

Client Commission (Soft Dollar) Arrangements: The Section 28(e) Safe Harbor

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I. Introduction

Section 28(e) of the Securities Exchange Act of 1934, as amended (15 U.S.C. § 78bb(e)), establishes a safe harbor for money managers who use client funds to purchase brokerage and research services for their managed accounts. Under Section 28(e), a money manager is protected from liability for a breach of fiduciary duty solely on the basis of having paid more than the lowest commission rate for “brokerage and research services provided by a broker-dealer,” the manager determines in good faith that the amount of the commission is reasonable in relation to the value of such services.

Client commissions utilized to pay for brokerage and research often are referred to as “soft dollars.” As fiduciaries, money managers are obligated to act in the best interest of their clients, and cannot use client commissions or other assets to benefit themselves, absent client consent. Money managers who obtain research services with soft dollars are not paying for those services with their own funds, which benefits the money manager and creates a conflict of interest in selection the broker-dealer(s) to execute the clients’ trades. Section 28(e) addresses this conflict by permitting money managers to pay more than the lowest commission rate (sometimes referred to as “paying up”) to obtain brokerage and research services, so long as they make a good faith determination regarding the reasonableness of commissions paid. A money manager that pays up for brokerage and research services under circumstances that do not fall within the protection of Section 28(e) could be liable for breach of fiduciary duty under state or federal laws, including Section 206 of the Investment Advisers Act and ERISA; while a broker-dealer that executes such trades could be liable for aiding and abetting the breach of fiduciary duty by the money manager.

II. Brokerage and Research Services

The analysis of whether a particular product or service falls within the safe harbor involves three steps: First, the money manager must determine whether the products or services offered by the broker-dealer constitute eligible brokerage and research under Section 28(e). Second, the manager must determine whether those services provide lawful and appropriate assistance in the performance of his or her investment decision-making responsibilities. Finally, the manager must make a good faith determination that the amount of commission paid is reasonable in light of the value of products and services that are obtained from the broker-dealer.

A. Brokerage Services

Under Section 28(e)(3)(C), a person provides “brokerage services” insofar as he or she “effects securities transactions and performs functions incidental thereto (such as clearance, settlement, and custody) or required in connection therewith. . . .” The SEC has said that brokerage services begin when an order is transmitted to a broker-dealer and end with the clearance and settlement of the trade. Accordingly, eligible brokerage services are measured from the time the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution to the time the funds or securities are delivered or credited to the advised account or the account holder’s agent.

Under this “temporal standard,” communication services eligible as “brokerage services” include those related to the execution, clearing, and settlement of securities transactions and other incidental functions, including the following: connectivity service between the money manager and the broker-dealer and other relevant parties such as custodians, including dedicated lines between the broker-dealer and the money manager’s order management system; lines between the broker-dealer and order management systems operated by a third-party vendor; dedicated lines providing direct dial-up service between the money manager and the trading desk at the broker-dealer; and message services used to transmit orders to broker-dealers for execution. Eligible brokerage services also include algorithmic trading software and software used by a broker-dealer to route orders to market centers. Legitimate post-trade services include post-trade matching; custodians, and institutions; electronic communication of allocation instructions between institutions and broker-dealers; routing settlement instructions to custodian banks and broker-dealers’ clearing agents; short-term custody related to effecting particular transactions in relation to clearance and settlement of the trade and comparison services required by SEC or self-regulatory organization (“SRO”) rules.¹

In contrast, hardware, such as telephone or computer terminals, including those used in connection with an order management system (“OMS”), as well as trading software, are not eligible for the safe harbor because they are not sufficiently related to order execution and fall outside the temporal standard for brokerage. In addition, software functionality used for recordkeeping or administrative purposes, such as managing portfolios, and quantitative analytical software used to test “what if” scenarios related to adjusting portfolios, asset allocation, or portfolio modeling do not qualify as brokerage as they are not integral to the execution of orders. Managers also are not permitted to use client commissions to meet their compliance responsibilities, such as analyzing the quality of executions for best execution purposes, or to satisfy trade financing obligations such as stock lending fees, or for capital introduction and margin services, as these services are not sufficiently related to order execution. Similarly, error correction trades or related services are not related to the initial trade since they are separate transactions to correct the manager’s error, not to benefit the advised account, and thus are not eligible brokerage services under the safe harbor.

The Securities and Exchange (“SEC”) or the Commission has interpreted Section 28(e) as encompassing commissions on agency transactions, as well as fees on riskless principal transactions in which both legs are

¹ Short-term custody related to effecting particular transactions and clearance and settlement of those trades fall within the safe harbor because the custody is tied to processing the trade between the time the order is placed and settled. However, long-term custody and custodial recordkeeping provided post-settlement, relating to long-term maintenance of securities positions, are not within the safe harbor and are not considered incidental to effecting securities transactions.

executed at the same price and the transactions are reported under trade reporting rules of the Financial Industry Regulatory Authority. The safe harbor is not available for other principal trades (including fixed income trades that are not executed on an agency basis) or transactions in other instruments traded net with no explicit commissions.² Further, client-directed brokerage transactions (whether to recapture a portion of the commission for the client or to pay client expenses such as sub-transfer agent fees, consultants' fees, or for administrative services) do not fall within Section 28(e) because the safe harbor is available only to persons who are exercising investment discretion.³

B. Research Services

Under Section 28(e)(3), a person provides research services insofar as he or she (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.

