



## IN THIS ISSUE:

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## A New Era in Soft Dollar Commission Arrangements: SEC Issues Revised Interpretation of Section 28(e)

By Steven W. Stone, Jack P. Drogin, & Theodore R. Lazo

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Commission arrangements between money managers and broker-dealers have been the subject of debate ever since the end of fixed commissions. When Congress abolished fixed commission rates in 1975, it enacted Section 28(e) of the Securities Exchange Act of 1934 (Exchange Act), which provides a safe harbor to protect arrangements in which a money manager might pay more than the lowest available commission rate based on the particular products and services it received from the broker-dealer. These arrangements, known as “soft dollar” arrangements, allow a money manager to take into account all of the brokerage and research products and services that it receives from a broker-dealer in directing its clients’ securities transactions, rather than simply considering the broker-dealer’s commission rates. Similar types of arrangements have developed in other jurisdictions, including the United Kingdom.

Twenty years after issuing its last substantive guidance, the Securities and Exchange Commission (SEC) has updated its views to reflect current industry practices. On July 18, the SEC issued a revised interpretation of Section 28(e),<sup>1</sup> which followed a proposed interpretation of Section 28(e) that the SEC issued for public comment in October 2005.<sup>2</sup> The SEC’s revised interpretation became effective on July 24, although market participants also may rely on the prior interpretation of Section 28(e) until January 24, 2007.

As expected, the SEC largely adopted the guidance that it proposed for determining what constitutes “research” and “brokerage” under Section 28(e). However, the SEC substantially revised its prior guidance regarding arrangements involving money managers and broker-dealers, indicating an intention to provide market participants with greater flexibility in structuring arrangements under Section 28(e). The SEC’s illustrative guidance on the types of products and services that constitute research and brokerage appears to be final, for now at least. However, the SEC requested additional comment on its interpretation of eligible arrangements involving money managers and broker-dealers, leaving open at least the possibility that the SEC’s guidance in that area may be further modified or refined.

The SEC’s revised interpretation follows a comprehensive effort by the SEC and its Staff to evaluate the application of Section 28(e)

from a practical standpoint. In 2004, then-SEC Chairman William Donaldson set up an internal task force to consider revisions to the SEC's interpretation of Section 28(e). Before the SEC issued its proposed interpretation, that task force met with a large number of industry representatives and worked hard to gather a substantial amount of information to gain a thorough understanding of industry practices in this area. The SEC's October 2005 release clearly reflects that the task force was successful in this regard, as well as in understanding challenges the securities industry faces in harmonizing global requirements governing commission arrangements. The SEC's release includes a detailed analysis of the complicated issues that arise in connection with soft dollars, and the revised guidance reflects the dynamic nature of client commission practices and the changes that have occurred in this area since the SEC last considered these issues 20 years ago.<sup>3</sup>

## Overview of Section 28(e)

Section 28(e) of the Exchange Act provides a safe harbor for persons exercising investment discretion over an account, under which a person will not be deemed to have acted unlawfully or to have breached a fiduciary duty solely by reason of having caused the account to pay a broker-dealer a higher commission for effecting a trade than another broker-dealer would have charged. However, to receive the benefit of the safe harbor, the person must make a good faith determination that the commission paid is reasonable in relation to the value of the brokerage and research services provided by the broker-dealer.

Unlike many other provisions of the Exchange Act, Section 28(e) does not provide the SEC with rulemaking authority to set requirements under the safe harbor.<sup>4</sup> As a result, the SEC has issued guidance on the parameters of the safe harbor over the years through interpretive releases. Historically, the SEC's interpretations have focused on the particular products and services that qualify as "research" or "brokerage" under the safe harbor.

The SEC's 2006 release is somewhat broader than its previous interpretations, and provides guidance on a number of general areas relating to Section 28(e) and soft dollar arrangements. However, the release focuses most significantly on two particular areas under the safe harbor: (1) eligible research and brokerage products and services; and (2) eligible arrangements involving money managers and broker-dealers.

