

Last week, the SEC released final interpretive guidance on the scope of Section 28(e) and soft dollar practices following unanimous adoption by the SEC at an open meeting on July 12, 2006¹. The guidance became effective on July 24, 2006 when it was published in the federal register. There will be a six-month transition period during which money managers may rely on prior SEC interpretations under Section 28(e) to assist with transition to the new interpretation.

General Principles

The final interpretive release reiterates the historical principles applicable to investment advisers or money managers seeking the benefit of the safe-harbor of Section 28(e): “research” or “brokerage” services must be *provided by a broker effecting securities transactions* to an investment adviser who must make a *good faith determination that the value of such services is reasonable in relation to the commissions paid*. The release further clarifies that to qualify as research or brokerage, a money manager must determine that a service provides “lawful and appropriate assistance” to a money manager in performing its investment decision making responsibilities.

The interpretive release provides guidance on the scope of permissible “research” and “brokerage” services which can be provided under Section 28(e).

Research

Definition. In further clarifying the scope of permissible “research”, the release reiterates that research must consist of *advice, analysis or reports*, within the subject matter requirements contemplated by Section 28(e)(3)(A) and (B). Accordingly, a person provides research insofar as he:

- (A) furnishes 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
- (B) furnishes analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts; . . .

To the above subject matter requirement, the release adds the requirement that such advice, analysis or reports reflect *substantive content – the expression of reasoning or knowledge*.

The final interpretive release also makes clear that the means of delivery of eligible research content (*i.e.*, paper, electronic (internet) or oral) does not effect whether the content qualifies as “research”. Also, consistent with the SEC’s proposed interpretive

¹ Our July 14th Soft Dollar Update was based on the discussions at the SEC open meeting prior to publication of the final interpretive guidance. This publication will serve to update our prior report.

guidance, the final release provides that eligible research content may be original research or a synthesis, analysis or compilation of the research of others.

Certain Research Items

- **Third Party Research.** The final interpretive guidance re-confirms the availability of Section 28(e) for third party research content provided by brokers. Similarly, proprietary research content prepared by brokers remains subject to the same analysis under Section 28(e) as third party research.
- **Market Data.** Market and economic data (e.g., quote feeds, historical trading data, economic data) continue to be included within the scope of Section 28(e).
- **Seminars.** Attendance fees for seminars remain eligible as research within 28(e), subject to satisfaction of all other elements of the safe-harbor.
- **Analytical Products/Market Research.** The release clarifies that research relating to the market for securities, *i.e.*, advice on execution strategies and optimal execution venues is eligible “research” content. The release suggests that such research may take the form of pre-trade and post-trade analytics and may be delivered through OMS’s or otherwise.
- **Proxy Services.** The release provides that proxy services may qualify as research, or a mixed use item, depending upon the scope of their use by an adviser. If such services are used for their analyses on issuers or the advisability of investing in securities, they may qualify as research. To the extent such services are used for administrative functions, such as casting and keeping track of votes, such services are general overhead of an adviser, and not eligible under Section 28(e).

Non-Eligible Research Items

Consistent with the requirement that research reflect substantive content and the expression of reasoning or knowledge, products with “inherently tangible or physical attributes”, are not eligible as research within 28(e).

- **Computer Hardware, Peripherals, Communication Lines.** Computer hardware and accessories, even if used solely to deliver research content, are not eligible as “research” within Section 28(e). Similarly, communication lines (e.g., phone lines, T-1’s) used to deliver research content are no longer eligible under the safe-harbor as research.
- **Mass-Market Publications.** Mass market publications will not be eligible as research under the safe harbor. These are “publications that are intended for and marketed to a broad, public audience”. According to the SEC, mass market publications are “circulated to a wide audience, intended for and marketed to the public, rather than to serve the interests of a small readership, and have low cost”. The release goes on to clarify that publications “marketed to a narrow audience, directed to readers with specialized interests in particular industries, products or issuers” and having a high cost, may qualify as research. Examples of these are trade magazines and technical journals concerning industries or product lines targeted to a narrow audience rather

than the general public. It is important to note that while a money manager may use a publication to assist in the exercise of their investment decision making responsibilities, the SEC is focused on the intent of the publication itself -- if it is intended to be mass marketed, it will not be eligible within the safe-harbor.

