

VERIFICATION

ASCENDANT INVESTMENT ADVISER COMPLIANCE CONFERENCE

March 10-12, 2010

Critical Elements of Commission Sharing Arrangements & Soft Dollars

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Critical Elements of Commission Sharing Arrangements & Soft Dollars

- Key Concepts
 - “Research” & “Brokerage”
 - “Good Faith Determination”
 - “Provided by” Test
 - “Effecting”
- Different Structures
 - Traditional
 - Third-Party
 - CSAs
- Current Issues

At a Glance - Research

- Research -- Content used for investment decision-making
- 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)

Examples of Research

- Research
 - Traditional research reports analyzing performance of a company or stock
 - Financial newsletters and trade journals
 - Quantitative analytical software and software that analyzes securities portfolios
 - Seminars & conferences
- Not Research
 - Products that don't reflect "expression of reasoning or knowledge"
 - Products with tangible or physical attributes
 - *Computer hardware & Accessories*
 - *Office furniture, travel expenses & entertainment*
 - *Meals associated with attending seminars*
 - *Website design, email software & Internet service*
 - *Legal expenses & Membership dues*
 - Proxy voting services
 - Except as used for investment decisions

At a Glance - Brokerage

- Products and services that
 - Relate to the execution of a trade
 - From when a money manager transmits an order through settlement
- Brokerage services
 - Order routing software and algo trading software
 - Exchange of messages among brokers, custodians, and institutions
 - Electronic communication of orders, allocation instructions
 - Routing settlement instructions to custodians and clearing agents
 - OMSs, based on functional analysis
 - Post-trade matching

Communications Services

- Information delivery mechanisms are ***not research***
 - Because they do not reflect substantive content related to investment decisions
 - E.g., telecom lines & computer cables
- Communications services for execution, clearing, or settlement of trades ***can be brokerage***
 - Dedicated lines between a broker and a money manager's OMS
 - Lines between a broker and OMSs operated by a third-party vendor
 - Dedicated lines providing direct dial-up service between a money manager and a broker's trading desk
 - Message services used to transmit orders to brokers for execution

Good Faith Determination

- Money managers bear the burden in making a “good faith determination” that the amount of commissions paid is *reasonable* in relation to the value of brokerage & research services received
- “Mixed Use” Products