## Eligible Research and Brokerage under the SEC's Revised Interpretation

The SEC's revised interpretation issued in July largely adopts the standards it proposed last year for determining the applicability of the safe harbor. Under the revised interpretation, a money manager must carry out a three-step analysis to determine whether a particular product or service falls within the safe harbor:

- (1) The money manager must determine whether the product or service constitutes brokerage or research services under Section 28(e);
- (2) The money manager must determine whether the product or service actually provides lawful and appropriate assistance in the performance of the money manager's investment decision-making responsibilities; and
- (3) The money manager must make a good faith determination that the amount of client commissions paid is reasonable in light of the value of products or services provided by the broker-dealer.

Ultimately, the Section 28(e) analysis hinges on whether a particular product or service constitutes "research" or "brokerage." The SEC's revised interpretation includes new standards for determining whether particular products and services constitute research or brokerage. Those standards are substantially the same as the standards the SEC proposed last year.

*Eligible Research* — To be eligible as research under the revised interpretation of Section 28(e), a product or service must satisfy several requirements:

- First, the product or service must constitute "advice," "analyses," or "reports."
- Second, the product or service must satisfy the "subject matter" requirements of Section 28(e) (which the SEC stated should be construed broadly to subsume other topics related to securities and the financial markets) by furnishing:
  - (1) Advice, either directly or through publications or writings, 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
  - (2) Analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts.
- Third, the product or service must reflect "the expression of reasoning or knowledge."<sup>5</sup>

*Eligible Brokerage* — Consistent with last year's proposal, the revised interpretation adopts what the SEC calls a "temporal standard" for determining eligible brokerage. Specifically, the temporal standard provides that brokerage begins when the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution and ends when funds or securities are delivered or credited to the advised account or the account holder's agent. The SEC noted further that brokerage services can include connectivity services and trading software (e.g., T1 lines) where they are used to transmit orders to the broker-dealer.<sup>6</sup>

*Eligible Products and Services under the Revised Interpretation* — The SEC's release includes extensive illustrative guidance on products and services that are eligible and ineligible under the safe harbor. In many ways, the SEC's illustrative guidance on specific products and services came as little surprise. For example, the SEC reaffirmed that traditional research reports are eligible under the safe harbor, but computer hardware and accessories that deliver research are not eligible. In addition, the SEC took commenters' suggestions into account in its final interpretation of the products and services that constitute research and brokerage under the safe harbor. As a result, the SEC's guidance shifted during the public comment process in several respects. The charts at the end of this article summarize the SEC's illustrative guidance, but some of the more notable aspects of the SEC's interpretation of eligible products and services include the following:

- **Order Management Systems:** In last year's proposal, the SEC stated that order management systems would not be eligible under the safe harbor as brokerage (the SEC did not address their eligibility as research). However, the SEC's revised interpretation wisely takes a functional approach to these services, and provides that a money manager may use soft dollars to pay for those aspects of its order management system that otherwise qualify as either brokerage or research (e.g., pre-trade and post-trade analytics, order routing services, algorithmic trading services, or direct market access systems).
- **Mass-Marketed Publications:** In a departure from its 1986 interpretation, the SEC's revised interpretation provides that mass-marketed publications do not constitute research under Section 28(e). Nevertheless, the SEC stated that the safe harbor does apply to publications that are not mass-marketed, including publications that, among other things, are marketed to a narrow audience; are directed to readers with specialized interests in particular industries, products, or issuers; and have high cost.
- **"Market" Research:** The SEC's revised interpretation provides that certain types of "market research" are eligible for the safe harbor. For example, eligible market research under Section 28(e) can include pre-trade and post-trade analytics, software, and other products that depend on market information to generate market research, including research on optimal execution venues and trading strategies. In addition, the safe harbor applies to advice from broker-dealers on order execution, including advice on execution strategies, market color, and the availability of buyers and sellers (and software that provides these types of market research).
- **Proxy Services:** The revised interpretation provides that certain proxy products and services that contain reports and analyses on issuers, securities, and the advisability of investing in securities may be eligible research under Section 28(e), subject to a mixed-use

allocation. However, the SEC stated that the safe harbor does not extend to proxy services that assist a money manager in deciding how to vote proxy ballots, or services that handle the mechanical aspects of voting, such as casting, counting, recording, and reporting votes. Many money managers had paid for these services with soft dollars based on the notion that a manager's proxy voting obligations are related to the investment decision-making process.<sup>7</sup>

On the whole, the SEC adopted a functional approach to determining the products and services that are eligible under Section 28(e). In many cases, this approach should help market participants by extending the safe harbor to discrete aspects of a product or service that previously might have been evaluated only in the context of the overall product or service. For example, the SEC's guidance on order management systems recognizes the utility of specific aspects of those products, even where the overlying system might not qualify under the safe harbor. Similarly, the SEC recognized the value of market data and electronic research services, even while excluding the computer equipment and accessories used to deliver them.