Brokerage

The final interpretive release defines “brokerage services” by the originally proposed temporal standard. Accordingly, brokerage means those services related to execution of securities transactions beginning when an order is transmitted to, or placed with, a broker-dealer and ending at the conclusion of clearance and settlement of the transaction.

- **Trading Software.** Software used by brokers to route orders to market centers as well as direct market access software and trading tools provided by brokers to managers continue to fall within the definition of brokerage. Similarly, algorithmic trading software is eligible brokerage within Section 28(e).
- **Communication Services.** Communication lines between advisers and brokers or their custodians, e.g., dedicated lines, will be eligible as brokerage services within Section 28(e). The Commission stated, however, that the hardware and phones connected to such lines would not be eligible as “brokerage”.
- **Custody.** The interpretive release distinguishes short-term custody services, *i.e.*, those services relating to effecting transactions and the clearance and settlement of trades, from long-term custody services and record keeping. Under the release, short term custody services may be paid for as brokerage within the safe harbor, while long-term custody is to be treated as general overhead.

Mixed Use

The final interpretive release makes clear that the concept of “mixed-use” allocation remains appropriate. The Commission reiterated the need for advisers to maintain adequate books and records concerning their good faith determinations regarding mixed-use allocations. Such records should document the basis upon which advisers make their allocations for mixed-use products. We would again encourage our customers to review their mixed-use allocations as well as their processes for determining such allocations and their record keeping in respect thereof.

Order Management Systems

In the original proposed guidance, the SEC suggested that OMS’s would not qualify as either “research” or “brokerage” under Section 28(e). In the final interpretive guidance, the SEC has refined its views to acknowledge the roles the modern OMS plays in both facilitating research, through the provision of integrated analytics, and effecting brokerage, via algorithmic trading functionality, direct market access and communicating trades to brokers. In this way, an OMS is eligible under the safe harbor to the extent its uses by an investment manager satisfy the requirements of research and/or brokerage. To the extent an adviser uses its OMS for functions outside of the safe harbor, such as accounting or compliance, an appropriate mixed use allocation should be applied.

Client Commission Arrangements

The final interpretive release provides increased flexibility for commission sharing arrangements or introducing brokerage arrangements to satisfy the requirements of Section 28(e) where such arrangements include the provisions of research. In this regard, the Commission re-iterates that a broker “effecting” transactions must “provide” the research to satisfy the requirements of Section 28(e). However, the SEC has expanded the means for a broker to satisfy each of the “effecting” and “provided by” requirements.

- To be considered to be effecting transactions, a broker must execute, clear or settle transactions, or engage in *one* of four specified functions. The four functions are as follows: an introducing broker must: (1) be financially responsible to the clearing broker-dealer for all customer trades until settlement, (2) make or maintain records relating to its customer trades as required by Commission and SRO rules, (3) monitor and respond to customer comments concerning the trading process and (4) generally monitor trades and settlements.
- The Commission has similarly expanded the means for brokers to satisfy the “providing” requirement for research. In this regard a broker may (A) maintain a financial obligation to pay for such research or (B) actually pay the research provider and (i) take steps to ensure the payment is for eligible research by reviewing the description of services to be paid for and (ii) maintaining procedures such that research payments are documented and paid for promptly.

With the increased flexibility in the “provided by” requirement of Section 28(e), brokers will no longer be required to assume payment obligations by entering into tri-party agreements with research vendors.

The Commission stated they will accept additional comments regarding client commission arrangements for 45 days from the date of the release, and may provide additional guidance in this area in the future.

Differences from the U.K. Financial Services Authority Standards

The Commission highlighted the following items which would qualify as “research or brokerage” under the final Interpretive Release, but are not eligible under the FSA’s soft commission arrangements guidelines: (a) seminars, (b) publications, (c) market data, (d) portfolio valuation services and (e) communication lines to brokers.

Disclosure of Use of Client Commissions

At the July 12th SEC open meeting, it was stated that the SEC’s Division of Investment Management would be preparing proposed disclosure rules regarding a money manager’s use of soft dollars, perhaps for release by year-end. The final interpretive release states, in a footnote, that the Commission will evaluate whether further action is necessary with regard to the disclosure and documentation of client commission practices.

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The above information is based on the final SEC interpretive release, the full text of which may be found at <http://www.sec.gov/rules/interp/2006/34-54165.pdf>. If you have any questions regarding soft dollars or the matters discussed herein, please do not hesitate to call your ITG/Hoenig account representative.

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