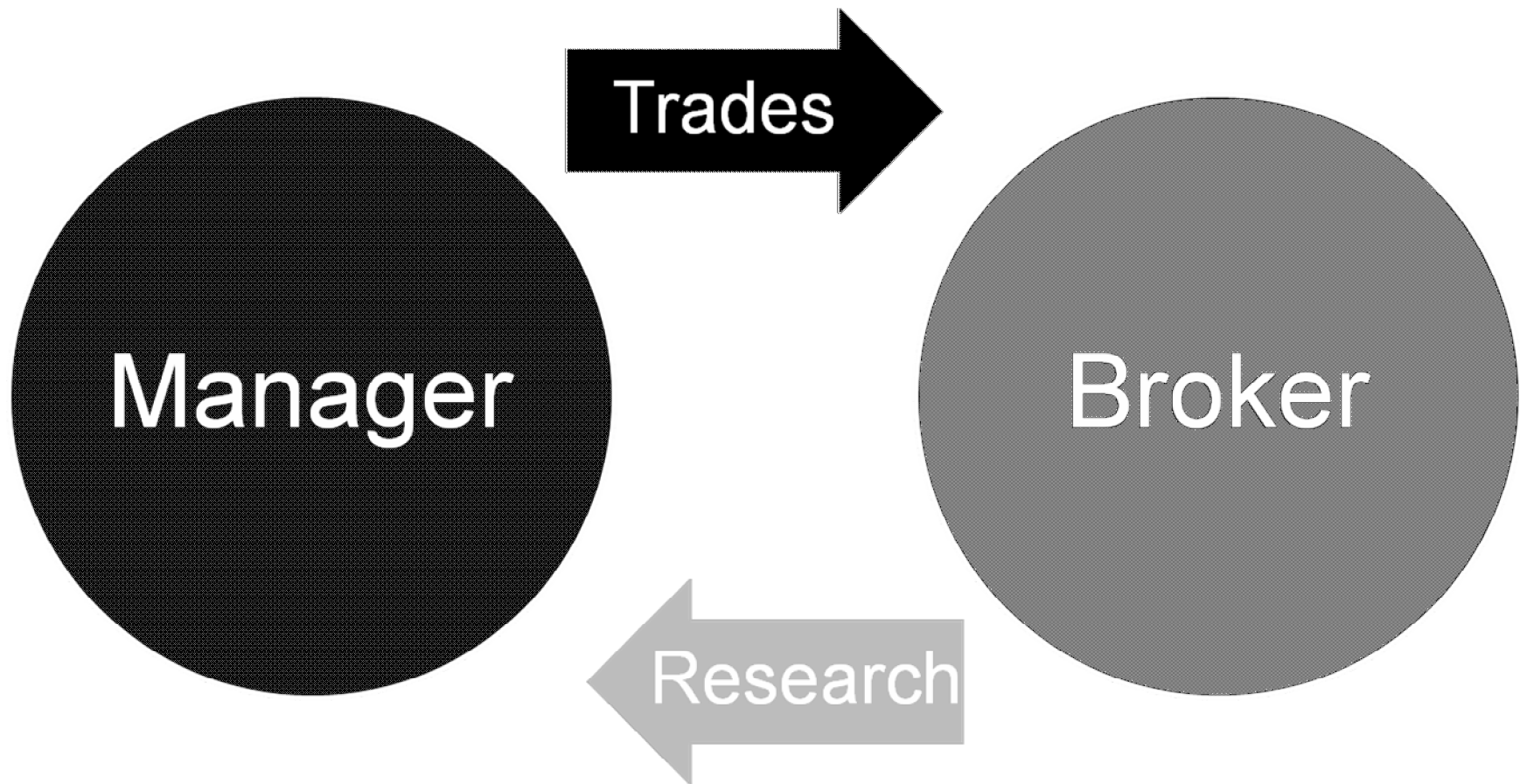
“Provided By” Requirement

1. Providing proprietary research
2. Paying for 3d-party research where broker is financially responsible
3. Paying for 3d-party research for which money manager is financially responsible where broker
 - Pays the research vendor directly
 - Reviews the description of the research for “red flags” that the research is not within the safe harbor and reaches agreement with the money manager that it will use client commissions only to pay for items that reasonably fall in the safe harbor
 - Develops and maintains procedures so that research payments are documented and paid for promptly