In other cases this functional approach may require market participants to make finer distinctions among products and services than was previously necessary. For example, the SEC stated that "analytical software that relates to the subject matter of the statute before an order is transmitted may fall within the research portion of the safe harbor, but not the brokerage portion of the safe harbor." However, the SEC also stated that quantitative analytical software used to test "what if" scenarios related to adjusting portfolios, asset allocation, or for portfolio modeling does not qualify as "brokerage" under the safe harbor because it falls outside the temporal standard. Nevertheless, the SEC also stated that, if money managers use analytical software to test "what if" scenarios related to adjusting portfolios, asset allocations, or portfolio modeling both for research and non-research purposes, the manager may make a mixed-use allocation for the product under Section 28(e). In any event, given the increasingly complex nature of analytical products, money managers will likely be expected to consider both the function and use of a particular product in determining whether, or to what extent, the product qualifies under Section 28(e).

Similarly, the SEC stated that a money manager's legal expenses generally would be considered overhead and therefore would not constitute research under Section 28(e). However, it is not clear that the SEC completely precluded legal expenses from qualifying as research. Presumably, money managers might be able to distinguish legal expenses related to how an adviser conducts its business (e.g., corporate legal services), which would be treated as overhead, from legal expenses related to specific investment decisions (e.g., legal advice on antitrust issues affecting a proposed merger or patent advice on a company's technology), which should be treated as research.



From a practical standpoint, money managers that do business in both the United States and the United Kingdom also will want to take into account the differences between the SEC's and Financial Services Authority's (FSA's) interpretations of research and brokerage relating to the use of market data. For example, the SEC's release indicates that raw market data may qualify as research under Section 28(e). However, the FSA has determined that raw data does not meet the requirements of a research service, although it permits money managers to justify using soft dollars to pay for raw data feeds as brokerage services. In particular, the FSA's definition of research requires that a product or service involve "analysis or manipulation of data to reach meaningful conclusions."

## Arrangements Involving Money Managers and Broker-Dealers

The SEC's revised interpretation departs significantly from its proposal, and from the SEC's 1986 interpretation, in the area of arrangements between money managers and broker-dealers. Both the SEC and its Staff have indicated that the modifications are designed to provide market participants with greater flexibility in structuring arrangements, but many of the details of the modifications remain subject to interpretation. Perhaps anticipating the need for further guidance, the SEC requested additional public comment on this aspect of the interpretation, and indicated that it may supplement the revised interpretation based on any comments it receives.

The SEC's guidance in this area arises from the fact that Section 28(e) expressly provides that the safe harbor is available for commissions paid to a broker-dealer for "effecting" securities transactions based on their relation to the value of the brokerage and research services "provided by" the broker-dealer. This aspect of the safe harbor requires that the broker-dealer providing brokerage and research must also be effecting transactions for the money manager. Additionally, the SEC had previously interpreted Section 28(e) such that a broker-dealer was "providing" research only if it produced a product or service or was legally obligated to pay for a product or service. The SEC's revised interpretation increases flexibility in structuring arrangements by modifying previous guidance on the application of the terms "effecting" and "provided by."

In the revised interpretation, the SEC expressly took into account so-called "commission-sharing arrangements" that are used in the United Kingdom. Under a commission-sharing arrangement, the executing broker agrees that part of the commission it earns will be redirected to one or more third parties, as directed by the money manager, as payment for research services provided to the money manager. These arrangements allow money managers to direct broker-dealers to collect and pool client commissions that may have been generated from orders executed at that broker-dealer, and periodically direct the broker-dealer to pay for research that the money manager has determined is valuable.

