Morgan Lewis

COUNSELORS AT LAW

Trading Conflicts of Interest

Steven W. Stone
Morgan, Lewis & Bockius, LLP

Michele Hawkins
Fort Washington Investment Advisor, Inc.

Ascendant Conferences + Education
The Next Step in Compliance:
The Integration of Operations and Business Management
Ritz-Carlton, New Orleans
April 9 – 11, 2008

Trading Conflicts of Interest

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

I. BEST EXECUTION FOR FUND AND NON-FUND CLIENTS OF AN INVESTMENT ADVISER

A. The Fiduciary Duty to Seek Best Execution. As assets in mutual fund and other advisory accounts have grown, the trading practices of advisers also have changed. Trading and best execution decisions for mutual fund advisers that manage other advisory accounts can pose complex issues, including the choice of broker-dealers to execute trades and possible conflicts that can arise among advisory clients where an adviser needs to direct trades to multiple broker-dealers.

B. Investment Advisers as Fiduciaries. Neither the Investment Company Act of 1940, as amended ("1940 Act") nor the Investment Advisers Act of 1940, as amended (the "Advisers Act") expressly delineate the fiduciary duties of registered investment advisers.[1] However, the U.S. Supreme Court has held that investment advisers are fiduciaries who have an affirmative duty to act in utmost good faith and provide full and fair disclosure of all material facts.[2]

C. The Duty to Seek Best Execution. Under common law, two of the primary duties owed by a fiduciary are the duty of care and the duty of loyalty. As a fiduciary, an investment adviser has the duty to perform its activities in a competent manner.[3] Principles of agency law provide that, unless otherwise agreed, an

---

* Steven W. Stone is a partner in the Washington, DC office of Morgan, Lewis & Bockius LLP.

1 *SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180, 194 (1963) (citations omitted) ("Capital Gains"). As a general rule, the nature of an investment adviser's fiduciary duties is determined by reference to principles of common law applicable to fiduciaries. Frankel, *The Regulation of Advisers – Mutual Funds and Investment Advisers* at §14.01 (2002 Supp.) ("Frankel"). *See also* Investment Advisers Act Release No. 40 (Jan. 5, 1945) ("It is clear, however, that investment advisers, in addition to complying with the federal law, are subject to whatever restrictions or requirements the common law or statutes of the particular state impose with respect to dealings between persons in a fiduciary relationship."). The extent of an investment adviser's duties, like the duties of other fiduciaries, depends on the expertise they represent themselves to have, their control over clients' assets and investment decisions, and the degree of clients' reliance on the advisers. *See* Frankel at § 13.01[A].

2 *Capital Gains*: *Transamerica Mortgage Advisers v. Lewis*, 444 U.S. 11, 17 (1979).

3 The duty of care requires a fiduciary to make decisions "only after paying attention, getting the relevant information, and deliberating. This is the basis for the fiduciary duty of care." Frankel at 13-7.

investment adviser must act solely for the benefit of the client in all matters connected with the relationship.[4] A specific duty flowing from an adviser's duties of care and loyalty is the duty to seek best execution of client transactions.[5] An investment adviser must seek to execute securities transactions for its clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances. In seeking to achieve best execution, the determinative factor is not the lowest possible commission cost but whether the transaction represents the best qualitative execution for the account under the circumstances. Accordingly, an investment adviser may take into account the full range and quality of a broker's services in selecting broker-dealers including, among other things, the value of research provided as well as execution capability, commission rate, financial responsibility, and responsiveness to the adviser, as well as other factors.[6]

D. The Duty of Loyalty – Conflicts of Interest and Disclosure. Inextricably related to the duty of loyalty is that, unless the client otherwise agrees, an investment adviser may not act for persons whose interests conflict with those of the adviser's client or deal with the client as an adverse party in a transaction connected with the adviser's relationship with the client.[7] However, under common law agency principles, an investment adviser is permitted to modify its duty of loyalty through clear disclosure and informed consent. In other words, an adviser can engage in a transaction even when the adviser is faced with a potential or actual conflict of interest, provided that the adviser informs its client in advance and obtains the client's consent.[8] Registered investment advisers, of course, are subject to certain provisions governing specific conflicts of interest that disclosure and consent do not completely resolve, *e.g.*, Section 10(f), Section 17(a) of the 1940 Act.

E. Best Execution – Brokers and Advisers. All broker-dealers and investment advisers have a legal duty to seek the best execution of their customers' and clients' securities transactions. The general duty to seek best execution for both broker-dealers and investment advisers derives from common law agency

---

4 *See* Section 387 of the Restatement of Agency (Second) (1958) (the "Restatement").

5 *See, e.g., Disclosure by Investment Advisers Regarding Soft Dollar Practices*, Investment Advisers Act Release No. 1469 (Feb. 14, 1995) (an investment adviser has a "fundamental obligation under the Advisers Act (and state law) to act in the best interest of its clients. This duty requires the adviser to obtain best execution of client transactions.").

6 Securities Exchange Act Release No. 23170 (Apr. 23, 1986) ("1986 Release").

7 *See* Restatement Sections 389 and 394.

8 *See, e.g.*, Restatement Sections 390 and 394. "One employed as agent violates no fiduciary duty to the principal by acting for another party to the transaction if he makes full disclosure of all relevant facts which he knows or should know, or if the principal otherwise knows of them and acquiesces in the agent's conduct.... The agent's disclosure must include not only the fact that he is acting on behalf of another party, but also all facts which are relevant in enabling the principal to make an intelligent determination." Comment b to Restatement Section 392; see also Comment a to Restatement Section 390. *See also* Frankel at § 13.01[B][1] ("the rules of the common law are mostly default rules, which [clients] can waive upon disclosure").

principles and fiduciary obligations.[9] Over the years, the best execution obligations for both broker-dealers and investment advisers have developed into multi-element analyses, but some of the elements differ between the two types of entities. For example, a broker-dealer's best execution obligation largely focuses on the price at which the client's order is executed in the marketplace, without considering the amount of commission that the broker-dealer charges.[10] On the other hand, an investment adviser's best execution obligation focuses on the client's total transaction cost, including the commission that the client pays the broker-dealer executing the transaction.