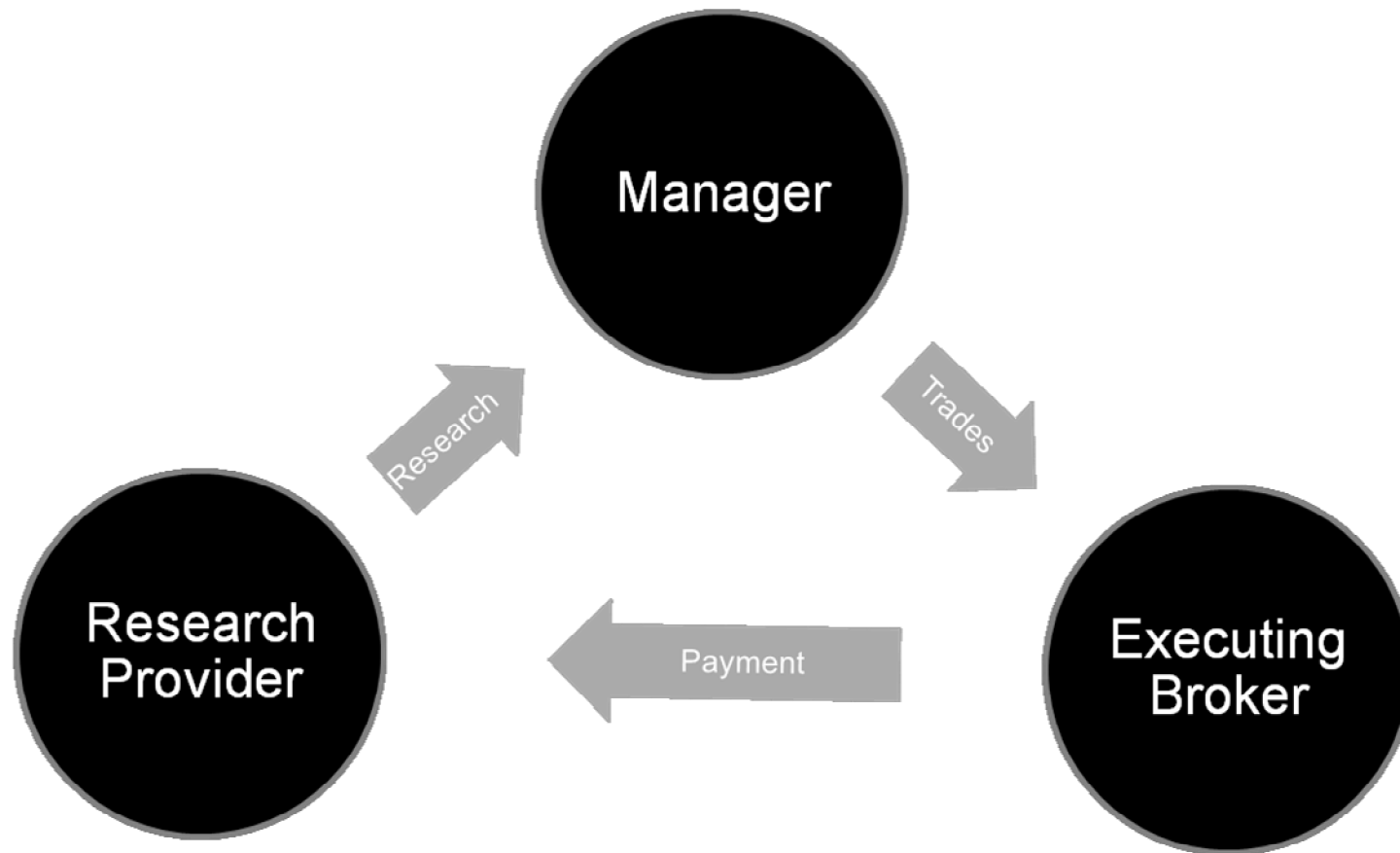
“Effecting” Test

- Executing, clearing or settling trades
 - Directly
 - Clearing arrangements
 - Step-outs and prime brokerage transactions
- Limited other functions – (any one, where others done by another broker)
 - Taking financial responsibility for trades until the clearing broker has received payment or securities
 - Making or maintaining records on trades per SEC and SRO rules, including blotters and order memoranda
 - Monitoring and responding to customer comments on the trading process
 - Generally monitoring trades and settlements