*The "Effecting" Requirement* — Historically, soft dollar arrangements involving multiple broker-dealers have been structured as introducing/clearing relationships. For example, a broker-dealer that produces research would "introduce" trades to a "clearing" broker for execution and clearing. In this regard, the SEC had taken the view generally that the safe harbor does not apply to arrangements in which the broker-dealer providing research receives a portion of the client's brokerage commissions without performing any role in the trade. Until this year, however, the most definitive statement on the level of activity necessary for a broker-dealer to be deemed to be performing a role in a trade came in a 1983 no-action letter in which the SEC Staff stated that the use of the safe harbor was not precluded where a broker-dealer provided research and performed four types of functions.<sup>8</sup>

In its proposal last year, the SEC had considered formally adopting the Staff's 1983 no-action position by interpreting the term "effecting" to require a broker-dealer's performance of all four functions. However, the revised interpretation provides that a broker-dealer may be considered to be effecting transactions under Section 28(e) if it performs at least *one* of the following four functions:

- (1) Taking financial responsibility for all customer trades until the clearing broker-dealer has received payment (or securities);
- (2) Making or maintaining records relating to customer trades required by SEC and SRO rules, including blotters and memoranda of orders;
- (3) Monitoring and responding to customer comments concerning the trading process; or
- (4) Generally monitoring trades and settlements.

The broker-dealer must nevertheless take steps to see that the other functions have been reasonably allocated to one or another of the broker-dealers in the arrangement, and in a manner that is fully consistent with their obligations under SEC and SRO rules.

*The "Provided By" Requirement* — Historically, the SEC has required that a broker-dealer be legally obligated to pay for research in order to satisfy the "provided by" requirement, and the SEC reaffirmed this concept in last year's proposal. In practice, this interpretation has required that broker-dealers in soft dollar arrangements either provide research directly (e.g., by producing research reports) or be contractually obligated to pay for research prepared by a third-party (e.g., market data services).

The SEC's revised interpretation retains this means of satisfying the "provided by" requirement, but also extends the safe harbor to certain arrangements where a broker-dealer is not legally obligated to pay for research. Under the revised interpretation, the "provided by" requirement generally may also be satisfied if a broker-dealer does the following:

- Pays the research vendor directly;

- Reviews the description of the research to be provided for “red flags” that indicate the services are not within Section 28(e), and agrees with the money manager to use client commissions only to pay for those items that reasonably fall within the safe harbor; and
- Develops and maintains procedures so that research payments are documented and paid for promptly.

The SEC did not provide specific guidance on complying with the new interpretation of the “provided by” requirement. For example, the SEC did not explain what types of “red flags” broker-dealers should look for in reviewing a research description. In addition, the SEC did not provide specific examples of the types of prompt payment procedures broker-dealers would have to develop and maintain.

*Structuring Arrangements Under the Revised Interpretation* — Based on public statements by the SEC and its Staff, the SEC’s revised interpretation appears to be designed to permit arrangements similar to commission sharing arrangements within the limits of Section 28(e). To that end, the SEC stated specifically in the release that an arrangement involving multiple broker-dealers will satisfy Section 28(e) if at least *one* of the broker-dealers satisfies the requirements for “effecting” transactions and “providing” research.<sup>9</sup> This aspect of the revised interpretation should permit arrangements that would not have been permitted under the SEC’s prior interpretations, including:

- An executing broker may pay for brokerage or research services at the money manager’s direction without being legally obligated to pay for the services. In those cases, the executing broker will have to satisfy the new “provided by” requirement by reviewing research descriptions and establishing policies and procedures for prompt payment of the services.
- An executing broker may share commissions with a broker-dealer that produces research but does not play an active role in the trading process. In those cases, the second broker-dealer will have to perform one of the four functions that make up the revised “effecting” requirement and allocate the remaining three to the executing broker.

