

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 241

[Release No. 34-52635; File No. S7-09-05]

### Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed interpretation; request for comment.

**SUMMARY:** The Securities and Exchange Commission is publishing for comment this interpretive release with respect to client commission practices under Section 28(e) of the Securities Exchange Act of 1934 (“Exchange Act”). Section 28(e) of the Exchange Act establishes a safe harbor that allows money managers to use client funds to purchase “brokerage and research services” for their managed accounts under certain circumstances without breaching their fiduciary duties to clients. In light of the Commission’s experience with Section 28(e) and in recognition of changing market conditions, the Commission is proposing to provide further guidance on money managers’ use of client assets to pay for research and brokerage services under Section 28(e) of the Exchange Act. This release also reiterates the statutory requirement that money managers must make a good faith determination that commissions paid are reasonable in relation to the value of the products and services provided by broker-dealers and that broker-dealers must be financially responsible for the brokerage and research products that they provide to money managers and must be involved in “effecting” the trade.

**DATES:** Comments should be received on or before November 25, 2005.

**ADDRESSES:** Comments may be submitted by any of the following methods:

#### Electronic Comments

- Use the Commission’s Internet comment form (<http://www.sec.gov/rules/interp.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-09-05 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

#### Paper Comments

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities

and Exchange Commission, 100 F Street, NE., Washington, DC 20549-9303.

All submissions should refer to File Number S7-09-05. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission’s Internet Web site (<http://www.sec.gov/rules/interp.shtml>). Comments are also available for public inspection and copying in the Commission’s Public Reference Room, 100 F Street, NE., Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** Jo Anne Swindler, Assistant Director, at (202) 551-5750; Patrick M. Joyce, Special Counsel, at (202) 551-5758; Stanley C. Macel, IV, Special Counsel, at (202) 551-5755; or Marlon Quintanilla Paz, Special Counsel, at (202) 551-5756, in the Office of Enforcement Liaison and Institutional Trading, Division of Market Regulation, United States Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-6628.

#### SUPPLEMENTARY INFORMATION:

##### I. Introduction and Summary

Section 28(e) of the Exchange Act establishes a safe harbor that allows money managers to use client funds to purchase “brokerage and research services” for their managed accounts under certain circumstances without breaching their fiduciary duties to clients. In this release, the Commission is proposing to issue interpretive guidance with respect to the safe harbor, with the particular goal of clarifying the scope of “brokerage and research services” in the light of evolving technologies and industry practices. The Commission invites public comment on its proposed interpretive guidance.

Fiduciary principles require money managers to seek the best execution for client trades, and limit money managers from using client assets for their own benefit.<sup>1</sup> Use of client commissions to

<sup>1</sup> An adviser has a fundamental obligation under the Investment Advisers Act of 1940 (“Advisers Act”) [15 U.S.C. 80b-1] and state law, to act in the best interest of his client. See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 189-191 (1963). “As a fiduciary, a money manager has an obligation to obtain ‘best execution’ of clients’ transactions under the circumstances of the particular transaction.” Exchange Act Release No. 23170 (Apr. 23, 1986), 51 FR 16004, 16011 (Apr. 30, 1986) (“1986 Release”). See also *Delaware*

pay for research and brokerage services presents money managers with significant conflicts of interest, and may give incentives for managers to disregard their best execution obligations when directing orders to obtain client commission services as well as to trade client securities inappropriately in order to earn credits for client commission services.<sup>2</sup> Recognizing the value of research in managing client accounts, however, Congress enacted Section 28(e)<sup>3</sup> of the Securities Exchange Act of 1934 (“Exchange Act”)<sup>4</sup> to provide a safe harbor that protects money managers from liability for a breach of fiduciary duty solely on the basis that they paid more than the lowest commission rate in order to receive “brokerage and research services” provided by a broker-dealer if the managers determined in good faith that the amount of the commission was reasonable in relation to the value of the brokerage and research services received.<sup>5</sup>

As discussed below in Part II, over the past thirty years, the Commission has issued several releases interpreting the Section 28(e) safe harbor. In 1998, the Commission published a report of its Office of Compliance Inspections and Examinations (“OCIE”) detailing a staff review of client commission practices at

*Management Co.*, 43 SEC 392, 396 (1967). The fundamental obligation of the adviser to act in the best interest of his client also generally precludes the adviser from using client assets for the adviser’s own benefit or the benefit of other clients, at least without client consent. See Restatement (Second) of Trusts Section 170 cmt. a, Section 216 (1959).

<sup>2</sup> Exchange Act Release No. 35375 (Feb. 14, 1995), 60 FR 9750, 9751 (Feb. 21, 1995) (“1995 Rule Proposal”) (the Commission took no further action on this proposal). See also *Sage Advisory Services LLC*, Exchange Act Release No. 44600, 75 SEC Docket 1073 (July 27, 2001) (Commission charged that adviser churned advised account to generate client commission credits to pay personal operating expenses and failed to seek to obtain best execution by causing account to pay commissions twice the rate the same broker charged other customers for comparable services).

To avoid confusion that may arise over the usage of the phrase “soft dollars,” in this release, the Commission uses the term “client commission” practices or arrangements to refer to practices under Section 28(e).

<sup>3</sup> 15 U.S.C. 78bb(e).

<sup>4</sup> 15 U.S.C. 78a.

<sup>5</sup> See Securities Acts Amendments of 1975, Pub. L. 94-29, 89 Stat. 97, 161-62 (1975).

