



Regulatory Update — SEC Proposes Revisions to Interpretation of Section 28(e) Safe Harbor

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Release 34-52635 (October 19, 2005) announces and solicits comment on a proposed interpretation of Section 28(e) of the Securities Exchange Act of 1934 by the Securities and Exchange Commission (“Commission”).¹ The interpretation, if adopted, will further define and constrain the circumstances under which money managers may safely use clients’ commission dollars to purchase “brokerage and research services.” The Release reviews the origins and history of Section 28(e) and the Commission’s prior efforts to provide interpretive guidance as to the meaning and scope of the section. Based on that history, the Commission derives a three-step analysis that should be used to determine whether particular products or services provided by broker-dealers in return for payments of client commission dollars are within Section 28(e)’s safe harbor:

First, do the products or services qualify as eligible “brokerage and research services” within the meaning of those terms set out in Section 28(e)(3)(A), (B) or (C)?

Second, if eligible, do the products or services actually provide the money manager with “lawful and appropriate assistance” in the performance of his investment decision-making responsibilities?²

Third, if so, can the manager determine in good faith that the amount of client commissions used to pay for the products or services is reasonable in light of the value of those products or services?

The impetus for the Commission’s interpretive release is its belief that the “lawful and appropriate assistance” standard has been construed too broadly by some to apply to services and products that are only remotely connected to the investment decision-making process (if at all). The Commission believes that such services and products instead should be considered administrative and overhead goods and services secured by money managers for their own benefit. The Release provides examples of services and products that the Commission deems wrongly treated as lawful and appropriate assistance, such as certified financial analyst exam review courses, membership dues and professional licensing fees, office rent, utilities, phone service, carpeting, marketing, entertainment, meals, copiers, office supplies, fax machines, couriers, backup

generators, electronic proxy voting services, salaries, and legal and travel expenses. The Commission also notes that client commissions have been used extensively to pay for mechanisms related to the delivery of research, including peripheral items that support hardware and software, such as power needed to run computers and dedicated telephone lines used to receive information into computers. The Commission suggests most or all of such items also should be regarded as overhead rather than “brokerage and research services.”³

Such practices are viewed by the Commission and many others as abuses of the statutory protection that Congress, in 1975, meant to afford money managers to enable them to continue to receive and pay for “brokerage and research” services and products with client commission dollars after the unfixing of commission rates.⁴ The prevalence of these practices and the difficulty of finding some means of preventing them have led to suggestions that Section 28(e) ought to be repealed or that its availability should somehow be restricted. The Release, however, does no more than propose, through interpretation of the section, to sort various types of services and products obtained by money managers from broker-dealers and paid for with client commissions into those that fall within either “brokerage services” or “research services” within the meaning of those terms as used in Section 28(e) and to more clearly articulate the principles governing availability of the protections that the section affords.

The proposed interpretation embraces certain fundamental propositions as to the availability of Section 28(e), discussed below.

“Brokerage and research” that qualifies for the safe harbor protection of Section 28(e) must fall within the criteria stated in subparagraph (e)(3) of that section and must be consistent with the Commission’s 1986 “lawful and appropriate assistance” standard (*i.e.*, such services must provide lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities). Further, broker-dealers must be

¹ 70 FR 61700 (October 25, 2005) (“Release”).

² See, e.g., Release No. 34-23170 (April 23, 1986), 51 FR 16004 (April 30, 1986) at 16006.

³ See Release at 61707.

⁴ See, e.g., Release at 61701-2 and Senate Com. on Banking, Housing and Urban Affairs, Securities Acts Amendments of 1975, S. Rep. No. 94-123 (1975) at 69. The risk addressed by Section 28(e) was that money managers might be deemed to have violated their fiduciary duties to their clients by expending client assets for their own benefit rather than the benefit of the clients when they obtain such products and services with client commission dollars.

financially responsible for the brokerage and research services that they provide to money managers and must be involved in “effecting” the trades that generate the commission dollars used by those managers to pay for those products and services.

The Commission proposes to confine the term “research services” within the meaning of Section 28(e)(3)(A) and (B) to advice, analyses, and reports that “reflect substantive content — that is, the expression of reasoning or knowledge.”⁵ Market, financial, economic, and similar data would be deemed to reflect such content. Certain quantitative analytical software and software that provides analysis of securities portfolios also would qualify for coverage by the safe harbor if it reflects reasoning or knowledge relating to subject matter that is included in subparagraphs (A) and (B) of the section. Physical items that do not reflect the expression of reasoning or knowledge, however, would be deemed to be outside the safe harbor. The Commission provides a lengthy recital of such non-research items, including travel expenses, entertainment, meals associated with attending seminars, office equipment, office furniture and business supplies, telephone lines, salaries (including research staff), rent, accounting fees and software, website design, e-mail software, internet service, legal expenses, personnel management, marketing, utilities, membership dues, professional licensing fees, and software to assist with administrative functions such as managing back-office functions, operating systems, and word processing. The Commission specifically points out that computer hardware and computer accessories would not be eligible “research services” because they do not reflect substantive content related in any way to making decisions about investing (even though they may assist in the delivery of research).

