New Soft Dollar Guidance: Time for "Soft" Unbundling of Brokerage Commissions between Research and Execution

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SEC Also Proposes Amendments to Regulation SHO

Interpretive Guidance on Soft Dollars

On July 18, 2006, the Securities and Exchange Commission (SEC, the Commission) issued an Interpretive Release that provides guidance on money managers' use of client commissions to pay for brokerage and research services.[1] Under the "soft dollar" safe harbor of Section 28(e) of the Securities Exchange Act of 1934 (Section 28(e), safe harbor), a money manager does not violate its fiduciary duty to obtain best execution for its clients solely because it pays more than the lowest available commission price if the money manager determines in good faith that the amount of the commission is reasonable in relation to the value of the "brokerage and research services" obtained.

Effective as of July 24, 2006, the Interpretive Release clarifies certain aspects of the safe harbor's scope. Most significantly, the Interpretive Release seeks to accommodate new flexible arrangements involving third-party research that promote the "functional separation of execution and research."[2] It also clarifies the definition of brokerage and research services that fall within the safe harbor, along the standards articulated in the 2005 proposing release on soft dollars (2005 Proposal).[3]

Given the rapidly evolving nature of institutional brokerage, the SEC will consider further comments on industry practices related to certain client commission arrangements used to obtain third-party research (referred to as "commission sharing arrangements" in the 2005 Proposal) in order to evaluate whether additional guidance, if any, is needed in the future. Comments should be received on or before **September 7, 2006**. It should be noted that the comment period does not delay the effective date of the Interpretive Release; market participants have a six-month grace period (ending on **January 24, 2007**) to bring their soft dollar practices into compliance with the new guidance.

Framework for Analyzing Eligible Services under Section 28(e)

The Interpretive Release describes a three-step analysis for determining whether a particular product or service falls within the safe harbor. This framework is consistent with, and reiterates in most parts, certain aspects of prior SEC guidance. In conducting its safe harbor analysis, the money manager must:

(1) Determine whether the product or service complies with the specific statutory limits of Section 28(e)(3)—i.e., whether the product or service constitutes eligible "research" or eligible "brokerage" services.

(2) Determine whether the eligible product or service provides lawful and appropriate assistance in the investment decision-making process. The Interpretive Release notes that items used for marketing purposes are not within the safe harbor—even if they are within the statutory meaning of "research"—because, when used for marketing, these items do not provide lawful and appropriate assistance to the money manager in undertaking investment decisions. For mixed-use products and services, the manager must reasonably allocate the costs according to the use of the product or service. The manager must maintain adequate books and records of its mixed-use cost allocations to enable it to make the necessary good faith determination regarding the reasonableness of the commissions paid.

(3) Make a good faith determination that client commissions are reasonable in relation to the value of the products or services provided by the broker-dealer.[4]

Eligible Research Services

The definition of "research services" in Section 28(e) is limited to advice, analyses and reports relating to the subject matter identified in Section 28(e)(3). The Interpretive Release provides that a money manager, in order to determine that a product or service is eligible research under Section 28(e), must conclude that the item: (i) reflects substantive content (i.e., that it reflects the expression of reasoning or knowledge); and (ii) relates to the subject matter. The form (e.g., electronic, paper or oral discussions) of the research does not affect the safe harbor analysis. The Interpretive Release reiterates the prior SEC view that the determination that a product or service is "research" within the meaning of Section 28(e) is only the first step of the safe harbor analysis; the money manager must also determine that the research provides lawful and appropriate assistance in the investment decision-making process and that the total commission paid is reasonable in relation to the value of the services received.