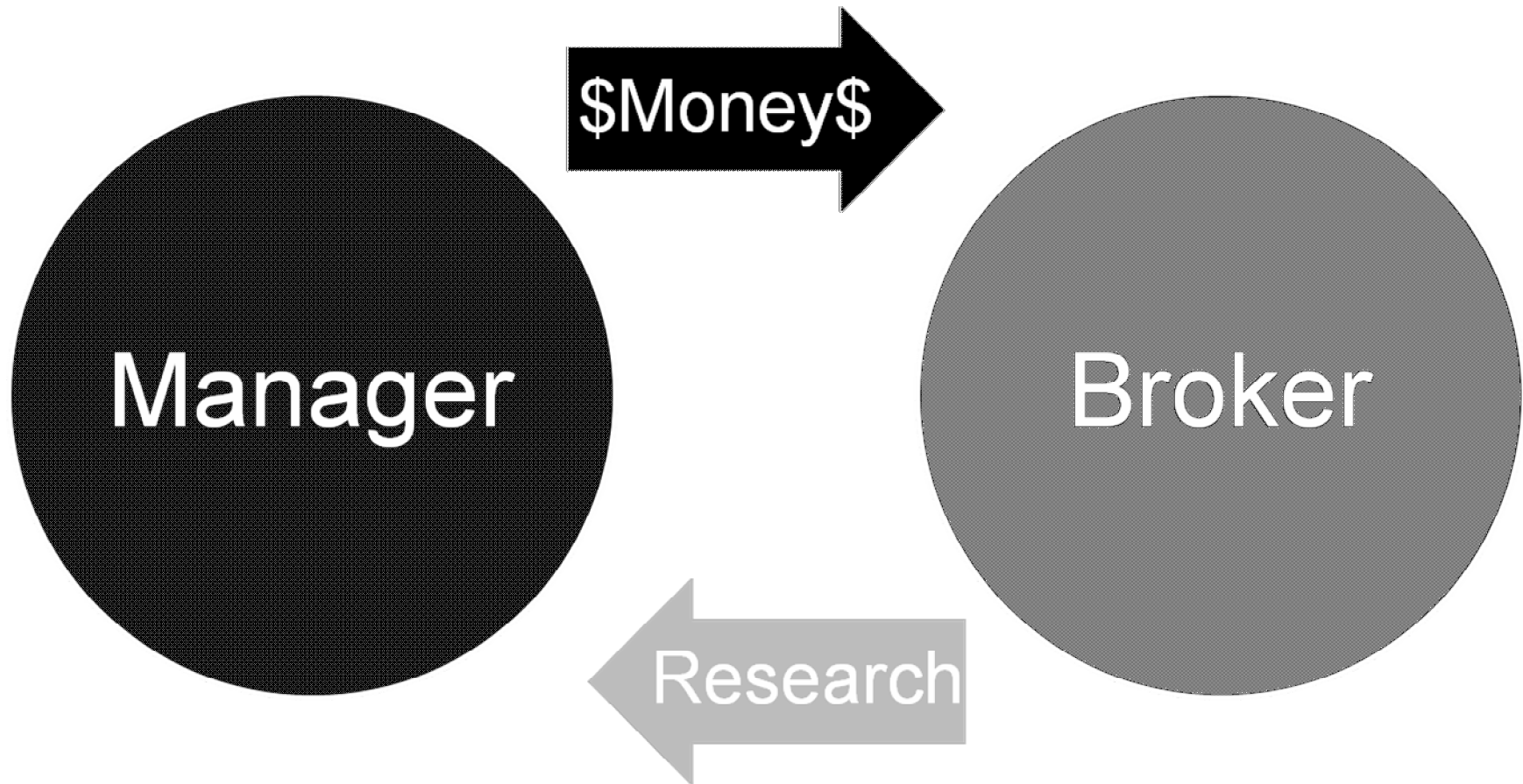
“Classic” (1975)