Congressional enactment of Section 28(e) did not alter the money manager’s duty to seek best execution. See 1986 Release, 51 FR at 16011. The directors of an investment company have a continuing fiduciary duty to oversee the company’s brokerage practices. See *Investment Company Act Release No. 11662* (Mar. 4, 1981), 46 FR 16012 (Mar. 10, 1981). In addition, the directors have an obligation in connection with their review of the fund’s investment advisory contract to review the adviser’s compensation, including any “soft dollar” benefits the adviser may receive from fund brokerage. See 1986 Release, 51 FR at 16010.

broker-dealers and investment advisers. The Commission also has brought enforcement actions involving client commission practices.<sup>6</sup>

In light of the Commission's experience with Section 28(e) and in recognition of changing market conditions, the Commission is proposing to provide further guidance on money managers' use of client assets to pay for research and brokerage services under Section 28(e) of the Exchange Act.<sup>7</sup> This release would interpret the scope of the safe harbor as follows:

- Eligibility of brokerage and research services for safe harbor protection is governed by the criteria in Section 28(e)(3),<sup>8</sup> consistent with the Commission's 1986 "lawful and appropriate assistance" standard.

- "Research services" are restricted to "advice," "analyses," and "reports" within the meaning of Section 28(e)(3).

- Physical items, such as computer hardware, which do not reflect the expression of reasoning or knowledge relating to the subject matter identified in the statute, are outside the safe harbor.

- Market, financial, economic, and similar data would be eligible for the safe harbor.

- "Brokerage services" within the safe harbor are those products and services that relate to the execution of the trade from the point at which the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution, through the point at which funds or securities are delivered or credited to the advised account.

- Mixed-use items must be reasonably allocated between eligible and ineligible uses, and the allocation must be documented so as to enable the money manager to make the required good faith determination of the reasonableness of commissions in relation to the value of brokerage and research services.

This release reiterates the statutory requirement that money managers must make a good faith determination that commissions paid are reasonable in relation to the value of the products and services provided by broker-dealers in connection with the managers'

responsibilities to the advisory accounts for which the managers exercise investment discretion.

Finally, the release reiterates that under Section 28(e), broker-dealers must be financially responsible for the brokerage and research products that they provide to money managers, and they must be involved in "effecting" the trade.

## II. "Brokerage and Research Services" Under Section 28(e) of the Exchange Act

### A. *Origins of the Section 28(e) Safe Harbor*

In the early 1970s, the Commission studied whether to require unfixing commission rates on national exchanges, which had been fixed by custom and regulation since the founding of the New York Stock Exchange nearly two hundred years earlier.<sup>9</sup> At the same time, the House and Senate began to consider whether to eliminate fixed commission rates legislatively.<sup>10</sup> The Commission adopted Rule 19b-3 under the Exchange Act,<sup>11</sup> which ended fixed commission rates on national securities exchanges effective May 1, 1975.<sup>12</sup> Just one month later, Congress passed legislation unfixing commission rates as part of the Securities Acts Amendments of 1975 ("1975 Amendments").<sup>13</sup>

In the era of fixed rates, when broker-dealers could not compete on the basis of the commissions that they could charge for executing orders, they competed on the basis of services including non-execution services that

they could offer.<sup>14</sup> Indeed, broker-dealers had long been accustomed to attracting order execution business from institutional money managers by offering them brokerage functions and research reports to distinguish their services from those of their competitors.<sup>15</sup> As the end of the fixed-rate era drew near, however, money managers and broker-dealers alike questioned how competition over commission rates would disrupt these practices. Institutional money managers expressed concern that, in an environment of competitive commission rates, they would be forced to allocate brokerage solely on the basis of lowest execution costs, or that paying more than the lowest commission rate would be deemed a breach of fiduciary duty, and that useful research might become more difficult to obtain.<sup>16</sup> Broker-dealers, which were accustomed to producing proprietary "Street" research, expressed concern that they could no longer be compensated in commissions for their work product if orders were routed to broker-dealers that provided execution-only service at lower rates.<sup>17</sup>

In an effort to address the industry's uncertainties about competitive commission rates, Congress included a safe harbor in the 1975 Amendments, codified as Section 28(e) of the Exchange Act.<sup>18</sup> The safe harbor provides generally that a money manager does not breach his fiduciary duties under state or federal law solely on the basis that the money manager has paid brokerage commissions to a broker-dealer for effecting securities transactions in excess of the amount

<sup>9</sup> See U.S. Securities and Exchange Commission, *Institutional Investor Study Report*, H.R. Doc. No. 64, 92d Cong., 1st Sess., Vol. 4, at 2206 (1971). See also U.S. Securities and Exchange Commission, *Special Study of Securities Markets*, H.R. Doc. No. 88-95, pt. 2, at 323 (1963) ("Special Study").

<sup>10</sup> See generally Senate Comm. on Banking, Housing and Urban Affairs, *Securities Industry Study Report of the Subcommittee on Securities*, S. Doc. No. 93-13 (1973).

<sup>11</sup> 17 CFR 240.19b-3. Rule 19b-3 was codified in certain respects by Section 6(e)(1) of the Exchange Act [15 U.S.C. 78f(e)(1)], which was enacted as part of the Securities Acts Amendments of 1975, Pub. L. 94-29, 89 Stat. 97, 107-08 (1975). See also Exchange Act Release No. 26180 (Oct. 14, 1988), 53 FR 41205 (Oct. 20, 1988) (rescinding Rule 19b-3).

<sup>12</sup> See Exchange Act Release No. 11203 (Jan. 23, 1975), 40 FR 7394 (Feb. 20, 1975).

<sup>13</sup> See Securities Acts Amendments of 1975, Pub. L. 94-29, 89 Stat. 97, 107-08 (1975) (enacting Section 6(e)(1) of the Exchange Act [15 U.S.C. 78f(e)(1)]). See generally Senate Comm. on Banking, Housing and Urban Affairs, *Securities Acts Amendments of 1975*, S. Rep. No. 94-75, at 69 (1975), reprinted in 1975 U.S.C.C.A.N. 179, 247; House Comm. on Interstate and Foreign Commerce, *Securities Reform Act of 1975*, H.R. Rep. No. 94-123 (1975); Joint Explanatory Statement of the Comm. of Conference, *Securities Acts Amendments of 1975*, H.R. Conf. Rep. No. 94-229, at 108 (1975), reprinted in 1975 U.S.C.C.A.N. 321, 338.

<sup>14</sup> See Exchange Act Release No. 12251 (Mar. 24, 1976), 41 FR 13678, 13679 (Mar. 31, 1976) ("1976 Release").

