



► Compliance Corner

Soft Dollars Revisited

— By: Paul M. Miller*

Has your firm confirmed recently that it is complying with the terms of its client commission arrangements in using soft dollars to acquire eligible brokerage and research services? This article deconstructs key aspects of that sentence under the SEC's 2006 interpretive guidance on soft dollars. It also discusses certain requirements of Section 28(e) of the Securities Exchange Act of 1934 ("Section 28(e)") that often get overlooked in today's multi-broker, multi-national, multi-asset trading environment.

Section 28(e)

Section 28(e) provides that an adviser exercising investment discretion with respect to an account shall not be deemed to have breached a fiduciary duty solely by reason of having caused the account to pay more than the lowest available commission to a broker-dealer for effecting a securities transaction if the adviser determines in good faith that the amount of the commission is reasonable in relation to the value of the brokerage and research services provided by the broker-dealer, either in terms of a particular transaction or in terms of the adviser's overall responsibilities to its accounts. The safe harbor permits a discretionary adviser to use client commissions (soft dollars) to purchase research and other brokerage services without violating the adviser's fiduciary duty, provided

the adviser satisfies the conditions of the safe harbor. Compliance with these conditions requires careful attention by advisory personnel, as there are several traps for the unwary.

Transactions Generating Soft Dollars. By its terms, the Section 28(e) safe harbor applies to transactions in securities only. Commissions paid to brokers for transactions involving futures and other assets that are not securities for purposes of the Exchange Act are not covered by the Section 28(e) safe harbor. In addition, the Section 28(e) safe harbor applies to agency transactions only. Except for specified types of riskless principal transactions, spreads and fees paid to brokers in connection with principal transactions are not covered by the Section 28(e) safe harbor. This distinction is critical, as transactions effected outside the United States (*e.g.*, in the European markets) are often conducted on a principal basis and therefore are not covered by the Section 28(e) safe harbor.

Eligible Research and Brokerage Services. In 2006, the SEC formulated a three-part test for determining whether a particular product or service falls within the safe harbor based upon the legislative intent of Section 28(e) and previous SEC guidance. Under this three-part test, an adviser is required to determine: (i) whether the product or

service is eligible research or eligible brokerage under Section 28(e); (ii) whether the eligible product or service provides lawful and appropriate assistance to the adviser in the performance of its investment decision-making responsibilities; and (iii) whether the amount of client commissions paid is reasonable in light of the value of products or services provided by the broker-dealer. For a research service or product to qualify, it must reflect the "expression of reasoning or knowledge" either through (i) advice relating to the value of securities, the advisability of investing in securities, and the availability of securities or buyers or sellers of securities or (ii) analyses or reports about issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts. In setting this standard, the SEC eliminated research payments tied to "hardware" such as computer equipment and telephone lines and to certain software items like e-mail and word processing software. Eligible research products and services could include research reports, software providing analysis of securities portfolios, discussions with research analysts, meetings with corporate executives, and data services (including services providing market data such as stock quotes, last sales prices and trading volumes,

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company financial data, and economic data such as unemployment and inflation rates and GDP figures).

For a brokerage service or product to qualify, it must be used to effect securities transactions during the period beginning when orders are first transmitted to broker-dealers and ending at the conclusion of clearance and settlement of the transactions covered by the orders. Eligible brokerage products and services could include: (i) connectivity services between an adviser and a broker-dealer and other relevant parties such as custodians, including (A) dedicated lines between the broker-dealer and the adviser's order management system, (B) lines between the broker-dealer and order management systems operated by a third party vendor, (C) dedicated lines providing direct dial up service between the adviser and the trading desk at the broker-dealer, and (D) message services used to transmit orders to broker-dealers for execution; (ii) software that provides algorithmic trading strategies; (iii) software used to transmit orders to direct market access systems; (iv) clearance and settlement in connection with trades; (v) short-term custody related to effecting trades; (vi) electronic communication of allocation instructions between institutions and broker-dealers; and (vii) routing settlement instructions to custodian banks and broker-dealers' clearing agents.

Determining whether a particular product or service is eligible under Section 28(e) can be difficult. Product descriptions and invoices are often vague, and invoices can include additional fees or charges for services or products that do not fall within definitions of eligible research services or eligible brokerage services. Advisory personnel should actively assess whether a product or service falls within the safe harbor and should monitor invoices and, absent appropriate

disclosure and client consent, use soft dollars to pay only for those services falling within the safe harbor.