1. *Broker-Dealers*. In addition to the common law and fiduciary principles, the duty of best execution for broker-dealers has been addressed in SEC releases,[11] judicial opinions,[12] and self-regulatory organization ("SRO") rules.[13] As noted above, commissions are generally not included in the determination of whether a broker-dealer is achieving best execution. However, broker-dealers are subject to separate legal restrictions on the amount of commission that they may charge.

2. *Broker-Dealers' Duty of Best Execution*. As a general matter, the duty of best execution requires a broker-dealer to seek the most advantageous terms for its customers' orders reasonably available under the circumstances. However, the SEC has recognized that obtaining best execution does not simply mean obtaining the best price or the fastest execution. The SEC has stated that factors other than price and speed may be relevant to best execution, including (1) the size of the order; (2) the trading characteristics of the security involved; (3) the availability of accurate information affecting choices as to the most favorable market center for execution and the availability of technological aids to process such information; and (4) the cost and difficulty associated with achieving an execution in a particular market center.[14]

---

9 *See, e.g.*, *Hall v. Paine*, 224 Mass. 62 (1916); *see also* Restatement Section 424.

10 The reasonability of commissions or other charges imposed by broker-dealers are governed primarily under self-regulatory organization rules relating to fair prices for services and, in some circumstances, suitability.

11 *See, e.g.*, Securities Exchange Act Release Nos. 49325 (Feb. 26, 2004) ("Regulation NMS Proposing Release") and 43590 (Nov. 17, 2000) ("Execution Quality Release"), and 37619A (Sept. 6, 1996) ("Order Handling Rules Release").

12 *See, e.g.*, Newton v. Merrill Lynch, 135 F.3d 266 (3rd Cir. 1998).

13 *See, e.g.*, NASD Rule 2320 (providing that broker-dealers must use reasonable diligence to ascertain the best market for a security, and buy or sell the security in such market so that the resulting price to the customer is as favorable as possible under prevailing market conditions); *see also* NYSE Rules 123A.41 and 123A.42 (providing that broker-dealers handling market and limit orders must use due diligence to execute the orders at the best price or prices available on the exchange).

14 *See* Regulation NMS Proposing Release, Execution Quality Release.

The determination of whether a broker-dealer is satisfying its best execution obligation does not necessarily require an order-by-order evaluation. In fact, the SEC has recognized that it could be impractical for a broker-dealer that handles a large volume of orders to make execution decisions on each individual order.[15] Accordingly, the SEC has stated that automated routing or execution of customer orders is not necessarily inconsistent with best execution.[16] However, when a broker-dealer does not make execution decisions on an order-by-order basis, the broker-dealer must carry out a regular and rigorous review of the quality of market centers to evaluate its best execution practices, including the determination of the markets to which it routes customer order flow.[17] In conducting that review, the broker-dealer must consider whether different markets may be more suitable for different types of orders or particular securities.[18] In addition, broker-dealers must periodically examine their best execution practices in light of market and technology changes and modify those practices if necessary to enable their clients to obtain the best reasonably available prices.[19]

3. *Investment Advisers*. An investment adviser's duty to seek best execution involves seeking the best total transaction cost for its clients, including commissions under the circumstances. More specifically, the SEC stated in a 1986 interpretive release that an investment adviser "must execute securities transactions for clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances."[20] However, the SEC has also stated that the amount of the transaction cost is not the sole determinative factor and that an investment adviser should consider the full range and quality of a broker-dealer's services, including, among other things, execution capability, the

---

15 *See* Securities Exchange Act Release No. 36130 (Sept. 29, 1995); *see also* Order Handling Rules Release.

16 Order Handling Rules Release.

17 *Id.*

18 *Id.; see also* NASD Notice to Members 01-22 (Apr. 2001) (stating that "[t]he focus of the [regular and rigorous review] analysis is to determine whether any 'material' differences in execution quality exist and, if so, to modify the firm's routing arrangements or justify why it is not modifying its routing arrangements. This analysis must compare the quality of the executions the firm is obtaining via current order routing and execution arrangements (including the internalization of order flow) to the quality of the executions that the firm could obtain from competing markets and market centers. Accordingly, a broker/dealer must evaluate whether opportunities exist for obtaining improved executions of customer orders.").

19 *Newton*, 135 F.3d at 271; *see also* Order Handling Rules Release.

20 1986 Release; *see In the Matter of Jamison, Eaton & Wood*, Investment Advisers Act Release No. 2129 (May 15, 2003) ("Jamison"); *In the Matter of Renberg Capital Management, Inc.*, Investment Advisers Act Release No. 2064 (Oct. 1, 2002); *In the Matter of Portfolio Advisory Services, LLC*, Investment Advisers Act Release No. 2038 (June 20, 2002); *see also In the Matter of Kidder, Peabody & Co., Inc.*, Investment Advisers Act Release No. 232 (Oct. 16, 1968); Rule 206(3)-2(c) under the Advisers Act (recognizing an investment adviser's duty to seek best execution of its customers' transactions).

value of research provided, commission rates, and responsiveness to the investment adviser.[21]

As part of its duty of best execution, an investment adviser must periodically and systematically evaluate the execution performance of all broker-dealers executing the adviser's transactions.[22] The SEC has held that an investment adviser must periodically review the quality of execution of its client's transactions even when the client has an existing relationship with the executing broker-dealer that predates the customer's relationship with the investment adviser.[23] Moreover, while the SEC expressly permits broker-dealers to determine their satisfaction of best execution obligations based on an overall review of execution quality, the SEC staff has implicitly endorsed the notion that both the 1940 Act and the Advisers Act may require an investment adviser to analyze its execution quality on individual transactions under certain circumstances.[24]

An adviser's specific duty to seek best execution varies with individual client trading arrangements because the concept of best execution is, as noted above, circumstantial. Some clients limit their adviser's choice of broker-dealers or the trading arrangements for their accounts. For example, in directed brokerage or commission recapture arrangements, a client directs an investment adviser to use a specific broker-dealer to execute some or all transactions for an advised account. Under these arrangements, known as "directed brokerage arrangements," an investment adviser's duty of best execution is substantially reduced, if not completely obviated, because the adviser's discretion to choose the executing broker-dealer is greatly curtailed, if not eliminated.[25]

II. SOFT DOLLARS

A. Introduction. 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, as amended ("Exchange Act"), which provides a safe harbor to protect arrangements in which a money manager

---

21 1986 Release; *Jamison*.