<sup>15</sup> See Special Study, H.R. Doc. No. 88-95, pt. 2, at 321.

<sup>16</sup> See 1995 Rule Proposal, 60 FR at 9750; Report of Investigation in the Matter of Investment Information, Inc. Relating to the Activities of Certain Investment Advisers, Banks, and Broker-Dealers, Exchange Act Release No. 16679, 19 SEC Docket 926, 931 (Mar. 19, 1980) ("III Report"); 1976 Release, 41 FR at 13679.

<sup>17</sup> *Securities Acts Amendments of 1975: Hearings on S. 249 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 94th Cong., 1st Sess. 329-31 (1975) ("S. 249 Hearings") (Combined statement of Baker, Weeks & Co., Inc., Donaldson, Lufkin & Jenrette Sec. Corp., Mitchell, Hutchins Inc., and Oppenheimer & Co.).

<sup>18</sup> See Securities Acts Amendments of 1975, Pub. L. 94-29, 89 Stat. 97, 161-62 (1975). Section 28(e) [15 U.S.C. 78bb(e)] governs the conduct of all persons who exercise investment discretion with respect to an account, including investment advisers, mutual fund portfolio managers, fiduciaries of bank trust funds, and money managers of pension plans and hedge funds. The scope of Section 28(e) therefore extends to entities that are within the jurisdiction of the Board of Governors of the Federal Reserve, the Office of the Comptroller of the Currency, the Department of Labor, and the Office of Thrift Supervision.

<sup>6</sup> See *infra* note 25.

<sup>7</sup> 15 U.S.C. 78bb(e). The Commission also is considering whether at a later time to propose requirements for disclosure and recordkeeping of client commission arrangements.

In 2004, Chairman William H. Donaldson created an agency-wide Task Force on Soft Dollars, which conducted a thorough review of client commission practices.

<sup>8</sup> 15 U.S.C. 78bb(e)(3).

another broker-dealer would have charged, if the money manager determines in good faith that the amount of the commissions paid is reasonable in relation to the value of the brokerage and research services provided by such broker-dealer.

As fiduciaries, money managers are obligated to act in the best interest of their clients, and cannot use client assets (including client commissions) to benefit themselves, absent client consent.<sup>19</sup> Money managers who obtain brokerage and research services with client commissions do not have to purchase those services with their own funds, which creates a conflict of interest for the money managers. Section 28(e) addresses these conflicts by permitting money managers to pay higher commissions on behalf of a client than otherwise are available to obtain brokerage and research services, if managers make their good faith determination regarding the reasonableness of commissions paid.<sup>20</sup> Conduct not protected by Section 28(e) may constitute a breach of fiduciary duty as well as a violation of the federal securities laws, particularly the Investment Advisers Act of 1940<sup>21</sup> and

<sup>19</sup> See *supra* note 1.

<sup>20</sup> The Commission has interpreted Section 28(e) as encompassing client commissions on agency transactions and fees on certain riskless principal transactions that are reported under NASD trade reporting rules. Exchange Act Release No. 45194 (Dec. 27, 2001), 67 FR 6, 7 (Jan. 2, 2002) (“2001 Release”). Managers may not use client funds to obtain brokerage and research services under the safe harbor in connection with fixed income trades that are not executed on an agency basis, principal trades (except for certain riskless principal trades), or other instruments traded net with no explicit commissions.

Further, 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) “clearly do not fall within the safe harbor of Section 28(e)” because “[t]he safe harbor is available only to persons who are exercising investment discretion.” 1986 Release, 51 FR at 16011. “A pension plan sponsor that has retained a money manager to make investment decisions, as is the case in directed brokerage arrangements, is not exercising investment discretion.” *Id.* Similarly, a mutual fund that has retained a money manager to make investment decisions is not exercising investment discretion. Unlike client commission arrangements that raise conflict of interest concerns addressed by Section 28(e), directed brokerage arrangements do not raise these concerns because they typically involve use of a fund’s commission dollars to obtain services that directly and exclusively benefit the fund. See Payment for Investment Company Services with Brokerage Commissions, Securities Act Release No. 7197 (July 21, 1995), 60 FR 38918 (July 28, 1995). The Commission has recently prohibited funds from using brokerage to pay for distribution. See Investment Company Act Release No. 26591 (Sept. 2, 2004), 69 FR 54728 (Sept. 9, 2004).

<sup>21</sup> 15 U.S.C. 80b–1. See 1986 Release, 51 FR at 16008–09 (discussing the principal provisions of the Advisers Act and rules and forms thereunder

the Investment Company Act of 1940 (“Investment Company Act”),<sup>22</sup> and the Employee Retirement Income Security Act of 1974 (“ERISA”).<sup>23</sup> In particular, money managers of registered investment companies and pension funds subject to ERISA may violate Section 17(e)(1) of the Investment Company Act or ERISA, respectively, unless they satisfy the requirements of the Section 28(e) safe harbor.<sup>24</sup>

### *B. Previous Commission Guidance on the Scope of Section 28(e)*

The Commission has issued three interpretive releases under Section 28(e) and a report pursuant to Section 21(a) of the Exchange Act that addresses issues associated with Section 28(e).<sup>25</sup> We discuss these below.

that impose disclosure and other obligations on investment advisers and related persons).

<sup>22</sup> 15 U.S.C. 80a–1. See 1986 Release, 51 FR at 16009 (discussing the principal provisions of the Investment Company Act and rules and forms thereunder that impose disclosure and other obligations on investment advisers of registered investment companies and related persons).

<sup>23</sup> Employee Retirement Income Security Act of 1974, 29 U.S.C. 1001. See also *Statement of Policies Concerning Soft Dollar and Directed Commission Arrangements*, ERISA Technical Release No. 86–1, [1986–87 Decisions] Fed. Sec. L. Rep. ¶ 84,009 (May 22, 1986).