Eligible Research Services. Among the examples of eligible research covered by Section 28(e) are traditional research reports, discussions with research analysts, meetings with corporate executives to obtain oral reports on the performance of a company, research-related seminars or conferences, software that provides analyses of securities portfolios, and corporate governance research and rating services.[5] Also included are market research, data services (including market data) that fall within Section 28(e)'s subject matter categories and some proxy services, depending on how they are used. Proxy services are to be subject to mixed-use criteria.[6]

Services Outside the Definition of Research. Among the items described in the Interpretive Release as falling outside the definition of eligible research are mass-market publications that are in general circulation and targeted to the retail public.[7] The SEC also said that inherently tangible products and services such as travel, entertainment and meals associated with attending seminars are not eligible under the safe harbor.[8] Other overhead items—such as office equipment, furniture, business supplies, salaries (including research staff), membership dues, professional licensing fees and software to assist with administrative functions—also are not eligible under the safe harbor. Finally, in contrast to the prior position taken by the SEC in 1986, **none** of the cost of computer hardware and delivery mechanisms associated with the oral delivery of research (e.g., telecommunications lines or computer cables) falls within the scope of the safe harbor.[9]

Eligible Brokerage Services

For purposes of the safe harbor, the Commission defines "brokerage" service as beginning at the moment the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution and ending when funds or securities are delivered or credited to the advised account or account holder's agent. This temporal standard is intended to distinguish between brokerage services that are related to the execution of securities transactions, which are eligible as "brokerage" under the safe harbor, and those that are overhead expenses, which are not. The Interpretive Release thus seeks to thwart any attempt to circumvent the new definition of eligible research by improperly reclassifying certain products and services as brokerage.

Eligible Brokerage Services. Under the new temporal standard, eligible brokerage services include communication services related to the execution, clearing and settlement of securities transactions, as well as other functions that are incidental to effecting securities trades (e.g., connectivity services between the money manager and the broker-dealer and other relevant parties such as a custodian). Software that is used in connection with routing trades and providing algorithmic trading strategies also is within the temporal definition.[10]

Services Outside the Definition of Brokerage. Hardware, such as telephones and computer terminals, software used for record keeping or administrative purposes and analytical software used to test hypothetical situations are considered to be ineligible overhead because these items are not essential for the execution of orders by a broker-dealer and do not fit within the temporal standard. Compliance testing and expenses, trade financing and error correction services also fall outside of the safe harbor. Short-term custody related to effecting specific transactions and settlement of those trades is considered eligible brokerage, but long-term custody and record-keeping services provided after settlement of transactions are outside the safe harbor.[11]

Third-Party Research and Client Commission Arrangements

The Interpretive Release reiterates the SEC's long-established view that third-party research can be beneficial to investors by explicitly stating that the safe harbor encompasses third-party research and proprietary research on "equal terms."[12] Moreover, the Interpretive Release makes a marked departure from the 2005 Proposal in construing the required elements of "provided by" and "effecting" under Section 28(e), as discussed below. The end result is that the Interpretive Release significantly expands the scope of the safe harbor by enabling a money manager to use client commissions to obtain research from **either** (i) an "introducing broker-dealer" whose role in "effecting" securities transactions is quite limited; or (ii) a "research preparer" whose services are deemed to be "provided by" by a broker-dealer remitting research payments as directed by the money manager.

This outcome is in response to the comments received in response to the 2005 Proposal recommending that money managers be afforded the "maximum flexibility to seek best execution, and separately, obtain research, by permitting a broker to be responsible for execution and another party to be responsible for providing eligible research."[13] The Interpretive Release is thus expected to lead to a greater degree of "soft" unbundling in the future—that is, allocations of client commissions by money managers between execution and research in a functionally separate manner.

"Effecting" Transactions. Section 28(e) permits the purchase of research and brokerage services with commission dollars if the services are "provided by" a broker-dealer involved in "effecting" the securities transaction. Under the Interpretive Release, a broker-dealer is involved in "effecting" a transaction if it executes, settles or clears the trade—or if it performs at least one of four specified functions and takes steps to assure itself that each of the other specified functions has been reasonably assigned to another broker-dealer in accordance with applicable rules of the SEC and self-regulatory organizations.

The four specified functions consist of: (i) taking financial responsibility for all customer trades until the clearing broker-dealer has received payment (or securities); (ii) making 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.[14] This aspect of the Interpretive Release is in sharp contrast to the standard suggested in the 2005 Proposal, which would have required a broker-dealer that is not executing, settling or clearing the trade to perform **all four** of the specified functions in order to be involved in "effecting" the trade under Section 28(e).