22 1986 Release; *Jamison; In the Matter of Portfolio Advisory Services*.

23 *Jamison*.

24 *See SMC Capital Inc.*, SEC No-Action Letter (pub. avail. Sept 5, 1995) ("SMC Capital") (granting no-action relief under Section 206, Section 17(d) and Rule 17d-1 to an investment adviser's order aggregation arrangement where the adviser agreed not to aggregate transactions unless it believed that the aggregation was consistent with its duty to seek best execution).

25 *Jamison* (finding that an investment adviser owed a duty of best execution to a client who executed through a broker-dealer with which it had a previously-established relationship, where the client had not executed a separate writing specifically directing the use of that broker-dealer)

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 SEC updated its views to reflect current industry practices. On July 18, 2006, the SEC issued a revised interpretation of Section 28(e),[26] which followed a proposed interpretation of Section 28(e) that the SEC issued for public comment in October 2005.[27] The SEC's revised interpretation became effective on July 24, 2006, 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 and gain a thorough understanding of industry practices in this area. The SEC's release clearly reflects that the task force was successful in this regard, as well as 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

---

[26] Securities Exchange Act Release No. 54165, 71 FR 41978 (July 24, 2006).

[27] Securities Exchange Act Release No. 52635 (Oct. 19, 2005), 70 FR 61700 (Oct. 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").

commission practices and the changes that have occurred in this area since the SEC last considered these issues 20 years ago.[28]

B. 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.[29] 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.

C. Eligible Research and Brokerage under the SEC's Revised Interpretation.

1. The SEC's revised interpretation largely adopts the standards it proposed 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:

   a. The money manager must determine whether the product or service constitutes brokerage or research services under Section 28(e);

---

[28] 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. 1986 Release, 51 FR 16004 (Aug. 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 (Dec. 27, 2001), 67 FR 6 (Jan. 2, 2002).

[29] 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.

b. 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

c. 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.

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

   a. **First**, the product or service must constitute "advice," "analyses," or "reports."

   b. **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:

      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

      Analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts.

   c. **Third**, the product or service must reflect "the expression of reasoning or knowledge."[30]

3. *Eligible Brokerage*. Consistent with the 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

[30] 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."

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.[31]

4. *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. Exhibit A to this outline summarizes 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:

   a. *Order Management Systems*: In the 2005 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).

   b. *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.

   c. *"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)

[31] However, as described below, the SEC indicated that connectivity services do not constitute research under the revised interpretation.

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).

d. *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 belief that a manager's proxy voting obligations are related to the investment decision-making process.[32]

5. *SEC's Functional Approach*.

a. 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.

b. 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

[32] *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 1940 Act (requiring registered investment companies to file annual reports containing their proxy voting records).

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).

c. 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.

d. 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 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."

D. 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.

1. *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.[33]

   In its 2005 proposal, 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

[33] *SEI Financial Services Company*, Letter from SEC's Division of Market Regulation to Morgan, Lewis & Bockius (Dec. 15, 1983).

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:

a. Taking financial responsibility for all customer trades until the clearing broker-dealer has received payment (or securities);

b. Making or maintaining records relating to customer trades required by SEC and SRO rules, including blotters and memoranda of orders;

c. Monitoring and responding to customer comments concerning the trading process; or

d. 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.

2. *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:

   a. Pays the research vendor directly;

   b. 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

   c. 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.

3. *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.[34] 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.[35]

---

[34] 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."

[35] 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. *See, e.g., Status of Service Providers in Goldman, Sachs & Co.'s XPRESS Program*, Letter from SEC's Division of Market Regulation to Morgan Lewis, & Bockius (Jan. 17, 2007) attached as Exhibit C.

E. What's Next?

1. 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.[36] The SEC has yet to issue any formal reaction to comments.

2. 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.

3. From a compliance standpoint, the SEC and its examination staff may expect to see more written documentation of practices under Section 28(e).[37] 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.

4. Additionally, the SEC and its staff have indicated that they will issue further proposals regarding recordkeeping disclosures of Section 28(e)

---

[36] *See, e.g.*, Letter from Federal Regulation of Securities Committee of the Business Law Section of the American Bar Association (Sept. 14, 2006), Letter from Ira D. Hammerman, Senior Vice President and General Counsel, Securities Industry Association (Sept. 7, 2006), and Letter from Elizabeth Krentzman, General Counsel, Investment Company Institute (Sept. 7, 2006) <available at http://www.sec.gov/comments/s7-13-06/s71306.shtml>.

[37] For example, the SEC staff may look to whether the firms are following the best practices articulated by the SEC staff in its *Inspection Report on the Soft Dollar Practices of Broker-Dealers*, Investment Advisers and Mutual Funds (Sept. 22, 1998) <available at http://www.sec.gov/news/studies/softdolr.htm > and follow-on studies from various associations. *See, e.g., Best Practices for Firms that Engage in Soft Dollar and Other Commission Arrangements*, Securities Industry Association (Nov. 1997); *see also Report of the Working Group on Soft Dollars Commission Recapture*, Department of Labor Advisory Council on Employee Welfare and Benefit Plans (Nov. 13, 1997); Brokerage Allocation Practices, Investment Company Institute (Mar. 1998); *AIMR Soft Dollar Standards: Guidance for Ethical Practices Involving Client Brokerage*, Association for Investment Management and Research (June 1998) <http://www.aimr.org/pdf/softdollars.pdf. A summary of the best practices articulated by the SEC staff in the Inspection Report and SIFMA is attached as Exhibit B.

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."[38]

5. 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?

III. TRADE AGGREGATION AND ALLOCATION

A. Overview. An adviser whose clients include registered and unregistered funds, retail and institutional accounts, or some combination thereof, can face challenging trading issues. The funds generally are "free to trade" accounts, while some institutional accounts may direct brokerage, and wrap fee account trades tend to be placed with the program sponsor. The existence of accounts that direct may effectively force an adviser to break up orders it might otherwise aggregate and send to a single broker.

---

[38] 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.