While the SEC noted that multi-broker arrangements under Section 28(e) have historically been structured as introducing/clearing arrangements, early indications from the SEC Staff are that the revised interpretation does not, in and of itself, require that broker-dealers use a clearing agreement to allocate performance of the four functions. Similarly, the SEC Staff has indicated that the functions do not necessarily have to be allocated to the executing broker-dealer, and could be allocated to a third broker-dealer.<sup>10</sup>

## What’s Next?

The SEC’s extended comment period on Section 28(e) arrangements ended on September 7, 2006, and comments submitted by industry groups were relatively few and brief,

perhaps reflecting the fact that industry participants are continuing to evaluate the effect of the revised interpretation on their existing arrangements.<sup>11</sup> In the meantime, however, the SEC’s guidance has started a paradigm shift in the structure of Section 28(e) arrangements. Both money managers and broker-dealers alike are revisiting their existing arrangements, with many money managers looking to develop “commission sharing” type arrangements under the revised interpretation and broker-dealers looking to “provide” research without taking on financial obligations. Additionally, some industry participants are exploring the idea of global commission arrangements involving U.S. and U.K. affiliates, although those arrangements may create some thorny issues in reconciling the differing governing laws.

From a compliance standpoint, the SEC and its examination staff may expect to see more written documentation of practices under Section 28(e). The SEC made this point expressly with mixed-use allocations, stating that money managers must keep adequate books and records concerning those allocations to enable the managers to make the good faith determinations required under Section 28(e). In addition, while the obligations under the text of Section 28(e) generally fall on money managers, certain aspects of the SEC’s guidance on soft dollar arrangements would impose specific diligence and recordkeeping requirements on broker-dealers.

Additionally, the SEC and its Staff have indicated that they will issue further proposals regarding recordkeeping disclosures of Section 28(e) arrangements. These proposals, which may be issued within the next 12 months, are likely to be controversial and will undoubtedly restart the debate on “unbundling” brokerage and research and disclosing how much of each commission payment pays for pure execution and how much pays for research and other brokerage services. Moreover, the SEC’s new interpretation on client commission sharing arrangements is likely to raise questions about when exactly a research service is considered “proprietary” or “third party.”<sup>12</sup>

Further, while the SEC’s revised interpretation answered a number of questions regarding the application of Section 28(e), a number of significant questions remain unanswered, including the following:

- What obligations do money managers have under the revised interpretation to verify that broker-dealers are satisfying the new “effecting” and “provided by” requirements?
- Are money managers permitted to share research with affiliates under Section 28(e)?
- How does the SEC’s revised interpretation relate to transactions in fixed-income securities, which historically have been viewed as outside the safe harbor?
- Does Section 28(e) permit money managers to transfer commission credits and debits between broker-dealers?

- To what extent will “hard dollar” research arrangements create investment adviser status issues for broker-dealers?

From a practical standpoint, there are a number of steps that money managers should take before the revised interpretation takes full effect on January 24, 2007.

- Review each research and brokerage product or service to confirm that the manager’s use of the product or service conforms to the three-step analysis under the new interpretation.
- Review research and brokerage products and services they receive under Section 28(e) arrangements to see whether any are excluded under the new interpretation. Particular items to consider are mass-marketed publications as well as computer and other hardware used to obtain research services. In addition, managers will want to review products and services received for items that have been considered research but do not meet the new standard of expressing reasoning or knowledge.
- Money managers that pay for proxy voting services with soft dollars must undertake a mixed use allocation so that the manager is paying with soft dollars for only that portion of the service that is used in making investment decisions (as opposed to decisions on how to vote proxies and the various administrative and clerical processes involved in voting proxies).
- Review and revise written policies and procedures to reflect the new interpretation and the manager’s related practices.
- Confirm that mixed use allocations are being memorialized and documented.
- Catalogue brokerage services excluded under the new interpretation based on the new temporal standard, such as services that precede the communication of an order or that are provided after the settlement of transactions (e.g. long-term custody).
- Confirm that the manager has a reasonable basis to believe that the structure of any multi-broker arrangements satisfies the requirement that at least one of the participating brokers both provides research services and effects the related transactions.
- Review and revise Form ADV<sup>13</sup> and any contractual disclosures and consider adding disclosure about conflicts that may arise if the manager, rather than the broker-dealer, assumes financial responsibility for research products and services.