"Providing" Research. Consistent with past guidance, the Interpretive Release states that a broker-dealer that is legally obligated to pay for research produced by a third party is "providing" that research. Under the Interpretive Release, however, a direct legal obligation to pay is not the **only** circumstance in which a broker-dealer may be deemed to "provide" research for purposes of Section 28(e). Rather, the safe harbor is available where a broker-dealer pays the research preparer directly and takes steps to assure itself that the client commissions that the money manager directs the broker-dealer to use for research payments cover eligible research services only.

Specifically, the Interpretive Release states that the following actions taken by a broker-dealer will "help determine" whether it has "provided" research for purposes of the safe harbor: (i) payment of the third-party research preparer directly; (ii) review of the description of the services to be paid for with client commission for any red flag and agreement with the money manager that client commissions will be used only to pay for services covered by the safe harbor; and (iii) development and maintenance of procedures for research payments to be documented and paid for promptly.[15]

Under this new guidance, broker-dealers should be able to structure a flexible client commission arrangement in a manner similar to the so-called "commission sharing arrangement" found in the

United Kingdom, where "money managers 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,"[16] **provided** that the broker-dealer satisfy all of the above stated requirements. In this regard, broker-dealers should be particularly mindful of the prompt payment requirement. As noted in the Interpretive Release, the issue of prompt payment may be relevant in deciding whether the broker-dealer has "provided" research within the meaning of Section 28(e).[17]

Obligations of Participating Broker-Dealers. The Interpretive Release cautions that while the Commission's guidance under Section 28(e) is not intended to impose "heightened responsibility" on broker-dealers, under certain circumstances, a broker-dealer may be liable for aiding and abetting a money manager's violation of the securities laws. Potential aiding and abetting liability may occur if a broker-dealer pays for items outside the scope of the safe harbor at the money manager's request, while knowing that the money manager has represented to its clients that it will operate solely within Section 28(e).[18] As discussed above, however, the Commission's interpretation of the safe harbor's applicability to client commission arrangements does demand some measure of vigilance on the part of a participating broker-dealer.

Regulation SHO Amendments

On July 14, 2006, the SEC issued a release with proposing amendments to Regulation SHO under the Securities Exchange Act of 1934 (Proposing Release).[19] The amendments are intended to further reduce the number of fail to deliver positions in certain threshold securities by eliminating the so-called "grandfather" exception[20] and limiting the options market maker exception[21] to Regulation SHO's mandatory closeout requirement. The SEC is also proposing to amend Rule 200(e)'s market decline limitation to reference the NYSE Composite Index (NYA), instead of the Dow Jones Industrial Average (DJIA). The proposed amendments arrive just slightly more than one-and-a-half years after Regulation SHO became fully effective on January 3, 2005. These amendments reflect the Commission's ongoing policy concern that persistent failures to deliver could be an indication that some market participants are engaged in the practice of "naked short selling."[22]

Elimination of the Grandfather Exception. The SEC adopted the grandfather provision because it was concerned about market volatility through short squeezes if large preexisting fail to deliver positions had to be closed out quickly once the security was deemed to be a threshold security.[23] The Proposing Release would require that any previously grandfathered fail to deliver positions be closed within 35 settlement days of the effective date of the amendments. Any fail to deliver positions in a security that becomes a threshold security after the effective date of this proposed amendment would be subject to the 13-consecutive-settlement-day, mandatory closeout requirement of Regulation SHO under Rule 203(b)(3).[24]

Limited Duration of Options Market Maker Exception. The Proposing Release would also limit the duration of the options market maker exception provided in Rule 203(b)(3)(ii) of Regulation SHO. Currently, the options market maker exception exempts fail to deliver positions in threshold securities if they were the result of a registered options market maker's short sales to establish or maintain a hedge on an options position created before the underlying security became a threshold security. As amended, this exception would cease to be available upon expiration or liquidation of the specific options position being hedged, and the 13-consecutive-settlement-day closeout requirement would apply. In other words, an options market maker's fail to deliver position based that the exception would be required to be closed out within 13 consecutive settlement days of the later of (a) the underlying security becoming a threshold security, or (b) the expiration or liquidation of the options position being hedged.