The SEC has said that a common element among advice, analyses, and reports is that each contains the expression of reasoning or knowledge about the subject matter. The content may be original research or a synthesis, or compilation of the research of others. Thus, in determining whether a product or service is eligible as research under Section 28(e), the money manager must conclude that it reflects the expression of reasoning or knowledge and relates to the subjects identified in Section 28(e)(3)(A) or (B) pertaining to securities and related matters. Under this standard, traditional research reports analyzing the performance of a particular company or stock clearly would be eligible, as would reports on other topics related to securities and the financial markets, such as a report concerning political factors impacting on securities and markets. In addition, discussions with research analysts, meetings with corporate executives to obtain oral reports on the performance of a company, corporate governance research and corporate governance rating services, software that provides analyses of securities portfolios as well as seminars and conferences all may be eligible under Section 28(e) so long as they reflect the expression of reasoning or knowledge relating to securities or the advisability of investing in securities.

SEC guidance distinguishes the eligibility of certain publications under Section 28(e) based on the audience to which they are marketed. Ineligible publications include those that are mass-marketed – *i.e.*, publications intended for and marketed to a broad, public audience – which are more appropriately considered as overhead expenses of money managers. On the other hand those publications marketed to a narrow audience, such as financial newsletters, trade magazines or technical journals which serve the specialized interests of a narrow group, may be paid for with client commission dollars. The method of distribution – for example, by e-mail or internet posting – does not necessarily determine whether a publication is mass-marketed. The focus is on the audience and the manner in which it is marketed in general.

C. “Mixed-Use” Items

In order for a product or service to be within the safe harbor, it must not only satisfy the specific criteria of the statute, but also must provide the money manager with lawful and appropriate assistance in making investment decisions. This standard focuses on how the manager uses the research. Where research products and services have mixed use – *i.e.* certain of them appropriately assist in the decision making process with respect to clients, while others do not – a money manager should make a reasonable allocation of the cost of the product according to its use. The money manager must keep adequate books and records concerning allocations in order to make the required good faith determination.

² *Id.* at 11 n.27.

³ *Id.*

Products or services that do not reflect the expression of reasoning or knowledge, including products with inherently tangible or physical attributes (such as telephone lines, office furniture or computer hardware),⁴ are not eligible research under the safe harbor. A money manager's operational overhead expenses would not constitute eligible research services. Excluded items include travel expenses, entertainment, and meals associated with attending seminars that may qualify as research or trips to meet with the corporate executives whose reports are within the safe harbor. Similarly, 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 are other examples of overhead items that are not eligible under the safe harbor.

As noted above, even if a money manager properly concludes that a particular product or service is analysis, advice or a report that reflects the expression of reasoning or knowledge, it would be eligible research only if the subject matter of the product or service falls within the categories specified in Section 28(e)(3)(A) and (B). Thus, for example, consultants' services may be eligible for the safe harbor if the consultant provides advice with respect to portfolio strategy, but such services would not be eligible if the advice relates to the managers' internal management or operations. Advice, analyses and reports regarding the market for securities, or market research, may be eligible under the safe harbor if they otherwise satisfy the research criteria. For example, pre-trade and post-trade analytics, including trade analytics transmitted through an OMS, software and other products that depend on market information to generate market research, including research on optimal execution venues and trading strategies, may be eligible. 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), also may be eligible research.

Data services, such as those that provide market data or economic data, including stock quotes, last sale prices, and trading volumes, contain substantive content and constitute "reports concerning . . . securities" under Section 28(e)(3)(B) and thus would be eligible as research services under the safe harbor. Other data would similarly be eligible research under the safe harbor if it reflects substantive content – related to the subject matter identified in the statute. For example, company financial data and economic data (such as unemployment and inflation rates or gross domestic product figures) would be eligible as research.

However, if any of these products and services also contain non-eligible brokerage or research or if they are not used in a way that provides assistance in investment decision making, they may be mixed-use items subject to payment by the money manager directly for the in-eligible portion of the offerings.

Proxy services, including research and voting products and services provided by proxy service providers, may be treated as mixed-use items, as appropriate. For example, reports and analyses on issuers, securities, and the advisability of investing in securities that are transmitted through a proxy service provider may be within Section 28(e), while products or services offered by a proxy service provider that handle mechanical aspects of voting, such as casting, counting, recording and reporting votes, are administrative overhead expenses of the manager and are ineligible under Section 28(e).