<sup>24</sup> Section 17(e)(1) of the Investment Company Act [15 U.S.C. 80a–17(e)(1)] generally makes it unlawful for any affiliated person of a registered investment company to receive any compensation for the purchase or sale of any property to or for the investment company when that person is acting as an agent for the company other than in the course of that person’s business as a broker-dealer. Essentially, Section 17(e)(1) may be violated if an affiliated person of a registered investment company, such as an adviser, receives compensation for the purchase or sale of property to or from the investment company. Absent the protection of Section 28(e), an investment adviser’s receipt of compensation under a client commission arrangement for the purchase or sale of any property, including securities, to or for the investment company may constitute a violation of Section 17(e)(1). See *U.S. v. Deutsch*, 451 F.2d 98, 110–11 (2d Cir. 1971), cert. denied, 404 U.S. 1019 (1972). If a client commission arrangement is not consistent with Section 28(e), disclosure of the arrangement would not cure any Section 17(e)(1) violation. See 1986 Release, 51 FR at 16010 n.55.

<sup>25</sup> See 2001 Release; 1986 Release; 1976 Release; III Report. In addition, the Commission has charged money managers and broker-dealers with violations of the federal securities laws in circumstances in which they did not act within the safe harbor and defrauded investors. See, e.g., *Portfolio Advisory Services, LLC, and Cedd L. Moses*, Advisers Act Release No. 2038, 77 SEC Docket 2759–31 (June 20, 2002); *Dawson-Samberg Capital Management, Inc. and Judith A. Mack*, Advisers Act Release No. 1889, 54 SEC 786 (Aug. 3, 2000); *Founders Asset Management LLC and Bjorn K. Borgen*, Advisers Act Release No. 1879, 54 SEC 762 (June 15, 2000); *Marvin & Palmer Associates, Inc., et al.*, Advisers Act Release No. 1841, 70 SEC Docket 1643 (Sept. 30, 1999); *Fleet Investment Advisors, Inc.*, Advisers Act Release No. 1821, 70 SEC Docket 1217 (Sept. 9, 1999); *Republic New York Sec. Corp. and James Edward Sweeney*, Exchange Act Release No. 41036, 53 SEC 1283 (Feb. 10, 1999); *SEC v. Sweeney Capital Management, Inc.*, Litig. Release No. 15664,

### 1. 1976 Release

In 1976, the Commission issued an interpretive release stating that the safe harbor did not protect “products and services which are readily and customarily available and offered to the general public on a commercial basis.”<sup>26</sup> The Commission identified these products and services as examples of excluded items: “newspapers, magazines and periodicals, directories, computer facilities and software, government publications, electronic calculators, quotation equipment, office equipment, airline tickets, office furniture and business supplies.”<sup>27</sup>

In that release, the Commission also admonished money managers not to direct broker-dealers to make “give-up” payments, in which the money manager asked the broker-dealer, retained to effect a transaction for the account of a client, to “give up” part of the commission negotiated by the broker-dealer and the money manager to another broker-dealer designated by the money manager for whom the executing or clearing broker is not a normal and legitimate correspondent. The Commission stated that in order to be within the definition of “brokerage and research services” under Section 28(e), “it was intended \* \* \* that a research service paid for in commissions by accounts under management be provided by the particular broker which executed the transactions for those accounts.”<sup>28</sup> At the same time, the Commission acknowledged the value of third-party research by stating that, “under appropriate circumstances, [Section 28(e) might] be applicable to situations where a broker provides a money manager with research produced by third parties.”<sup>29</sup> The Commission emphasized that the money manager “should be prepared to demonstrate the required good faith determination in connection with the transaction.”<sup>30</sup>

### 2. Report in the Matter of Investment Information, Inc.

In 1980, the Commission issued a report pursuant to Section 21(a) of the

66 SEC Docket 1613 (Mar. 10, 1998), 1999 U.S. Dist. LEXIS 22298 (1999) (order granting permanent injunction and other relief); *Renaissance Capital Advisers, Inc.*, Advisers Act Release No. 1688, 66 SEC Docket 408 (Dec. 22, 1997); *Oakwood Counselors, Inc.*, Advisers Act Release No. 1614, 63 SEC Docket 2034 (Feb. 11, 1997); *S Squared Technology Corp.*, Advisers Act Release No. 1575, 62 SEC Docket 1446 (Aug. 7, 1996); *SEC v. Galleon Capital Mgmt.*, Litig. Release No. 14315, 57 SEC Docket 2593 (Nov. 1, 1994).

<sup>26</sup> 1976 Release, 41 FR at 13678.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* at 13679.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

Exchange Act following an investigation of Investment Information, Inc.'s ("III") client commission arrangements ("III Report").<sup>31</sup> III managed the client commission programs of money managers. Typically, under these arrangements, the money manager directed brokerage transactions to broker-dealers that III designated. The broker-dealers, who provided execution services only, retained half of each commission and remitted the balance to III. III retained a fee (for "services" that III provided to money managers, ostensibly for managing the client commission accounts) and credited a portion of its commission to the money manager's account. The money manager could either recapture the credited amount (*i.e.*, receive cash) for the benefit of his client or use the credit to purchase research services.<sup>32</sup> The money managers made the arrangements for acquiring the research services directly with the service vendors, and III simply paid the bills for the services as the money managers requested. The executing broker-dealers were unaware of the specific services the money managers acquired from the vendors. III was not a registered broker-dealer, and it did not perform any kind of brokerage function in the securities transactions.

