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THE SEC'S NEW SOFT DOLLAR RULES: FULL AND CANDID DISCLOSURE IS STILL THE SAFEST BET

After years of deliberation, the Securities and Exchange Commission issued its new soft dollar rules on July 24, 2006. The Interpretive Release (the "Release") provides new guidance on how money managers' use of soft dollars will qualify for the "brokerage and research services" safe harbor in Section 28(e) of the Securities Exchange Act of 1934.

THE FUSS

The securities industry is likely greeting the new rules with both a collective sigh of relief and a yawn. The relief is that the SEC - long known to dislike soft dollars - did not attempt to curtail if not eliminate the practice. The yawn is that the Release does little to change the need for money managers to err on the side of disclosing their soft dollar practices in a full and candid manner.

The backdrop for assessing soft dollar practices is the fiduciary duties that money managers have to seek the best execution for client securities trades. A conflict of interest arises when a money manager uses his or her clients' assets (the commission fees paid for securities trades) and obtains from the executing broker products or services that the manager uses to benefit other clients or even the manager. Thus, the receipt of soft dollars creates a question of whether the manager has received best execution for a particular client on a particular trade - another area begging for clarity but beyond the scope of this update.

To avoid potential conflicts of interest, money managers have relied on the Section 28(e) safe harbor. Section 28(e) allows managers to use client funds to purchase "brokerage and research services" (i.e., soft dollars) without breaching fiduciary duties if the managers determine in good faith that the amount of the commission was reasonable in relation to the value of the brokerage and research services the client received. Any brokerage products or services that do not qualify for the safe harbor must be disclosed to the clients whose commissions are used to obtain these other products and services.

What did the SEC think was not working? For one, SEC audits of money managers found consistent under-disclosure of non-research-related soft dollar practices and resulting creative arguments by managers that a particular service was in fact "research." (Free rent anyone? Boondoggle to Bermuda for a "seminar?") The SEC also believed that new technologies and evolving trading techniques rendered the existing soft dollar rules more or less obsolete. The SEC, therefore, wanted to bring clarity as to what constitutes "brokerage and research services" under the safe harbor. Our view is that, while it does a good job clarifying the middle, the Release does not establish bright lines on the edges. And that is where most money managers need better clarity. As a result, unless a manager is confident a particular soft dollar product or service qualifies for the safe harbor, then he or she should continue to err on the side of disclosure.

THE MUSS

The Release recommends that money managers use a three-step analysis to assess whether a brokerage product or service qualifies for the Section 28(e) safe harbor:

1. The application of relevant eligibility criteria;
2. The manager's lawful and appropriate use of the eligible service or product; and
3. The manager's good faith determination that the commissions paid are reasonable in light of the value of research services received.

Step 1: Are the Services and/or Products Eligible Under the Safe Harbor?

Money managers may use client commissions to pay only for eligible “brokerage and research services.”

Eligible Brokerage Services and Products. To satisfy the safe harbor, brokerage services and products must relate to trade execution from the point when the manager communicates with the broker for the purpose of transmitting a trade order through the point when funds or securities are delivered or credited to the client account. Eligible services and products include functions incidental to effecting securities transactions, such as clearance, settlement, custody, and related communications. Trading software used to route orders and algorithmic trading software are also considered eligible brokerage services.

Conversely, order management systems and hardware (e.g., telephones or computer terminals), trade analytics, surveillance systems, and compliance mechanisms are not eligible, because they are not integral to the broker’s execution of orders.

Eligible Research Services and Products. Research services and products fall within the safe harbor if they: i) provide *advice*, either directly or through publications or writings, as to the value of securities, the advisability of buying or selling securities, and the availability of securities; or ii) furnish *analyses* and *reports* concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts. Eligible advice, analyses, and reports must provide substantive content or what the Release calls “the expression of reasoning or knowledge,” i.e., “intellectual content.”