B. Concerns Associated with Disaggregation. Disaggregating trades may raise concerns. For example:

- The first accounts to trade may receive a better price than accounts trading down the line, especially with large orders or thinly-traded securities. This is because the first and following trades may tend to "push" the market (that is, create market impact).

- If the sell-side community understands that the adviser disaggregates orders, the adviser effectively may be "signaling" or "tipping" its executing broker-dealers that larger volume may be forthcoming, and some broker-dealers might use this information to the detriment of the adviser's clients.[39]

- The adviser's similarly-managed accounts may experience performance dispersion as a result of paying different prices for a security, incurring different transaction costs, or failing to purchase the security due to market impact concerns or limited availability. Disaggregation may also lead to performance dispersion between the adviser's similarly-managed funds, institutional accounts and other accounts.

C. Failure to Aggregate Does Not Result in a Breach of Fiduciary Duty. An adviser does not breach its fiduciary duty to its clients merely by failing to aggregate orders for client accounts. The adviser could, depending on the circumstance, have to disclose to its clients that it will not aggregate and any material consequences of the failure to aggregate, such as potentially higher commissions.[40]

D. Other Procedures for Placing Client Orders Permitted. Using multiple broker-dealers to execute transactions in the same security for fund and non-fund accounts is the reverse of aggregation. In approving procedures that called for *pro rata* allocation among client accounts, the SEC staff observed that there may be other allocation methods that advisers can use without violating Section 206 of the Advisers Act.[41] Advisers should be able to satisfy their fiduciary duties by employing methodologies or procedures, other than aggregating transactions and sending them to a single broker, provided these procedures are disclosed to clients

---

39 *See* Wagner & Glass, *The Dynamics of Trading and Directed Brokerage*, 2 J. Pension Plan Investing 53, 63 n.21 (1998) ("Wagner"). ("Although not necessarily common, 'worst case' scenarios of broker conduct that managers worry about include a dealer who gets a call from a manager asking for a price quote instead colludes with other dealers to inflate prices; a dealer who gets a manager's call immediately buys up all available stock so that the manager has to buy from the dealer regardless of price; a dealer who gets a manager's call surreptitiously tips off a good client of the dealer who in turn buys up all of the available stock with the intent of selling it back to the manager; and a dealer who gets a manager's call may know of a willing seller but represents to both sides that the other one wants a higher price so as to widen the spread (and the broker's profit).").

40 *Pretzel & Stouffer*, SEC No-Action Letter (pub. avail. Dec. 1, 1995).

41 *SMC Capital*.

and designed to ensure that clients are treated equitably and fairly over time and that no client account is systematically disadvantaged.

E. Other Types of Procedures. Rather than broadcast orders across multiple brokers simultaneously, an adviser may place orders with one broker and, once those orders have been executed, place orders with the next broker (and so on). Sequential allocation is done to avoid multiple orders from one adviser competing with one another for execution. It also avoids the "data leakage" problem – the excessive market impact that could result if the market thought that multiple brokers were working orders, although some market impact may occur.[42] These procedures include the following:

1. *Random Rotation*. Many advisers seek to deal with these sequencing issues by implementing a rotational process in which funds and other free to trade accounts, directed accounts take turns going first.[43] Random rotation seeks to ensure that clients are treated fairly and equitably over time, but it can place fund and institutional orders at the mercy of directed orders, especially when the broker-dealer handling the directed accounts takes time to execute a large order. The rotation schedule can be determined on a trade-by-trade basis, preferably through random selection (*i.e.*, each trade produces a new rotation) or it can be set in advance, again through random selection (*i.e.*, the rotation is fixed for a set time period or a set number of trades). In the latter case, the adviser will have to determine how to accommodate new client accounts.

2. *Last to Trade*. Where a client explicitly directs that all trades be executed through a particular broker, the adviser may decide to place that client's trades behind those of its clients who have non-directed accounts (i.e., at the "back of the bus").[44] However, accounts that consistently trade last are likely to trade on less favorable terms than clients who trade ahead of them. In any situation in which client accounts are traded last because of the directions, circumstances or arrangements surrounding the clients' accounts, an adviser should disclose the practice to the affected clients together with the possible effects on execution and account performance.

3. *Percentage of Assets-Based Rotation*. A less widely used methodology is rotation based on percentage of assets. The adviser creates a rotation

---

42 *See, e.g., Boards Fight Front-Running of Funds*, BoardIQ (March 6, 2007).

43 In a recent survey of wrap fee arrangement trading practices, 57% of respondents noted that their firms employ a trading rotation to determine where wrap accounts trade in relation to traditional accounts. *2005 Survey of Wrap Trading Practices*, conducted by TraderForum

44 Lemke at § 2:105. *See also* Wagner & Glass at 63. ("Since managers have an obligation to seek the best possible price for the greatest number of clients, they tend to place (sequence) the blocks of aggregated orders in front of directed trades (which would have been part of the block order but for the [client's] direction). In practice, what this means is that the manager will wait until the block order is completed before even beginning to try to execute the directed order.").

determined by the percentage of assets, by client type. For example, if fund assets represent 73% of the adviser's assets under management, and institutional accounts and retail accounts present 20% and 7%, respectively, then the fund would trade first 73% of the time, institutional accounts 20% of the time and retail accounts 7% of the time. This approach is sometimes used when an adviser first starts managing non-fund assets, to avoid putting large accounts at the mercy of small ones.

4. *Simultaneous Release*. Advisers typically avoid the simultaneous placement of orders for different clients through multiple broker-dealers because those orders may compete with each other for execution, and may present the potential for excessive market impact. However, simultaneous release of all orders may not affect clients if, for example, the order is for a highly liquid security, because the market may absorb multiple orders without significant price movement.

5. *Step-Outs*. A step-out generally involves the adviser's direction that an executing broker-dealer allocate – or "step out" – all or part of a trade to another broker-dealer for clearance and settlement. Step-outs are attractive to advisers because they may allow the adviser to accommodate client directed trading (*e.g.*, commission recapture) arrangements and to obtain soft dollar credits under Section 28(e) of the Exchange Act. The use of "step outs" may alleviate problems associated with rotational or back-of-the-bus procedures. Brokers may be willing to take on step-out transactions because they will earn the commission on the other side of the trade, or to attract more commission business from the adviser, even though settlement may be more complicated. Step-outs raise potential thorny "cross-subsidization" or "free riding" issues, because step-out orders are, in essence, executed for free while the adviser's other clients pay their negotiated commissions.[45]

6. *Hybrid Approaches*. Some advisers may use two or more of the procedures described above, including aggregation, in combination.