The Commission found that these arrangements did not fall within Section 28(e) of the Exchange Act because the broker-dealers that were "effecting" the transactions "in no significant sense provided the money managers with research services."<sup>33</sup> They only executed the transactions and paid a portion of the commissions to III. The broker-dealers were not aware of the specific services that the managers acquired and did not pay the bills for these services. The Commission concluded that, although Section 28(e) does not require a broker-dealer to produce research services "in-house," the services must nevertheless be "provided by" the broker-dealers. The Commission found that a broker-dealer is not providing research services when it pays obligations the money manager owes to a third party. The Commission indicated that, consistent with Section 28(e), broker-dealers could arrange to have the third-party research provided directly to the money manager, with the

payment obligation falling on the broker-dealer.<sup>34</sup>

### 3. 1986 Release

Following a staff examination of client commission practices in 1984–1985, the Commission concluded that the 1976 standard was "difficult to apply and unduly restrictive in some circumstances," particularly as the types of research products and their method of delivery had proliferated and become more complex.<sup>35</sup> The Commission expressed concern that "uncertainty about the standard may have impeded money managers from obtaining, for commission dollars, goods and services" that they believed were important to making investment decisions.<sup>36</sup>

The Commission withdrew the 1976 standard and construed the safe harbor to be available to research services that satisfy the statute's definition of "brokerage and research services" in Section 28(e)(3) and provide "lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities."<sup>37</sup> We concluded that a product or service that was readily and customarily available and offered to the general public on a commercial basis nevertheless could constitute research. The 1986 Release also re-affirmed that, under appropriate circumstances, money managers may use client commissions to obtain third-party research (*i.e.*, research produced by someone other than the executing broker-dealer).<sup>38</sup> The 1986 Release also emphasized the importance of written disclosure of client commission arrangements to clients and reiterated a money manager's duty to seek best execution.

The 1986 Release also introduced the concept of "mixed use." In many cases, a product or service obtained using client commissions may serve functions that are not related to the investment decision-making process, such as accounting or marketing. Management information services, which may integrate trading, execution, accounting, recordkeeping, and other administrative matters such as measuring the performance of accounts, were noted as an example of a product that may have a mixed use. The Commission indicated that where a product has a mixed use, an investment manager should make a reasonable allocation of the cost of the

product according to its use, and should keep adequate books and records concerning the allocations.<sup>39</sup> The Commission also noted that the allocation decision itself poses a conflict of interest for the money manager that should be disclosed to the client. In the 1986 Release, the Commission stated that a money manager may use client commissions pursuant to Section 28(e) to pay for the portion of a service or specific component that assists him in the investment decision-making process, but he cannot use client commissions to pay for that portion of a service that provides him administrative assistance.<sup>40</sup>

The 1986 Release also addressed third-party research. Citing to the III Report, the Commission reaffirmed its view that, "while a broker may under appropriate circumstances arrange to have research materials or services produced by a third party, it is not 'providing' such research services when it pays obligations incurred by the money manager to the third party."<sup>41</sup> In the III Report, the Commission found that the money managers and the research vendors, rather than the broker-dealers, had made all of the arrangements for acquiring the services.<sup>42</sup>

### 4. 2001 Release

Until 2001, the Commission interpreted Section 28(e) to be available only for research and brokerage services obtained in relation to commissions paid to a broker-dealer acting in an "agency" capacity.<sup>43</sup> That interpretation meant that money managers could not rely on the safe harbor for research and brokerage services obtained in relation to fees charged by market makers when they executed transactions in a "principal" capacity. The Commission interpreted the term "commission" in Section 28(e) in this fashion because, in the Commission's view, fees on principal transactions were not quantifiable and fully disclosed in a way that would permit a money manager to determine that the fees were reasonable in relation to the value of research and brokerage services received.<sup>44</sup>

In 2001, the Nasdaq Stock Market asked the Commission to reconsider this interpretation of Section 28(e) to apply

<sup>39</sup> *Id.* at 16006.

<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

<sup>42</sup> *Id.* at 16007.

<sup>43</sup> See 2001 Release, 67 FR at 6; 1995 Rule Proposal, 60 FR at 9751 n.10; Investment Company Act Release No. 20472 (Aug. 11, 1994), 59 FR 42187, 42188 n.3 (Aug. 17, 1994).

<sup>44</sup> 2001 Release, 67 FR at 7.

<sup>31</sup> See III Report, 19 SEC Docket at 926.

<sup>32</sup> Applying the 1976 standard, the Commission found that certain services received by some participating money managers were not research services because these services were readily and customarily available and offered to the general public on a commercial basis. These included such items as periodicals, newspapers, quotation equipment, and general computer services. See III Report, 19 SEC Docket at 931 n.17.

<sup>33</sup> *Id.* at 931–32.

<sup>34</sup> *Id.* at 932.

<sup>35</sup> 1986 Release, 51 FR at 16005.

<sup>36</sup> *Id.* at 16005–06.

<sup>37</sup> *Id.* at 16006.

<sup>38</sup> *Id.* at 16007.

also to research and brokerage services obtained in relation to fully and separately disclosed fees on certain riskless principal transactions effected by National Association of Securities Dealers, Inc. ("NASD") members and reported under NASD trade reporting rules.<sup>45</sup> Based on required disclosure of fees under confirmation rules and reporting of the trade under NASD rules, the Commission determined that the money manager could make the necessary determination of the reasonableness of these charges under Section 28(e). The Commission therefore modified its interpretation of "commission" for purposes of the Section 28(e) safe harbor to encompass fees paid for riskless principal transactions in which both legs are executed at the same price and the transactions are reported under the NASD's trade reporting rules.<sup>46</sup>

#### C. 1998 Office of Compliance Inspections and Examinations ("OCIE") Report

In 1998, after OCIE conducted examinations of approximately 355 broker-dealers, advisers, and funds, the Commission published the staff's report, which described the range of products and services that advisers obtain under their client commission arrangements.<sup>47</sup> The report raised concerns about the nature of products and services that were being treated as "research," the purchase of "mixed-use" items, disclosure by advisers about their client commission arrangements, and recordkeeping.<sup>48</sup> The 1998 OCIE Report made several recommendations for improving commission practices, including that the Commission provide further guidance on the scope of the safe harbor and require better recordkeeping and enhanced disclosure of client commission arrangements and transactions.<sup>49</sup>

#### D. Report of the NASD's Mutual Fund Task Force

In 2004, the NASD Mutual Fund Task Force, composed of senior executives from mutual fund management

<sup>45</sup> See Letter from Hardwick Simmons, Chief Executive Officer, The Nasdaq Stock Market, Inc. to Harvey L. Pitt, Chairman, U.S. Securities and Exchange Commission (Sept. 7, 2001) (on file with the Commission).