## Conclusion

The SEC’s revised interpretation of Section 28(e) should provide money managers and broker-dealers with both clarity and flexibility in structuring commission arrange-

ments. However, industry participants will undoubtedly face interpretive questions as they tailor and update their practices under the revised interpretation. Given the complex nature of commission arrangements, not to mention the dynamic and evolving nature of the marketplace, the SEC may very well consider these issues again before another 20 years pass.

## What Is Eligible and What Is Not?

The charts on pages 8 and 9 outline products and services that are eligible or ineligible as research and as brokerage. Products and services in *italics* indicate changes from the SEC’s 1986 Release.

## Notes

1. Securities Exchange Act Release No. 54165, 71 FR 41978 (July 24, 2006).
2. Securities Exchange Act Release No. 52635 (October 19, 2005), 70 FR 61700 (October 25, 2005). The SEC’s proposal followed recommendations from the NASD’s Mutual Fund Task Force in 2004 as well as a rulemaking initiative adopted in 2005 by the United Kingdom’s Financial Services Authority (“FSA”).
3. The SEC last considered the substantive issues regarding the scope of products, services, and arrangements that qualify under Section 28(e) in a 1986 interpretive release. Securities Exchange Act Release No. 23170 (August 23, 1986), 51 FR 16004 (August 30, 1986). However, in 2001, the SEC issued an interpretation of Section 28(e) to extend the safe harbor to certain riskless principal transactions on the Nasdaq Stock Market. Securities Exchange Act Release No. 45194 (December 27, 2001), 67 FR 6 (January 2, 2002).
4. Section 28(e) does provide the SEC with limited authority to adopt recordkeeping requirements. However, the SEC has not adopted rules directly pursuant to that authority.
5. As described below, however, the SEC was somewhat flexible in this respect. For example, the SEC indicated that market data constitutes research under Section 28(e) even though data, literally speaking, might not reflect “the expression of reasoning or knowledge.”
6. However, as described below, the SEC indicated that connectivity services do not constitute research under the revised interpretation.
7. See, e.g., Rule 206(4)-6 under the Investment Advisers Act of 1940 (requiring investment advisers to establish written policies and procedures that are reasonably designed to assure that advisers vote client securities in the best interest of clients); Rule 30b1-4 under the Investment Company Act of 1940 (requiring registered investment companies to file annual reports containing their proxy voting records).
8. *SEI Financial Services Company*, Letter from SEC’s Division of Market Regulation to Morgan, Lewis & Bockius (December 15, 1983).
9. Specifically, footnote 182 states that “[i]n Section 28(e) arrangements involving multiple broker-dealers, at least one of the broker-dealers (but not necessarily all) must satisfy the requirements for ‘effecting’ transactions and ‘providing’ research.”
10. In addition to the issues raised in the SEC’s release, there are other significant considerations that money managers and broker-dealers should consider when restructuring arrangements pursuant to the revised interpretation. For example, a research provider could become subject to investment adviser registration if it provides research directly in return for compensation.

Similarly, a research provider could be subject to broker-dealer registration if it receives transaction-based compensation as a result of a Section 28(e) arrangement.

11. See, e.g., Letter from Federal Regulation of Securities Committee of the Business Law Section of the American Bar Association (September 14, 2006), Letter from Ira D. Hammerman, Senior Vice President and General Counsel, Securities Industry Association (September 7, 2006), and Letter from Elizabeth Krentzman, General Counsel, Investment Company Institute (September 7, 2006) (*available at* <http://www.sec.gov/comments/s7-13-06/s71306.shtml>).
12. The Department of Labor has proposed amendments to Form 5500, under which ERISA plans would be required to provide more detailed disclosure regarding payments to service providers (including broker-dealers). See *Proposed Revision of Annual Information Return/Reports*, 71 FR 41616 (July 21, 2006). If adopted, these amendments effectively would require an ERISA plan to disclose the amount of soft dollar benefits provided to its money manager from the plan's brokerage commission. This requirement could, in turn, require ERISA plans' money managers to unbundle brokerage costs and report the value of research services to those clients.
13. The Form ADV is filed with the SEC by Registered Investment Advisers. Filers are required to list information about themselves and their firms, including assets under management, adviser backgrounds, a firm balance sheet, types of fee arrangements, types of investments and other business activities.