The Release repeats the Commission’s long standing interpretation of Section 28(e) to the effect that third party research is on par with proprietary research for purposes of the section so long as the broker-dealer to whom commission dollars are paid for such research (i) “provides” the research and is responsible for either obtaining or producing it, and (ii) is responsible for “effecting” the securities transactions used to generate those commissions. Third party research is “provided” by a broker-dealer if the providing broker-dealer either develops the research itself, in-house, or if it has a legal obligation to pay a third party for that research. So long as the broker-dealer is obligated to pay for the research, the third party

can send the research to the money manager directly. A money manager will not be protected by Section 28(e), however, if he uses a broker-dealer to pay an obligation that the money manager has already incurred to a third party research provider.

“Brokerage services” within the meaning of Section 28(e)(3)(C) would be construed to mean services that relate to any aspect of effecting securities transactions, from the point at which the money manager communicates an order to a broker-dealer through the conclusion of clearance and settlement of the transaction (that is, from the time at which the manager communicates with the broker-dealer for the purpose of transmitting an order for execution through the delivery or crediting of funds or securities to the advised account).

The Commission would distinguish brokerage services from research services by noting that the latter include services provided before the communication of an order by a money manager whereas brokerage services relate to activities after communication of an order. Brokerage services include the execution, clearing and settlement of securities transactions and other incidental functions. These other incidental functions, characterized by the Commission as “connectivity” services between a money manager and a broker-dealer and other relevant parties, such as custodians, would include dedicated lines between the broker-dealer and the manager’s order management system or order management systems of the manager operated by third party vendors, dedicated lines between the broker-dealer’s trading desk and the money manager, and message services used to transmit orders to broker-dealers for execution. The Commission would take the position, however, that order management systems themselves and hardware such as telephones or computer terminals are not eligible as “brokerage” because they are not “sufficiently related” to order execution.⁶ It would take the same position with respect to products and services such as trade analytics, surveillance systems, and compliance mechanisms “because they are not integral to the execution of orders by the broker-dealer.”⁷

The Commission reemphasizes that, in the case of all “brokerage and research services,” money managers must make a good faith determination that commissions paid are reasonable in relation to the value of the products and

⁵ See Release at 61707.

⁶ See Release at 61708.

⁷ *Id.*

services provided by broker-dealers in connection with the managers' responsibilities to the advisory accounts for which the managers exercise investment discretion. This means that the money manager must actually make use of the products or services for investment decisions and cannot pay commissions for such products or services if the money manager is unable to conclude that the amount of commissions paid are reasonable in relation to the value of the research or brokerage received. The Commission warns money managers against seeking to obtain eligible products, such as market data, to "camouflage" the payment of higher commissions to broker-dealers for ineligible services, such as "shelf space" (*e.g.*, to compensate them for marketing particular mutual funds).

Finally, as to mixed-use items (*i.e.*, those involving some brokerage and research aspects along with other aspects that are useful to the money manager's business, but unrelated to the manager's investment decision-making process and responsibilities to clients, such as marketing or accounting), the Commission reminds money managers that they must reasonably allocate the cost of such items between eligible and ineligible uses and must document how such allocations are made. Documentation will enable money managers to demonstrate that they have made the required good faith determination of the reasonableness of the commissions used to acquire those items in relation to the value of the portion allocable to brokerage and research services that qualify for purposes of Section 28(e)(3).

In addition to soft dollars, the Release discusses commission sharing and directed brokerage arrangements. The Commission explains that a commission-sharing arrangement can not constitute a mere "give-up," but must entail activity by the commission-receiving party to justify the receipt of the split commission. The Commission asserts that the mere establishment of an introducing broker-clearing broker arrangement is insufficient to meet this test without more and takes the position that the introducing broker must perform sufficient services to be entitled to a share of commission dollars. At a minimum, the introducing broker must (i) be financially responsible to the clearing broker-dealer for all customer trades until the clearing broker-dealer has received payment or securities; (ii) make and/or maintain records relating to its customer trades required by Commission and self-regulatory organization rules; (iii) monitor and respond to customer comments concerning the trading process; and (iv) generally monitor trades and settlements. The Release also applies this approach to arrangements involving "step-ins" and "step-outs."

The Commission seeks comment on its proposed interpretations of Section 28(e), including whether it has "accurately identified the industry practices for which guidance would be most useful," and whether there are other significant issues arising under Section 28(e) that the Release does not address. While the Release seeks the submission of comments by November 25, 2005, the Commission historically has not moved promptly to deal with problems arising under Section 28(e). As a result, it seems likely that comments submitted after that date will receive due attention in connection with consideration of whether to adopt the interpretations proposed in the Release.

For Further Information

If you have questions concerning this memorandum or the Commission's proposed interpretation of Section 28(e), please contact any of the following members of our Securities and Futures Market Regulation Group:

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