<sup>46</sup> 2001 Release, 67 FR at 7.

<sup>47</sup> See Office of Compliance Inspections and Examination, U.S. Securities and Exchange Commission, *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds 3* (Sept. 22, 1998) ("1998 OCIE Report"), available at <http://www.sec.gov/news/studies/softdollar.htm>.

<sup>48</sup> 1998 OCIE Report, at 4–5.

<sup>49</sup> *Id.* at 47–52.

companies and broker-dealers, as well as representatives from the academic and legal communities, published observations and recommendations to the Commission concerning client commission practices and portfolio transaction costs.<sup>50</sup> In particular, the NASD Task Force Report recommended that the Section 28(e) safe harbor be retained, but that the interpretation of the scope of research services be narrowed to better tailor it to the types of client commission services that principally benefit the adviser's clients rather than the adviser.<sup>51</sup> The NASD Task Force Report recommended that the Commission interpret the safe harbor to protect only brokerage services as described in Section 28(e)(3) and the "intellectual content" of research, but not the means by which such content is provided.<sup>52</sup> The NASD Task Force Report suggested that this approach would exclude magazines, newspapers, and other such publications that are in general circulation to the retail public, and such items as computer hardware, phone lines, and data transmission lines.<sup>53</sup> The NASD Task Force Report emphasized that the safe harbor should encompass third-party research and proprietary research on equal terms, and recommended improved disclosure.<sup>54</sup>

<sup>50</sup> See NASD, Report of the Mutual Fund Task Force, "Soft Dollars and Portfolio Transaction Costs" (Nov. 11, 2004) ("NASD Task Force Report"), available at [http://www.nasd.com/web/groups/rules\\_regs/documents/rules\\_regs/nasdw\\_012356.pdf](http://www.nasd.com/web/groups/rules_regs/documents/rules_regs/nasdw_012356.pdf).

<sup>51</sup> NASD Task Force Report, at 5.

<sup>52</sup> NASD Task Force Report, at 6–7. The Task Force proposed that "intellectual content" be defined as "any investment formula, idea, analysis or strategy that is communicated in writing, orally or electronically and that has been developed, authored, provided or applied by the broker-dealer or third-party research provider (other than magazines, periodicals or other publications in general circulation)." *Id.* at 7.

<sup>53</sup> Specifically, the NASD Task Force indicated that its proposed definition of research services would exclude the following: computer hardware and software, unrelated to any research content or analytical tool; phone lines and data transmission lines; terminals and similar facilities; magazines, newspapers, journals, and on-line news services; portfolio accounting services; proxy voting services unrelated to issuer research; and travel expenses incurred in company visits. NASD Task Force Report, at 7.

<sup>54</sup> Regarding disclosure, the NASD Task Force Report recommended, among other things: (a) Ensuring that fund boards obtain information about a fund adviser's brokerage allocation practices and client commission services received; (b) mandating enhanced disclosure in fund prospectuses to improve investor awareness; (c) applying disclosure requirements to all types of commissions; and (d) enhancing disclosure to investors about portfolio transaction costs. NASD Task Force Report, at 4. See *infra* note 7.

#### E. United Kingdom Financial Services Authority ("FSA")

On July 22, 2005, the FSA adopted final client commission rules in conjunction with issuing policy statement PS 05/9.<sup>55</sup> The final rules describe "execution" and "research" services and products eligible to be paid for by commissions, and specify a number of "non-permitted" services that must be paid for in hard dollars, such as custody not incidental to execution, computer hardware, telephone lines, and portfolio performance measurement and valuation services.<sup>56</sup> The policy statement also acknowledges that some products and services may be permitted or non-permitted depending on how they are used by the money manager.<sup>57</sup> The rules will become effective beginning in January 2006, with a transitional period until June 2006.<sup>58</sup>

With the globalization of the world's financial markets, many U.S. market participants have a significant presence abroad, and in particular in the U.K. To the extent that the Commission's approach to client commissions is compatible with that taken in the U.K., market participants' costs of compliance with multiple regulatory regimes would be reduced. Therefore, we have taken the FSA's work into account in developing our position in this release, while recognizing the significant differences in our governing law and rules, such as the fact that the U.K. does not have a statutory provision similar to

<sup>55</sup> U.K. Financial Services Authority, Policy Statement 05/9, Bundled Brokerage and Soft Commission Arrangements: Feedback on CP 05/5 and Final Rules (July 2005) ("FSA Final Rules"), available at [http://www.fsa.gov.uk/pages/library/policy/policy/2005/05\\_09.shtml](http://www.fsa.gov.uk/pages/library/policy/policy/2005/05_09.shtml). The rules apply only to equity trades and not to fixed income trades. FSA Final Rules, at Annex, p. 6 (Conduct of Business Sourcebook Rule 7.18.1). The FSA proposed the rules in March 2005. See Consultation Paper 05/5, Bundled Brokerage and Soft Commission Arrangements: Proposed Rules (Mar. 2005) ("FSA Rule Proposal"), available at [http://www.fsa.gov.uk/pubs/cp/cp05\\_05.pdf](http://www.fsa.gov.uk/pubs/cp/cp05_05.pdf).

<sup>56</sup> See FSA Final Rules, at Annex, pp. 8–9 (Conduct of Business Sourcebook Rules 7.18.4 to 7.18.8). See also FSA Rule Proposal, at 63–64.

<sup>57</sup> FSA Final Rules, at 5. The rules also set forth the principle that investment managers should inform advisory clients how their commissions are being spent, and indicate that, in evaluating compliance with this principle, the FSA will have regard for the extent to which investment managers adopt the disclosure standards developed by industry associations such as the U.K. Investment Management Association ("IMA"). See FSA Final Rules, at Annex, p. 11 (Conduct of Business Sourcebook Rule 7.18.14). See also Investment Management Association, Pension Fund Disclosure Code, Second Edition (Mar. 2005), available at <http://www.investmentuk.org/news/standards/pfdc2.pdf>.