F. Disclosure. Advisers should have appropriate Form ADV or other disclosure informing clients of their trading practices and any related conflicts. In particular, an adviser should clearly disclose the trading process it employs, the

[45] *See* Wagner & Glass at 64. ("Unfortunately, while step-outs permit a manager to send an entire block trade to one broker (and thereby avoid sequencing delays), they too have some troublesome drawbacks. In particular: [s]tep-outs cannot be used with principal brokers[;] [i]f a significant portion of an order (more than 20 to 25 percent) has to be stepped out, the executing broker, when busy, may prioritize other orders (where it gets to keep all of the commissions) first[;] [i]f a manager is 'working' an order over several days, it needs to be concerned that the recipient of the first day's step out doesn't use that information to front run, or compete, with the manager's subsequent trades.").

circumstances under which it deviates from that process, and the consequences to the clients of employing that process.[46]

IV. SUGGESTED TRADE EXECUTION PRACTICES

A. Advisers Should Consider a Rotation Procedures for Account Order Placement.

1. In determining the appropriate trading strategy, advisers should consider employing an appropriate rotation procedure, unless a simultaneous release method would not harm client accounts or create market impact. All accounts should be included in the rotation. If rotation is not feasible, the adviser should, consistent with its fiduciary duties, consider excluding "directed accounts" from its rotation schedule and trade them last, provided that the adviser provides clear disclosure about this treatment and its consequences.

2. The rotation procedure could be flexible. For example, an adviser could employ a percentage of assets-based rotation where the adviser's larger accounts are traded alternately with the adviser's smaller accounts - a two "rotation wheel" approach. This can mitigate a potential disadvantage of strict rotation procedures – putting the adviser's larger accounts at the mercy of its smaller ones.

3. Advisers should monitor and periodically test their order placement procedures to ensure that clients are treated equitably and fairly over time and that no client account is systematically disadvantaged over time. Advisers are required to monitor and test their procedures under Rule 38a-1 under the 1940 Act and Rule 206(4)-7 under the Advisers Act.

B. Advisers Should Conduct Best Execution Reviews. Advisers should conduct periodic and systematic reviews of their clients' executions. Advisers can do this on a sampling basis, or they can compare their fund performance composites to non-fund composites for the same style to determine if any material discrepancies exist that could indicate lesser quality execution for the non-fund trades. Other factors could affect performance, such as the smaller size and number of securities in retail accounts, the tendency towards more investment restrictions in certain institutional accounts or increased flows in and out of mutual funds as compared to other advisory accounts.

C. Advisers Should Disclose Broker Selection and Order Placement Practices to Clients.

1. Advisers should disclose their practices for selecting broker-dealers. They also should disclose the potential for free-riding and cross-subsidization in

[46] *See generally In re Mark Bailey & Co. and Mark Bailey*, Investment Advisers Act Release No. 1105 (Feb. 24, 1988) (SEC outlined a series of disclosures that should have been made by an investment adviser who did not negotiate commissions for certain client-directed transactions.).

the use of step-outs if these issues would have a material impact on client accounts.

2. Advisers should disclosure their procedures for order placement. The disclosure should explain that the procedures are designed to ensure that clients are treated equitably and fairly over time. The adviser should generally describe the types of practices employed if this information is material to clients. The disclosure should also explain whether the adviser will aggregate a client's order with other clients' orders and the circumstances under which the adviser might do so. If it does not aggregate orders, the adviser should disclose that fact and the consequences of not aggregating, such as the potential for the order traded first to move the market.

3. If directed accounts are traded last, the adviser should disclose that fact and its consequences, such as potentially obtaining a price inferior to prices obtained on earlier executions.

V. ERISA CROSS-TRADE ISSUES

A. ERISA Prohibition of Cross Trades Prior to the Enactment of the Pension Protection Act of 2006. Prior to the passage of the Pension Protection Act of 2006 (the "Pension Protection Act"), which was signed into law on August 17, 2006, Section 406(b)(2) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") prohibited an investment manager or other fiduciary from causing a plan subject to the fiduciary provisions of ERISA and other tax-qualified retirement and savings accounts to engage in a direct purchase or sale of securities with another client of the investment manager, even though such cross trading could result in cost savings either or both parties. The Department of Labor ("DOL") had issued class exemptions to the prohibition permitting "agency" cross trades and "passive" cross trades under certain conditions.

B. Pension Protection Act of 2006. The Pension Protection Act was billed as a sweeping overhaul of the nation's private pension system containing a number of provisions that directly affect the way investment managers, broker-dealers and other plan service providers interact and deal with plans subject to the fiduciary provisions of ERISA and tax-qualified retirement and savings accounts. Specifically, the Pension Protection Act provides a number of changes and exemptions to ERISA's fiduciary duty provisions and the prohibited transaction rules under both ERISA and the Internal Revenue Code (the "Code"), including the following changes with regard to active cross trades for large plans:

1. *Cross Trade Prohibited Transaction Exemption*. The Pension Protection Act contains a long awaited prohibited transaction exemption under ERISA and the Code for active cross trades. The Pension Protection Act added new Section 408(b)(19) to ERISA, which provides an exemption

from the prohibitions of Section 406 for any transaction described in section 406(a)(1)(A) and 406(b)(2) involving a cross trade between a plan and any account managed by the same investment manager under certain conditions. For purposes of this exemption, "cross trade" means the trading of securities between a "large plan" and another account managed by the same investment adviser who meets the definition of an "investment manager" under ERISA or the Code. This exemption is only available for "large plans," meaning a plan with assets of, or part of a master trust with assets of, $100 million or more, where:

a. the transaction is a purchase or sale for no consideration other than cash payment against prompt delivery of a security for which market quotations are available;

b. the transaction is effected at the independent current market price of the security as determined under the 1940 Act Rule 17a-7(b) applicable to mutual funds;

