, 2006 – Adoption with refinements
  - Comment period remains open for certain brokerage arrangements
  - Optional NOW – Mandatory on January 24, 2007
- SEC's new interpretation followed
  - 2004 NASD Mutual Fund Task Force recommendations
  - FSA's 2005 rulemaking initiatives
- Many of the SEC's changes were anticipated, but there were a few unexpected ones

# At a Glance - Research

- SEC Reaffirmed past guidance in most respects
  - Research must be used for investment decision-making
  - Third-party research is okay
- Research *includes* (in contrast to FSA stance)
  - Market data
  - 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 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:

1. Whether the product or service fits the specific statutory limits of Section 28(e) (*i.e.*, is it an eligible product or service under the safe harbor)
2. Whether the eligible product or service actually provides lawful and appropriate assistance in the performance of its investment decision-making responsibilities
3. 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

# Examples of Research

- Research (if it satisfies 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

# Examples – 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
  - Communications services
  - Office furniture
  - Travel expenses & entertainment
  - Meals associated with attending research seminars
  - Website design, E-mail software & Internet service
  - Legal expenses
  - Membership dues
- *Mass Marketed Publications*
- *Proxy voting services*
  - Except for making investment - not voting - decisions

# At a Glance – Brokerage

- Brokerage services 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 *include*
  - 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
  - Order management systems based on functional analysis

# Communications Services

- Information delivery mechanisms are not research
  - They do not reflect substantive content related in any way to investment decision-making
- But, communications services related to execution, clearing or settlement would constitute brokerage, including
  - Dedicated lines between a broker and a manager's OMS
  - Lines between a broker and OMSs operated by third-parties
  - Dedicated lines providing direct dial-up service between a manager and the broker's trading desk
  - Message services used to transmit orders to a broker

# “Effected” & “Provided by” Tests

- A broker effects a trade if it:
  - Executes, clears or settles the trade; or
  - Does one of the following:
    - Takes financial responsibility for customer trades until the clearing broker has received payment (or securities)
    - Makes or maintains records relating to customer trades required by SEC and SRO rules
    - Monitors and responds to customer comments about the trading process
    - Generally monitors trades & settlements

# “Effected” & “Provided by” Tests

- A broker provides research if it:
  - Is legally obligated to pay for it; or
  - Does each of the following:
    - Pays the research vendor directly
    - Reviews research descriptions for “red flags” & agrees with the money manager to use client commissions only to pay for items reasonably in the safe harbor
    - Develops & maintains procedures to document and make payments promptly

# 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

# Mixed Use Allocations

- 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

# What Managers Must Do By 1/07

- Review research & brokerage services now received to
  - See whether any are excluded under the new interpretation
  - Confirm you are using research in a way that fits the “3 tests”
  - If you pay for proxy voting services with soft dollars, do a mixed use allocation
- Confirm you have a reasonable basis to believe that any multi-broker arrangements satisfy the requirements that the brokers both
  - Provide the soft dollar services
  - Effect the related transactions
- Review and revise your policies and procedures to reflect the new interpretation and your related practices
  - Confirm that the firm is memorializing mixed use allocations
- Review and revise your Form ADV and any contract disclosure
  - Consider adding disclosure that you may encounter conflicts if you assume financial responsibility for soft dollar products (instead of the broker)

# What Managers May Want to do By 1/07

- Establish soft dollar arrangements for products or services that were not clearly covered under past interpretations, such as:
  - Items for which you were responsible for payment
- Consider emerging brokerage arrangements designed to allow for commission sharing
  - Designed permit multi-broker arrangements comparable to practice in the UK

# Upcoming SEC Initiatives

- SEC did not require unbundling
  - But may propose rules to increase the transparency of soft dollar use
  - Specifically, the SEC is expected to propose rules to specify
    - Reports a manager needs to give clients, especially fund boards
    - Recordkeeping obligations for soft dollar products and services