<sup>58</sup> FSA Final Rules, at 5. Firms may continue to comply with existing rules until the earlier of the expiration of existing agreements or June 30, 2006.

Section 28(e).<sup>59</sup> This proposed interpretive guidance is generally consistent with the FSA's rules, with a few exceptions.<sup>60</sup>

### III. Commission's Interpretive Guidance

In light of recent developments in client commission practices, evolving technologies, marketplace developments, and the observations of the staff in examinations of industry participants, we have revisited our previous guidance as to the meaning of the phrase "brokerage and research services" in Section 28(e). After careful consideration, we are proposing a revised interpretation that would replace Sections II and III of the 1986 Release.<sup>61</sup> Specifically, we are providing guidance with respect to: (i) The appropriate framework for analyzing whether a particular service falls within the "brokerage and research services" safe harbor; (ii) the eligibility criteria for "research"; (iii) the eligibility criteria for "brokerage"; and (iv) the appropriate treatment of "mixed-use" items. We also discuss the money manager's statutory requirement to make a good faith determination that the commissions paid are reasonable in relation to the value of the brokerage and research services received. Finally, we provide guidance on third-party research and commission-sharing arrangements.

Section 28(e) applies equally to arrangements involving client commissions paid to full service broker-dealers that provide brokerage and research services directly to money managers, and to third-party research arrangements where the research services and products are developed by third parties and provided by a broker-dealer that participates in effecting the transaction. Today, it remains true that, if the conditions of the safe harbor of Section 28(e) are met, a money manager

does not breach his fiduciary duties solely on the basis that he uses client commissions to pay a broker-dealer more than the lowest available commission rate for a bundle of products and services provided by the broker-dealer (*i.e.*, anything more than "pure execution").

#### A. Present Environment

In the 1986 Release, the Commission incorporated from the legislative history the phrase "lawful and appropriate assistance" to the money manager in carrying out his investment decision-making responsibilities in developing the Commission standard governing the range of brokerage and research products and services that may be obtained by a money manager within the safe harbor.<sup>62</sup> Since that time, some have construed this standard broadly to apply to services and products that are only remotely connected to the investment decision-making process. In some cases, "administrative" or "overhead" goods and services have been classified as research.<sup>63</sup> In the 1998 OCIE Report, examiners reported that 28% of the money managers and 35% of the broker-dealers that were examined had entered into at least one client commission arrangement that, in the staff's view, was outside of the scope of Section 28(e) and the 1986 Release.<sup>64</sup> In particular, OCIE examiners identified numerous examples of advisers that it believed failed to separate overhead or administrative expenses from those items that provide benefits to clients as brokerage and research services.<sup>65</sup> Examples of non-research items included: certified financial analyst (CFA) exam review courses, membership dues and professional licensing fees, office rent, utilities, phone, carpeting, marketing, entertainment, meals, copiers, office supplies, fax machines, couriers, backup generators, electronic proxy voting services, salaries, and legal and travel expenses.<sup>66</sup>

Client commissions are also used extensively to pay for mechanisms related to the delivery of research or brokerage services. In the 1998 OCIE Report, staff reported that some advisers used client commissions to pay for various peripheral items that support hardware and software, such as the power needed to run the computer and

the dedicated telephone line used to receive information into the computer.<sup>67</sup>

The products and services available to money managers have grown more varied and complex. For example, a single software product may perform an array of functions, but only some of the functions are properly "brokerage and research services" under Section 28(e). In the 1998 OCIE Report, staff reported that "the types of products available for purchase with client commissions have greatly expanded since 1986," leaving industry participants to grapple with decisions as to whether these products are "research" or "brokerage" within the safe harbor, or whether these products should be considered part of money managers' overhead expenses to be paid for by managers with their own funds.<sup>68</sup>

The Commission observes that developments in technology have led to difficulties in applying client commission standards that were developed over the past thirty years. In addition, OCIE staff reported that money managers have taken an overbroad view of the products and services that qualify as "brokerage and research services" under the safe harbor.<sup>69</sup> The complexity of products and services creates uncertainty about whether client commissions may be used within the safe harbor to purchase all or a portion of particular products and services. This uncertainty may result in the use of client commission dollars to acquire products and services that are outside of the safe harbor, improper allocation of research and non-research mixed-use products and services (as contemplated by the 1986 Release), or inadequate documentation of allocations.<sup>70</sup>

Questions regarding the use of client commissions have led legislators, regulators, fund industry participants, and investors to consider whether some uses of client commissions should be banned, the safe harbor withdrawn, or changes made to the regulatory landscape.<sup>71</sup> As a first step to address

<sup>59</sup> We have also taken note of the views of other regulators. See Ontario Securities Commission, Concept Paper 23-402, *Best Execution and Soft Dollar Arrangements* (Feb. 8, 2005), available at [http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part2/cp\\_20050204\\_23-402\\_bestexecution.jsp](http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part2/cp_20050204_23-402_bestexecution.jsp); Australian Securities and Investments Commission, Press Release 04-181, *Soft Dollar Benefits Need Clear Disclosure* (June 10, 2004), available at [http://www.asic.gov.au/asic/ASIC\\_PUB.NSF/byid/77D7FCEFB7653EC5CA256EAF002F6C2?opendocument](http://www.asic.gov.au/asic/ASIC_PUB.NSF/byid/77D7FCEFB7653EC5CA256EAF002F6C2?opendocument).

<sup>60</sup> The FSA has determined that market data that has not been analyzed or manipulated does not meet the requirements of a research service, but permits managers to justify using client commissions to pay for raw data feeds as execution services. The FSA also has identified seminars as "non-permitted" services. FSA Final Rules, at 2.15 and Annex, p. 9 (Conduct of Business Sourcebook Rules 7.18.7 and 7.18.8(d)).

<sup>61</sup> Our proposed interpretation would not replace other sections of the 1986 Release.