c. no brokerage commission, fee (except certain customary transfer fees, where certain advance disclosures are made) or other remuneration is paid in connection with the transaction;

d. a plan fiduciary independent of the investment manager authorizes in writing, in advance and in a document separate from any other written agreements of the parties, the ability of the investment manager to conduct such cross trades;

e. the investment manager provides the plan fiduciary written disclosure, in a separate writing, of the conditions under which cross trades can occur;

f. the investment manager provides the plan quarterly reports detailing all cross trades executed in the quarter;

g. the investment manager does not condition its fees on the use of cross trades or charge a higher fee where the plan fiduciary refuses to permit cross trades under this exemption;

h. the investment manager has adopted certain written cross-trading policies and procedures that provide for the allocation of cross trades among participating accounts in an objective manner; and

i. the investment manager designates an individual responsible for periodically reviewing cross trades to ensure that they were conducted in conformity with the manager's policies and procedures and to certify, under penalty of perjury, to the plan fiduciary, such person's findings and conclusions.

2. *DOL Cross Trade Exemption Interim Final Rule*. The Pension Protection Act also directed the DOL to consult with the SEC and issue regulations governing the content of written policies and procedures that an investment manager is required to adopt in order to rely on the Pension Protection Act's cross trading exemption. The DOL issued an interim final rule (72 Fed. Reg. 6473), effective on April 13, 2007 (the "Interim Final Rule") to implement this condition.

a. The Interim Final Rule requires that an investment manager implement policies and procedures designed to (i) provide sufficient information in order to enable a plan fiduciary to assess the investment manager's cross trading program, and (ii) require the investment manager's compliance officer to review cross trades and reflect such review in an annual report issued to authorizing plan fiduciaries. The Interim Final Rule requires that the content of the policies and procedures be clear and concise and written in a manner calculated to be understood by plan fiduciaries authorizing cross trades. The Interim Rule does not require a specific format for the policies and procedures as long as they are sufficiently detailed to facilitate the periodic review and determination of compliance by the investment manager's compliance officer. The Interim Rule also requires that the policies and procedures include:

(i) a statement of policy describing the criteria used to determine that a cross trade will benefit both parties in a transaction;

(ii) a description of how the investment manager will determine that the cross trades are effected at the independent current market price within the meaning of Rule 17a-7(b) under the 1940 Act and applicable SEC guidance, and the identity of the sources used to establish prices;

(iii) a description of the procedures for ensuring compliance with the exemption's $100 million minimum plan asset size requirement initially and thereafter on a quarterly basis;

(iv) a description of how the investment manager will mitigate any potentially conflicting divisions of loyalty and responsibility to the parties involved in the cross trade;

(v) a requirement that the investment manager allocate cross trades among accounts in an objective and equitable manner, as well as a description of the allocation method(s) available to and used by the investment manager, e.g. pro

rata or queue methods;

(vi) identification of the compliance officer responsible for periodically reviewing compliance with the investment manger's cross trading policies and procedures and that person's qualification for the position; and

(vii) a description of the scope of review conducted by the compliance officer, specifically noting whether the review is limited to compliance with the policies and procedures or whether it extends to overall compliance with the cross trading exemption.

b. The DOL has asked for comments on all aspects of the Interim Final Rule, including whether the scope of the compliance officer's responsibilities under the new rule should be expanded to encompass compliance with all of the requirements of the cross trading exemption, not just the policies and procedures exemption. The DOL has also expressed an interest in receiving information on the current practices of compliance officers with regard to determining compliance with applicable prohibited transaction exemptions under ERISA.

C. Unresolved Issues and Insight.

1. Should plans with assets of less than $100 million also be permitted to engage in cross trades with appropriate safeguards? If not, should plans with assets of at least $100 million be required to monitor their asset size less frequently, as more frequent monitoring may prove burdensome, and a plan with $99 million is not necessarily less sophisticated than a plan with $101 million?

2. The DOL interest in public comment on the scope of a compliance officer's responsibilities and current practices determining compliance with applicable statutory or administrative exemptions under ERISA may signal new DOL interest in what compliance officers are doing with regard to ERISA.

3. The new rulemaking could be of interest to all investment advisers, whether or not they have ERISA clients, as it may provide helpful guidance on how to draft cross trading procedures.

EXHIBIT A*

PRODUCTS AND SERVICES ELIGIBLE AS RESEARCH	PRODUCTS AND SERVICES NOT ELIGIBLE AS RESEARCH
• Traditional research reports that analyze the performance of a particular company or stock • Meetings with corporate executives to obtain oral reports on the performance of a company • Market data • Discussions with research analysts • Seminars or conferences that provide substantive content relating to issuers, industries, or securities • *Trade magazines and technical journals concerning specific industries or product lines that are marketed to and serve the interests of a narrow audience* • *Proxy services that transmit reports and analyses on issuers, securities, and the advisability of investing in securities* • Corporate governance research (including corporate governance analytics) and corporate governance rating services that provide reports and analyses about issuers • *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")* • Consultants' services that provide advice with respect to portfolio strategy • *Software and other products that generate "market research," including research on optimal execution venues and trading strategies* • *Financial newsletters and financial and economic publications that are not targeted to a wide, public audience* • Quantitative analytical software and software that provides analyses of securities portfolios • Company financial data and economic data (such as unemployment and inflation rates or gross domestic product figures) • Pre-trade and post-trade analytics (including analytics transmitted through order management systems)	• *Computer hardware (including terminals) and computer accessories.* • *Telecommunications lines, transatlantic cables, and computer cables* • *Mass-marketed publications* • *Travel expenses, entertainment, and meals associated with meetings with analysts or corporate executives or with attending seminars* • *Proxy services that assist a money manager in deciding how to vote proxy ballots* • *Proxy products or services that handle the mechanical aspects of voting, such as casting, counting, recording, and reporting votes* • Consultants' services that provide advice relating to the managers' internal management or operations • Overhead expenses (*e.g.*, office equipment, office furniture and business supplies, salaries, rent, accounting fees and software, legal expenses, personnel management, marketing, and utilities) • Website design, e-mail software, and internet services • *Membership dues and professional licensing fees* • Software to assist with administrative functions (*e.g.*, managing back-office functions) • Operating systems, word processing, and equipment maintenance and repair services

* Products and services in italics indicate changes from the SEC's 1986 Release.