Mixed-Use Items. In 2006, the SEC also reiterated its previous guidance regarding products and services that have a "mixed use." A mixed use item is any eligible product or service that is used by the adviser in its investment decision-making process and for other purposes, such as in preparing account statements for clients or in preparing marketing materials. When an eligible product or service is also used by an adviser for other purposes, the adviser must make a reasonable allocation of the cost of the product according to its use (*i.e.*, permitted soft dollar usage vs. other usage) and maintain records concerning allocation determinations.

Assessing whether an eligible product or service also has a mixed use can also be difficult and requires regular monitoring by advisory personnel. As new products or services are added to the list of eligible soft dollar products, advisory personnel should inquire as to the use of the product by other departments within the adviser (*e.g.*, operations/administration and marketing departments) and determine the basis for allocating the cost of the product between the two uses, documenting the basis for each determination. Once a cost allocation has been established for a mixed use product, the determination should be revisited regularly to ensure the allocation corresponds to current usage of the product and to permit the adviser to make its required good faith determinations discussed below.

Good Faith Determinations. As noted above, Section 28(e) requires that an adviser determine in good faith that the amount of the commission is reasonable in relation to the value of the brokerage and research services provided by the broker, either in terms

of a particular transaction or in terms of the adviser's overall responsibilities to its accounts. Advisory personnel should seek to ensure that these determinations occur regularly and that the determinations are documented. Furthermore, individuals making the good faith determinations should include portfolio managers, analysts and traders who use the research and brokerage services acquired with soft dollars, in addition to administrative, compliance and legal personnel.

Client Commission Arrangements (CCAs)

A significant trend in the soft dollar area since the release of the SEC's interpretive guidance in 2006 has been the use of client commission arrangements. The SEC release permits an adviser to generate commission credits in an account at a broker-dealer and direct the broker-dealer to make payments from those credits from time to time to others to pay for eligible research and brokerage services. Most major brokerage firms offer client commission arrangements that aggregate commission credits in one account, permit an adviser to direct the broker to pay for eligible products or services provided by other brokers and third parties, and generate and retain records relating to the products or services.

The SEC set forth several criteria for these arrangements in its 2006 interpretive release. In order to rely on the Section 28(e) safe harbor, an adviser must ensure that the broker accumulating the commissions in such arrangements is involved in effecting the trades generating the commissions. If the broker is not executing, clearing or settling trades, the broker must perform at least one of the following functions and take steps to see that the remaining

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functions have been allocated to one or another of the other broker-dealers in the arrangement. The four functions are: (i) taking responsibility for all customer trades until the clearing broker-dealer has received payment; (ii) making and/or maintaining records relating to customer trades; (iii) monitoring and responding to customer comments concerning the trading process; and (iv) generally monitoring trades and settlements.

In evaluating a client commission arrangement, it is important to identify the roles of the parties involved and to ensure that the broker responsible for paying for the eligible brokerage and research services is involved in effecting trades.

Section 28(e) requires that the broker-dealer receiving commissions for effecting transactions provide the brokerage and research services. In the context of third party research, the broker-dealer must pay for the research

at the direction of the adviser and take steps to ensure that the payments are used only for eligible research services. More specifically, the broker-dealer that is effecting transactions must (i) pay the research provider directly, (ii) review a description of the services to be paid for with client commissions under the safe harbor for red flags that indicate the services are not within Section 28(e) and agree with the adviser to use client commissions only to pay for those items that reasonably fall within the safe harbor, and (iii) develop and maintain procedures so that research payments are documented and paid for promptly.

Advisers reviewing client commission arrangement documentation should ensure that the documentation addresses the foregoing Section 28(e) and client commission arrangement requirements. General representations

provided by the adviser to the broker in the documentation regarding the adviser's compliance with Section 28(e) and its acquisition of only Section 28(e) eligible services cover only one aspect of the requirements.

**Paul M. Miller is a partner in the Washington, DC office of Seward & Kissel LLP in the firm's Investment Management Group. He may be reached at millerp@sewkis.com or (202) 737-8833. This article is intended to provide general information on the matters discussed and should not be relied upon for legal advice. ■*



*Paul M. Miller,
Partner, Seward &
Kissel LLP*