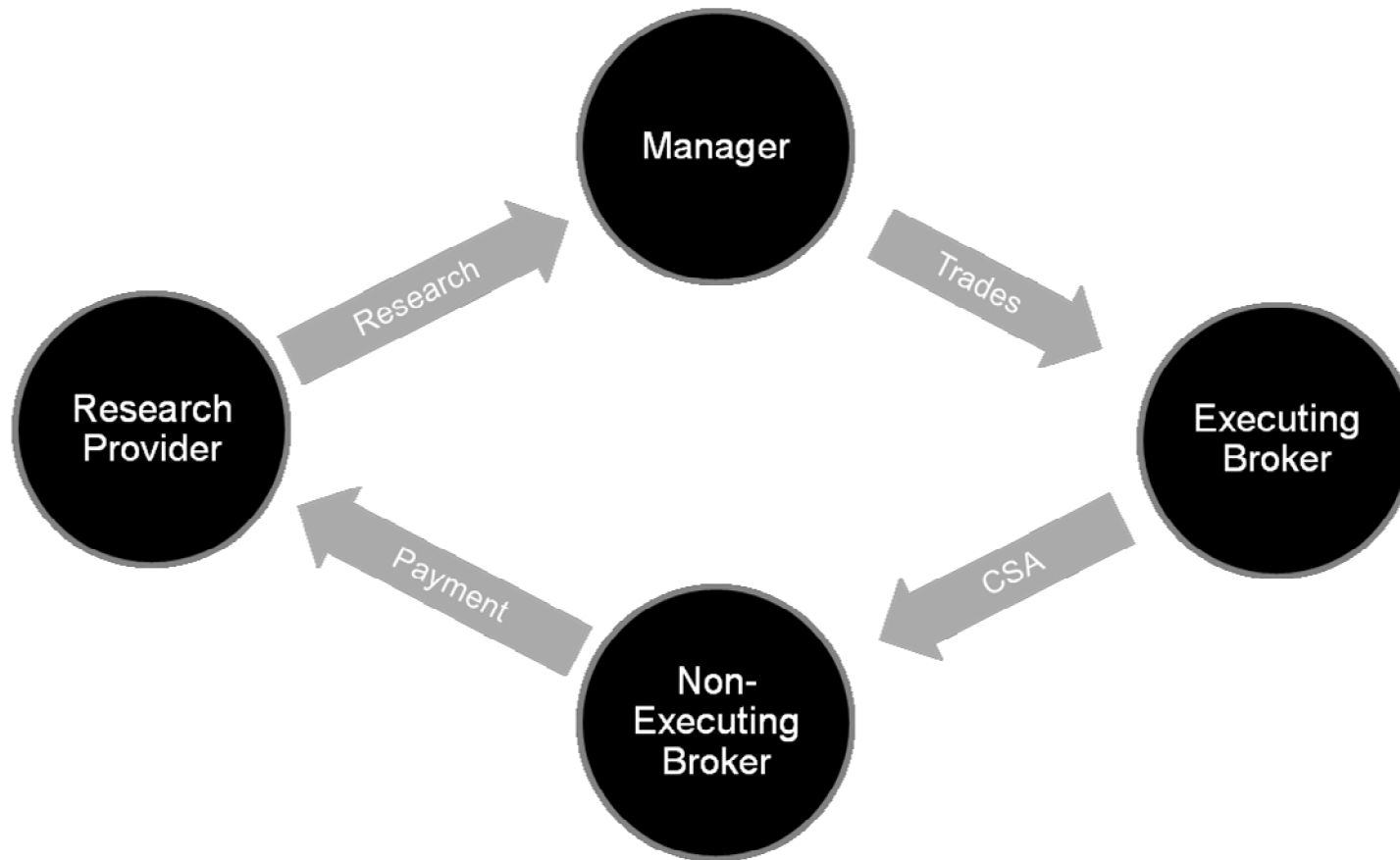
Third-Party Arrangement (1986)