PRODUCTS AND SERVICES ELIGIBLE AS BROKERAGE	PRODUCTS AND SERVICES NOT ELIGIBLE AS BROKERAGE
• Connectivity services between and among money managers, broker-dealers and other relevant parties (*e.g.*, custodians) • Dedicated lines between a broker-dealer and a money manager's order management system or between a money manager and a broker-dealer's trading desk • Post-trade matching of trade information (*e.g.*, allocation instructions between institutions and broker-dealers, settlement instructions to custodian banks and broker-dealers' clearing agents) • Comparison services that are required by the SEC or SRO rules (*e.g.*, electronic confirmation and affirmation of institutional trades) • Order routing and algorithmic trading software • Software for transmitting orders to direct market access systems • Short-term custody (*i.e.*, custody related to effecting particular transactions in relation to clearance and settlement of the trade)	• Compliance products and services (*e.g.* services that analyze portfolio information to evaluate a money manager's fulfillment of its duty of best execution, to determine whether portfolio managers are overtrading securities, or to determine breaches of fiduciary duty) • Products or services that create trade parameters for compliance with regulatory requirements, prospectus disclosure, or investment objectives • Products or services that "stress-test" a portfolio under a variety of market conditions or monitor style drift • Error correction trades or related services in connection with errors made by money managers • Long-term custody (*e.g.*, services provided by custodial banks) and custodial recordkeeping • Trade financing (*e.g.*, stock lending fees, and capital introduction and margin services)

EXHIBIT B

BEST PRACTICES SUGGESTED FOR CONSIDERATION BY THE SEC STAFF AND SIFMA

	WHO?	BEST PRACTICE	COMMENTARY
Procedures and Oversight			
1	SEC	**Centralize responsibility.** "A designated person or committee is responsible for overseeing the firm's soft dollar and client directed brokerage activities and for establishing the firm's operating policies for these activities."	Each of these suggestions makes sense to establish an internal control environment, among other things, to lessen a broker-dealer's potential liability for soft dollar abuses by investment advisers.
	SIFMA	**Adopt written procedures.** "Firms should adopt and implement, consistent with each Firm's resources, culture and risk management assessments, policies and procedures with respect to their practices involving commission arrangements. These policies and procedures should include supervisory procedures reasonably designed to ensure compliance with the policies, procedures and applicable law and should clearly delineate responsibility for handling the various aspects of the Firm's commission arrangements."	
3	SIFMA	**Procedures should be approved by board or management and updated periodically.** "The policies and procedures of a Firm should be approved by the Firm's board of directors, a committee thereof or an appropriate level of management, and should be periodically reviewed and revised to reflect business, market and legal developments."	
4	SIFMA	**Incorporate into initial and continuing education.** "As part of their initial training and continuing education programs, Firms should advise relevant personnel as to the law and their policies concerning commission arrangements."	
Establishing Arrangements			
5	SIFMA	**Know the customer. "**One of the keys to a successful customer relationship is to understand the customer and the nature of its business. 'Knowing the customer' not only enables a Firm to better service the customer's needs, but also assists the Firm in properly handling commission arrangements."	The obligation to "know your customer" should not be confused with an obligation to obtain reasonable assurances, for example, that an investment adviser is meeting its legal obligations under soft dollar arrangements. A broker-dealer may have a higher duty of inquiry under "know your

	WHO?	BEST PRACTICE	COMMENTARY
			customer" concepts than what should be required in the soft dollar context.
6	SEC	**Confirm that adviser is authorized to receive soft dollar products or services.** "At the time that a soft dollar arrangement is being established, the broker-dealer determines whether the adviser has discretionary management authority for its clients' assets and requests and obtains a written description of the adviser's authority, and the types of products and services the adviser is authorized to obtain."	In documenting a soft dollar arrangement with an investment adviser, a broker-dealer may wish to: < Make clear that any soft dollar research is being provided to assist the adviser in serving client accounts over which it has investment discretion < Obtain assurances from the investment adviser that it has investment discretion for accounts whose brokerage it directs for soft dollar credits < Obtain assurances from the investment adviser that its receipt of soft dollar products and services has been (and will be) appropriately disclosed to clients (together with the adviser's standard form of such disclosure) < Obtain from the investment adviser a statement of the types of products and services that, under its client agreements, it is authorized to receive and an undertaking that, in requesting any particular product or service, the adviser will be deemed to represent that it is authorized to receive the product or service. < Notify the investment adviser of legal issues, need to consult legal counsel and disclosure obligations (see items 7 & 8 below)
7	SEC & SIFMA	**Confirm that customer is authorized to enter into and receive benefits under directed brokerage arrangements.** SEC: "At the time that a client of an adviser begins negotiations to establish a directed brokerage arrangement, the broker-dealer determines whether the rebates of commissions or products/services to be supplied are within the advisory client's authority to request and that the party receiving the benefits under the	In documenting a directed brokerage arrangement with a customer, a broker-dealer may wish to obtain assurances from the customer that: < The customer has the authority to enter into the directed brokerage arrangement

	WHO?	BEST PRACTICE	COMMENTARY
		arrangement is authorized to receive such benefits. The firm requests and obtains from the client a written description of its authority to enter into the arrangement and to receive the indicated products/services." SIFMA: "Firms that engage in directed brokerage arrangements, including commission recapture programs, should take reasonable steps to ensure that commission credits are applied to the payment of commission refunds to, or expenses of, the beneficial owner of the account that paid the commissions."	< All amounts the customer requests to be paid by the broker-dealer will be in respect of direct expenses properly and actually incurred by or on behalf of the customer < All amounts paid by the broker-dealer will become part of the customer's assets, in accordance with all documents and laws governing the customer's account < The customer understands its best execution obligations under applicable law
8	SIFMA	**Notify adviser of legal issues and need to consult counsel.** "Recognizing that Firms are not, and should not act as, legal counsel to fiduciaries, a Firm nevertheless should notify the fiduciary that soft dollar arrangements can present a variety of legal issues for the fiduciary and recommend that the fiduciary review the details of the proposed soft dollar arrangement with its own legal counsel or compliance advisors."	
9	SIFMA	**Notify adviser of disclosure responsibilities.** "Firms should notify the fiduciary that it may have an obligation to disclose its soft dollar arrangements and brokerage allocation practices to its clients."	
10	SIFMA	**Don't require adviser to commit on commission target.** "Although it is typical to develop anticipated levels of brokerage, a Firm should not require a fiduciary to obligate itself formally to direct a specific amount of commission business to the Firm."	
11	SIFMA	**Notify adviser on need to allocate costs for mixed-use products.** "Firms generally should notify the fiduciary that many research and brokerage services are capable of mixed or multiple use and, depending upon the fiduciary's use of a service, that a reasonable allocation of the cost of the service may be necessary."	
12	SIFMA	**Recommend that adviser reconsider allocations periodically.** "Because the fiduciary's use of a service may change over time, Firms should recommend that the fiduciary periodically review and, where appropriate, revise its cost allocations to ensure that the allocation is reasonable given the fiduciary's current use of the service."	