Money managers may use soft dollars to obtain traditional company research reports, market research, advice on market color and execution strategies, market data, and trade analytics. Financial newsletters and trade journals, computer software that provides securities or quantitative analysis, and seminars or conferences may be eligible, depending on the subject matter.

Research services and products failing to reflect the “expression of reasoning or knowledge” are not eligible, since they principally benefit managers rather than clients. Thus, (i) mass-marketed publications, (ii) computer hardware and accessories, and (iii) overhead costs such as travel expenses, entertainment, and meals associated with attending seminars and the salaries of research staff are not eligible even if they assist in the delivery of research. In other words, while the “intellectual content” of research is eligible, the means by which the research is provided is not.

Mixed-Use Services or Products. Mixed-use services or products obtained with soft dollars must be reasonably allocated between eligible and ineligible uses. For example, an allocable portion of the cost of portfolio performance evaluation services or reports may be eligible as research, but money managers must use their own funds to pay for the allocable portion of such services or reports that is used for marketing purposes. Trade analytical software (which may sometimes be put to administrative use), proxy voting services, and order management systems may qualify as mixed-use products. Money managers must maintain adequate documentation regarding mixed-use services or products, so as to provide a basis on which to determine the allocation and to prove to SEC examiners that the money manager has made a good faith effort to arrive at a reasonable allocation.

Commission Sharing Arrangements. Money managers sometimes obtain soft dollar services or products pursuant to commission-sharing arrangements. These exist when a manager executes trades with one broker and obtains research or other services from a different broker. Managers should determine whether the involvement of multiple brokers benefits the client and is necessary to effect a trade. The safe harbor is available when a manager uses a broker that is involved in “effecting” the manager’s trades and “provides” the research. Thus, to be “effecting” transactions, the broker must either execute, clear, or settle the trade or perform one of four specified functions and allocate the other functions to other brokers. The safe harbor is also available if the pertinent broker is either legally obligated to pay for the research or pays the research preparer directly and ensures that the services to be paid for with client commissions are within the safe harbor.

Step 2: Does the Service or Product Provide “Lawful and Appropriate Assistance” in the Manager’s Investment Decision-Making Process?

To qualify for the safe harbor, brokerage or research products or services must provide money managers with “lawful and appropriate assistance” in making investment decisions. For example, managers may use soft dollars to pay for analyses of account performance, which is an eligible service because it reflects the requisite intellectual content. Such service falls within the safe harbor if used for assistance in investment decision-making responsibilities but falls outside the safe harbor if used for marketing purposes.

Step 3: Reiteration of the Good Faith Value Determination.

The Release reiterates the statutory requirement that money managers must determine in good faith that the commissions they pay are reasonable in relation to the value of the brokerage and research services and/or products they obtain from the broker-dealer. This determination is subjective and may not yield the same answer in circumstances that appear to be the same.

THE WHEN

The Interpretive Release became effective upon publication in the Federal Register on July 24, 2006, but market participants may rely on prior SEC guidance for the six-month period following publication.

THE WHAT NOW

Money managers should use the Release’s three-step analytical process to review the nature and extent of their current soft dollar arrangements. Based on what they conclude from their analysis, the managers must ensure they have made appropriate soft dollar disclosure in their Form ADVs, hedge fund offering documents, and marketing materials.

Be careful. If a manager incorrectly concludes that a service or product is within the safe harbor, he or she may wind up providing inadequate disclosure. Accordingly, be certain that an arrangement falls squarely within the safe harbor if you plan not to disclose it either at all or with particularity. If it does not, make full and candid disclosure.

We also note that the Release’s three-step analysis will assist money managers of registered investment companies and pension funds subject to ERISA in determining whether they are complying with the Investment Company Act and ERISA. This determination is imperative, since use of client commissions to pay for products that are outside the safe harbor may violate these other laws.

The Release is available at <http://www.sec.gov/rules/interp/2006/34-54165.pdf>.

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