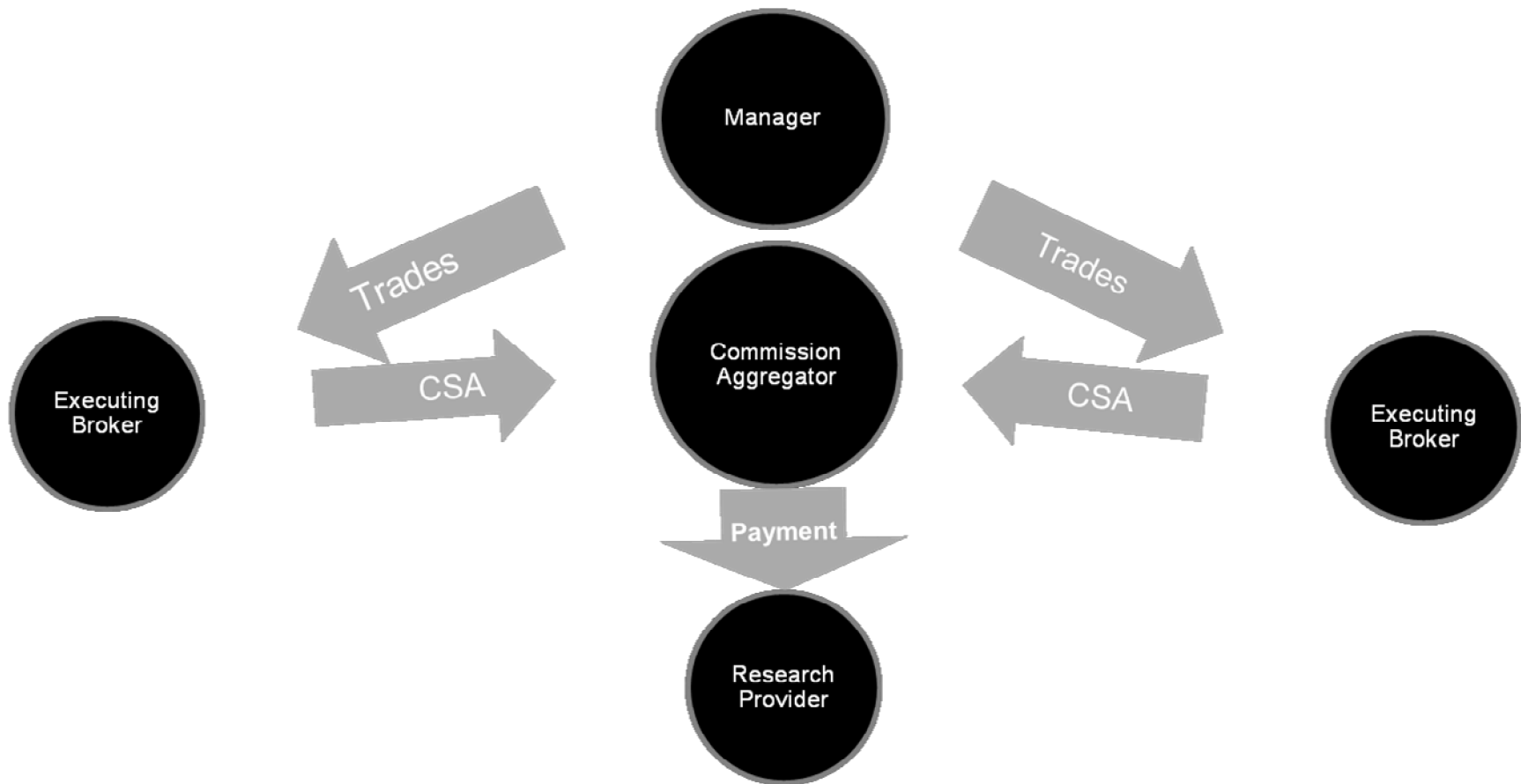
“Hard Dollar” (2004)