⁴ Reversing a 1986 interpretative position, the SEC stated in the Section 28(e) Release that computer hardware and computer accessories, while perhaps assisting in the delivery of research, would not be eligible research services because they do not reflect substantive content related in any way to making decisions about investing. The peripherals and delivery mechanisms associated with computer hardware, including telecommunications lines, transatlantic cables, and computer cables, are also outside the research services safe harbor. See Section 28(e) Release, at 33.

III. Good Faith Determination as to Reasonableness

Section 28(e) requires a money manager to make a good faith determination that the commissions paid are reasonable in relation to the value of the brokerage and research services received. The burden of proof in demonstrating this good faith determination rests with the money manager. A money manager satisfies its Section 28(e) obligation in this regard if he or she honestly believes the amount of commissions paid is reasonable in relation to the value of the research or brokerage product or service received, either in terms of the particular transaction or the manager's overall responsibilities for discretionary accounts.

Under this analysis, a money manager may purchase an eligible item of research with client commissions if he or she finds the research valuable in formulating investment decisions, while another money manager could not rely on Section 28(e) to acquire the very same item if he or she does not use the item for investment decisions or determines that the commissions paid are not reasonable for the service.

A money manager may not obtain eligible products, such as market data, to camouflage the payment of higher commissions to broker-dealers for ineligible services, such as mutual fund shelf space or client referrals. Further, if research products or services that are eligible under Section 28(e)(3) have been simply copied, repackaged, or aggregated, the money manager must make a good faith determination that any additional commissions paid in respect of such copying, repackaging, or aggregation services are reasonable. Finally, where a broker-dealer also offers its research for an unbundled price, that price should inform the money manager as to its market value and help the manager make its good faith decision.

IV. Third-Party Research and Client Commission Arrangements

A. "Provided by" the Broker-Dealer

The 28(e) safe harbor encompasses third-party research and proprietary research on equal terms. However, it requires that the broker-dealer receiving commissions for effecting transactions must "provide" brokerage or research services. The SEC has interpreted this to permit money managers to use soft dollars to pay for research produced by someone other than the executing broker-dealer (third-party research). Research is "provided by" a broker-dealer if the broker-dealer (i) prepares the research; (ii) is financially obligated to pay for the research; or (iii) is not financially obligated to pay for the research but such broker-dealer pays the research provider directly. The broker-dealer takes steps to assure itself that the client commission dollars that the manager directs it to use to pay for such services are used only for eligible brokerage and research.⁵ Third party research is eligible under the safe harbor even if the money manager participates in its selection. The third party also may send the research directly to the broker-dealer's customer.

B. Effecting Transactions

Section 28(e) requires that the broker-dealer providing the research also be involved in "effecting" the trade. This provision is intended to preclude the paying of "give-ups," a practice developed during the fixed commission era in which a portion of the commission charged by the executing broker-dealer was paid to another broker-dealer that had no role in performing the trade generating the commission, but, instead, was being paid for services such as steering clients to the money manager, that benefited the manager exclusively.

⁵ See Section 28(e) Release, at 7. The Section 28(e) Release identifies the following steps to ensure that the "provided by" element is satisfied and the safe harbor may be used: (i) the broker-dealer pays the research preparer directly; (ii) the broker-dealer reviews the description of the services to be paid for with client commissions for red flags that indicate the services are not eligible research or brokerage services and agrees with the money manager to use soft dollars only to pay for those items that reasonably fall within the safe harbor; and (iii) the broker-dealer develops and maintains procedures so that research payments are documented and paid for promptly.

In 1986, however, the SEC indicated that payment of a part of a commission by an executing or clearing broker-dealer to an introducing broker would not necessarily be a give-up outside the protection of Section 28(e). Today it's common for money managers to use commission sharing arrangements to execute trades with one broker-dealer and obtain research and other brokerage services from another broker-dealer. Where more than one broker-dealer is involved in a commission sharing arrangement, the SEC takes the view that the second broker must be engaged in securities activities of a more extensive nature than merely the receipt of commissions paid to it for research provided to money managers. The fact that the parties to a commission sharing arrangement have a clearing agreement prepared in accordance with NYSE or NASD requirements is not dispositive of whether the "effecting" requirement has been met. To satisfy 28(e), each broker-dealer must play a role in effecting the money manager's trades. In this regard, the SEC said that a broker-dealer that is "effecting" the trade when it performs at least one of four minimum functions and take steps to see that the other functions have been reasonably allocated to one or another of the broker-dealers in the arrangement in a manner that is fully consistent with their obligations under SRO and SEC rules. The four functions are: (1) taking financial responsibility (*i.e.*, be at risk for the customer's failure to pay) for all customer trades until the clearing broker-dealer has received payment (or securities); (2) making and/or maintaining records relating to its customer trades required by SEC and SRO rules, including blotters and memoranda of orders; (3) monitoring and responding to customer comments concerning the trading process; and (4) generally monitoring trades and settlements. Notwithstanding these functions, a broker-dealer is deemed to be effecting transactions if it is executing, clearing or settling the trade.

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