Upon effectiveness of the proposed amendments, any previously excepted fail to deliver positions in a threshold security—with respect to which the options position that gave rise to the hedge has been liquidated or has expired—would have to be closed out within the 35-day-settlement period after the effective date of this amendment.[25] While recognizing that options market makers need to be able to hedge options positions by short selling and that preventing them from doing so could result in a liquidity problem, the SEC also believes that once an option has expired or been liquidated, there is no longer any reason to maintain an open fail.[26]

Amendments to Rule 200(e). Regulation SHO currently includes a limited exception under Rule 200 (e) to facilitate certain index arbitrage transactions where a broker-dealer is unwinding an index arbitrage position involving a long basket of stock and one or more index futures or options contracts. This exception does not apply if the sale occurs during a period beginning at a time when DJIA has declined below its closing value on the previous trading day by at least two percent and terminating upon the establishment of the closing value of the DJIA on the next succeeding trading day.

The reference to the DJIA was based in part on NYSE Rule 80A (Index Arbitrage Trading Restrictions), which has since been amended to use the NYA rather than the DJIA, to calculate limitations on index arbitrage trading. In order to maintain uniformity with NYSE Rule 80A and to maintain a uniform protective measure, the SEC proposes to amend Rule 200(e)(3) of Regulation SHO to reference the NYA instead of the DJIA, and to add language to clarify how the two-percent limitation is to be calculated in accordance with NYSE Rule 80A for purposes of Rule 200(e)(3).

Comment Period. The SEC is particularly interested in receiving comments on the costs associated with the proposed elimination of the grandfather exception and the impact of narrowing the exception for options market makers on their willingness to make a market in options for threshold securities. In addition, the SEC seeks comment about other possible ways to modify Regulation SHO. For example, the Proposing Release includes a number of open-ended questions, such as whether exchange-traded funds are subject to unique clearance and settlement difficulties that warrant an exception from the mandatory closeout requirement; whether the closeout requirement for Rule 144 restricted securities should be extended; and whether information about aggregate fail to deliver positions should be publicly disclosed. Comments should be received on or before **September 19, 2006**.

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[1] *See Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*, Exchange Act Release No. 54165, 71 Fed. Reg. 41,978 (July 24, 2006). *Also available at*http://www.sec.gov/rules/interp/2006/34-54165.pdf.

[2] Interpretive Release at 56.

[3] *See* Exchange Act Release No. 52635 (Oct. 19, 2005), 70 Fed. Reg. 61,700 (Oct. 25, 2005).

[4] Interpretive Release at 26.

[5] Interpretive Release at 28-29.

[6] Interpretive Release at 34-36.

[7] Interpretive Release at 31.

[8] Release at 32.

[9] Interpretive Release at 32-33 (retracting the suggestion contained in the 1986 release that money managers could use client commissions to pay for the portion of the cost of computers that relate to receiving research).

[10] Interpretive Release at 41.

[11] Interpretive Release at 42-43.

[12] Interpretive Release at 49-50.

[13] Interpretive Release at 51.

[14] Interpretive Release at 57.

[15] Interpretive Release at 59-60.

[16] Interpretive Release at 55.

[17] Interpretive Release at fn 184.

[18] Interpretive Release at 60-61.

[19] *See Amendments to Regulation SHO*, Exchange Act Release No. 54,154, 71 Fed. Reg. 41, 710 (July 21, 2006). *Also available at*http://www.sec.gov/rules/proposed/2006/34-54154.pdf.

[20] The "grandfather" exception to the mandatory closeout requirement exempts fails to deliver that came into existence before a security became a threshold security.

[21] The options market maker exception provides an exception for fails to deliver in a threshold security that are the result of short sales by registered options market makers, if the short sales have been made in order to create or maintain a hedge on options positions created before the security became a threshold security.

[22] Proposing Release at 8.

[23] Proposing Release at 6-7.

[24] Proposing Release at 10.

[25] Proposing Release at 19.

[26] Proposing Release at 20.

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