	WHO?	BEST PRACTICE	COMMENTARY
Maintaining Arrangements			
13	SEC	**Determine that requested soft dollar benefits fit within adviser's authority.** "Established procedures are used to determine whether products and services requested by advisers are consistent with the adviser's authority over clients' commissions."	
14	SEC	**Maintain a master list of payees.** "An appropriate unit of the broker-dealer produces a master approved list of all third-party soft dollar arrangements and client-directed brokerage arrangements. No payments are made to third-party vendors or to clients under rebate programs unless the arrangement appears on this list."	In *Republic*, the SEC criticized RNYSC for paying invoices made out to fictitious vendors and for not inquiring about new or unfamiliar vendors or the nature of the services they "purportedly rendered." If a broker-dealer is unfamiliar with the products and services for which it is paying, the broker-dealer may consider requesting samples of the research. The broker-dealer may also consider documenting the type and cost of the products and services provided by third parties.
15	SIFMA	**Notify adviser when requested product or service appears inappropriate.** "During the course of a soft dollar arrangement, a Firm may be asked to provide the fiduciary with a product or service that does not appear to be appropriate under the arrangement. Although the fiduciary ultimately is responsible for using the product or service in a manner that is consistent with its authority and fiduciary obligations, Firms' policies and procedures should be reasonably designed to notify a fiduciary when the requested product or service does not appear to be appropriate."	
16	SEC	**Contract with third-party research vendors for broker-dealer obligated to pay.** "The broker-dealer establishes a contractual relationship with each third-party vendor of research products and services so that it is obligated for payment under all such contracts."	In connection with soft dollar arrangements involving third-party research, broker-dealers may wish to: < Make clear to the vendor that the broker-dealer's obligation to the vendor relates only to the payment of the vendor's fees and that it is not responsible for the investment adviser's use of the research or compliance with the terms of any licensing agreement with the investment adviser < Make clear to the investment adviser that any third-party

	WHO?	BEST PRACTICE	COMMENTARY
			research is provided by an independent organization that is itself responsible for the research and that the research is provided "as is" without any representation as to accuracy by the broker-dealer. < Make clear that the investment adviser is expected to use any third-party research in a manner consistent with its fiduciary responsibilities and client contracts
17	SEC	**Don't pay vendor invoices submitted by an adviser unless broker-dealer is obligated to pay the particular vendor.** "Invoices for products and services submitted by advisers for which the broker-dealer is not contractually liable for payment are not paid."	In *Republic*, the SEC specifically noted that, "RNYSC and Sweeney did not *question* or *reject* a single soft dollar invoice or request for payment. SCM simply forwarded its requests to RNYSC, and Sweeney continued to approve the payments using client-owned soft dollar benefits. No one at RNYSC raised the issue of whether the firm should cease paying soft dollars for SCM."
18	SEC	**Periodically review commissions paid and notify adviser if commission payments are materially out of balance.** "Commissions paid under each soft dollar arrangement by advisers are periodically reviewed in relation to the products and services provided to the advisers, and advisers are informed if their commission situations are materially out of balance."	
19	SIFMA	**Soft dollar credits should not be earned on futures or principal trades.** "If the fiduciary seeks to rely upon the Section 28(e) safe harbor, credits should not be provided for transactions in futures or transactions in which the Firm acts as principal."	In addition, broker-dealers should not agree to use soft dollars to absorb trading losses. *See Charles Lerner, Esq.* (pub. avail. Oct. 25, 1988); *In re Jack Allen Pirrie*, Advisers Act Release No. 1284 (July 29, 1991).
Record keeping			
20	SIFMA	**Maintain accurate records.** "Firms should maintain accurate records and properly account for trading activity that is subject to a commission arrangement. For example, Firms should maintain adequate record keeping systems and internal controls to ensure that the appropriate beneficial owners and fiduciaries are credited with the	Among the records that should be maintained in the soft dollar area are the following: < Soft dollar client letters < Directed brokerage agreements

	WHO?	BEST PRACTICE	COMMENTARY
		commissions received and that any commissions credited toward a product or service that is capable of mixed or multiple use are consistent with the fiduciary's usage allocation."	< Other customer agreements and representation letters < Agreements with third-party research vendors < Related resolutions, partnership or advisory agreements, by-laws, certifications, and trading authorizations < Correspondence relating to soft dollar and directed brokerage arrangements, including correspondence with third-party research vendors < Invoices and requests for payment marked to show when and how disposed of < Monthly statements of soft dollar credits, directed brokerage credits and payments made
22	SEC & SIFMA	**Send a periodic statement.** SEC: "The broker-dealer sends each adviser a periodic statement of all proprietary and third-party research and non-research services provided, including commitment amounts and year-to-date commissions directed." SIFMA: "Firms should report trading activity, including the commission paid and the capacity in which the Firm acted, and should, upon request, provide information regarding any commission amounts credited (as well as any debit balance) toward research or other services provided. A Firm should present this information in a clear and understandable format."	The SEC Soft Dollar Report contained a sample statement (attached as Exhibit A) to be used for this purpose. In addition, the SEC Soft Dollar Report actually recommended that the SEC adopt a rule requiring all broker-dealers to provide an annual statement to each investment adviser detailing all products, services and research provided to the investment adviser in exchange for soft dollars.