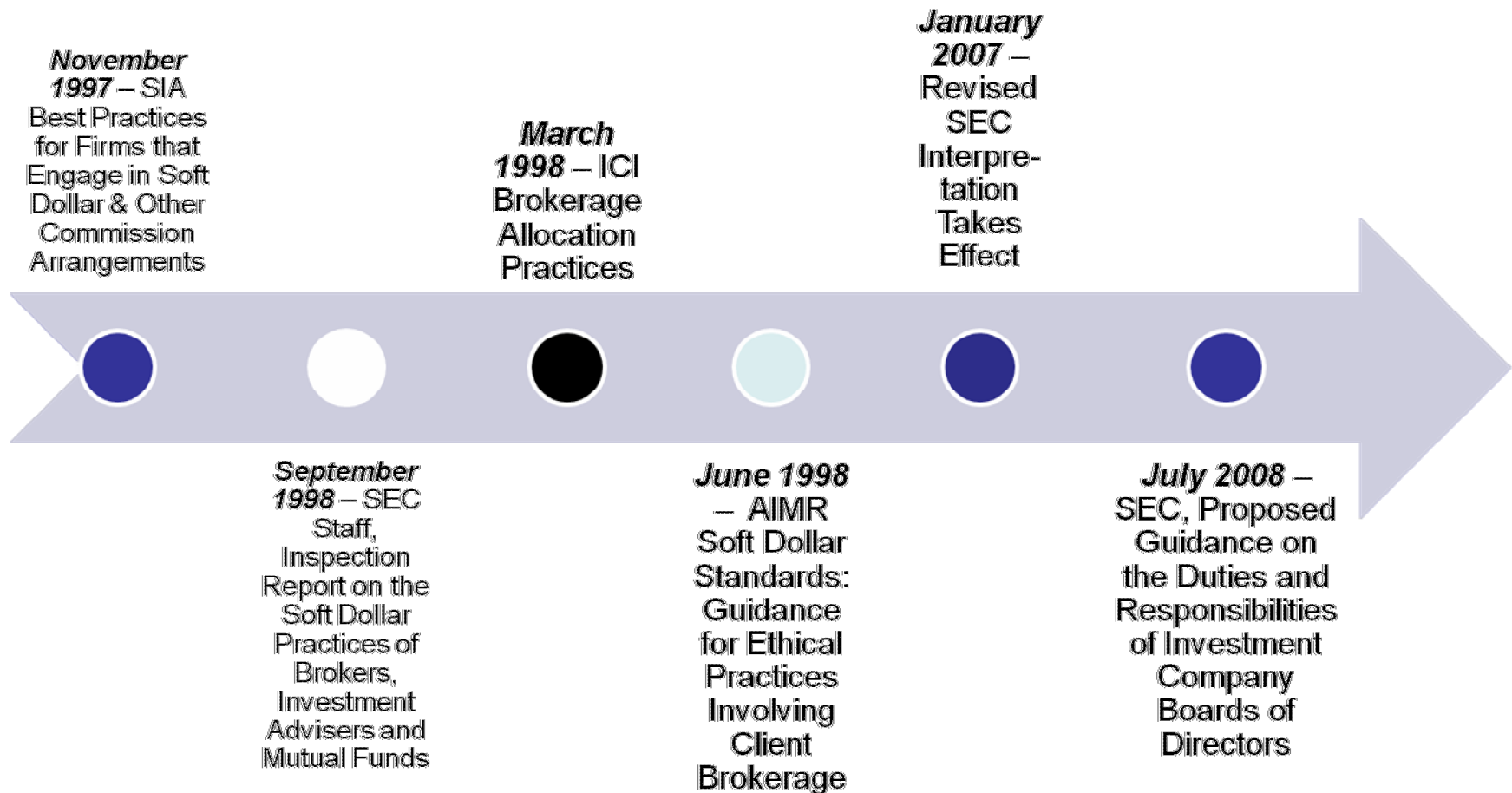
Commission Sharing Arrangement (2006)



Commission Aggregation Arrangement (2009)



Emerging Focus on Best Practices



Focus on Mutual Fund Boards (2008)

- Proposed 2008 Guidance would task mutual fund boards with asking:
 - How the adviser identifies the amount and types of research obtained
 - How soft dollar budgets are established and how brokerage allocations are made
 - How the adviser determines its use of soft dollars is within the safe harbor
 - How soft dollar products and services are allocated among clients
 - How mixed-use products are evaluated

Current Issues

- Client “no soft” or “no third-party” bars & “free riding” issues
- Tax issues
- Use of aggregators
- Protecting soft dollar balances
- Portability of soft dollar balances
- Converting soft dollar balances to client rebates
- Sharing research with affiliates
- Cross border trading
- Disclosure Issues

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