<sup>62</sup> See Senate Comm. on Banking, Housing and Urban Affairs, Securities Acts Amendments of 1975, S. Rep. No. 94-75, at 71 (1975), *reprinted in* 1975 U.S.C.C.A.N. 179, 249. See also *supra* note 76.

<sup>63</sup> 1998 OCIE Report, at 31.

<sup>64</sup> *Id.* at 22, 31.

<sup>65</sup> *Id.* at 31.

<sup>66</sup> *Id.* at 31-32.

<sup>67</sup> *Id.* at 34-35.

<sup>68</sup> *Id.* at 49.

<sup>69</sup> See *id.* at 3-4, 31-32.

<sup>70</sup> See *id.* at 4-6, 32-33.

<sup>71</sup> See, e.g., Mutual Funds Integrity and Fee Transparency Act of 2003, H.R. 2420, 108th Cong. (2003) (This bill would have required, among other things, that the Commission do the following: issue rules requiring mutual funds to disclose their policies and practices regarding the use of client commissions to obtain research, advice, or brokerage activities; issue rules requiring managers to maintain copies of the written contracts with third-party research providers; and conduct a study on the use of client commission arrangements by managers.); Mutual Fund Transparency Act of 2003, S. 1822, 108th Cong. (2003) (This bill would have required, among other things, that the Commission

the present environment, the Commission has determined to provide further guidance on the scope of the safe harbor.<sup>72</sup> Further guidance in this area may be particularly important because, under existing law and rules, money managers must disclose client commission arrangements as material information,<sup>73</sup> and may provide more detailed disclosure when they receive products or services that fall outside the scope of the safe harbor. If a money manager incorrectly concludes that a product or service is within the safe harbor, the money manager may provide disclosure that is inadequate. In addition, guidance 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, respectively, because using client commissions to pay for products that are outside the safe harbor may violate these laws.

#### *B. Framework for Analyzing the Scope of the "Brokerage and Research Services" Under Section 28(e)*

The Commission has recognized the need to interpret the scope of the terms "brokerage and research services" in Section 28(e) in light of Congress's intention to provide a limited safe harbor for conduct that otherwise may be a breach of fiduciary duty. The Senate Committee Report on the 1975 Amendments regarding Section 28(e) states: "The definition of brokerage and research services is intended to comprehend the subject matter in the broadest terms, subject always to the good faith standard in Subsection

issue a rule to require mutual funds to disclose as fund fees and expenses brokerage commissions paid by the fund and borne by shareholders.). See also Letter from Matthew P. Fink, President, The Investment Company Institute, to William H. Donaldson, Chairman, U.S. Securities and Exchange Commission (Dec. 16, 2003) (urging the Commission to issue interpretative guidance excluding from the Section 28(e) safe harbor: (1) Computer hardware and software and other electronic communications facilities used in connection with trading investment decision-making; (2) publications, including books, newspapers, and electronic publications, that are available to the general public; and (3) third-party research services), available at <http://www.sec.gov/rules/petitions/petn4-492.htm>.

<sup>72</sup> In addition to concerns over the scope of the safe harbor under current market conditions, the Commission recognizes that improvements may be necessary in disclosure and documentation of client commission practices. For example, the ability to enforce client commission standards may be hampered by inadequate documentation. The Commission will evaluate whether further action is necessary.

<sup>73</sup> See Form ADV, Pt. II, Items 12.B and 13.A. See also *Sage Advisory Services LLC*, Exchange Act Release No. 44600, 75 SEC Docket 1073 (July 27, 2001).

(e)(1)).<sup>74</sup> However, as previously noted by the Commission, "Since Section 28(e) involves a statutory exemption for conduct which might otherwise constitute a breach of fiduciary duty owed by a money manager to his client, the Commission believes that the section should be construed in light of its limited purposes."<sup>75</sup>

In the 1986 Release, the Commission adopted the "lawful and appropriate assistance" standard for "brokerage and research services,"<sup>76</sup> which was intended to supplement the statutory elements of the analysis of whether a money manager's payment for a product or service with client commissions is within the safe harbor. While the 1986 Release focused on the application of the "lawful and appropriate assistance" standard to research, we believe the standard also applies to brokerage services.

Taking into account the legislative history of Section 28(e) and our prior guidance, the analysis of whether a particular product or service falls within the safe harbor should involve three steps. First, the money manager must determine whether the product or service falls within the specific statutory limits of Section 28(e)(3)(A), (B), or (C) (i.e., whether it is an eligible product or service under the safe harbor).<sup>77</sup> Second,

<sup>74</sup> Senate Comm. on Banking, Housing and Urban Affairs, Securities Acts Amendments of 1975, S. Rep. No. 94-75, at 71 (1975), reprinted in 1975 U.S.C.C.A.N. 179, 249.

<sup>75</sup> III Report, 19 SEC Docket at 931.

<sup>76</sup> See 1986 Release, 51 FR at 16006 n.9 (quoting from Senate Comm. on Banking, Housing and Urban Affairs, Securities Acts Amendments of 1975, S. Rep. No. 94-75, at 71 (1975), reprinted in 1975 U.S.C.C.A.N. 179, 249) (The Report concludes, "Thus, the touchstone for determining when a service is within or without the definition in Section 28(e)(3) is whether it provides lawful and appropriate assistance to the money manager in the carrying out of his responsibilities."). In articulating the "commercial availability" standard for safe-harbor eligibility in the 1976 Release, the Commission also expressly recognized "lawful and appropriate assistance" as the "touchstone" for whether a service is within or without the provision of Section 28(e)(3). 1976 Release, 41 FR at 13679.

<sup>77</sup> See 1986 Release, 51 FR at 16006. See also 1976 Release, 41 FR at 13679 ("The term 'brokerage and research services', as used in Section 28(e), is defined in Section 28(e)(3)."). Section 28(e)(3) states that, a person provides brokerage and research services 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;

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

(C) effects securities transactions and performs functions incidental thereto (such as clearance, settlement, and custody) or required in connection therewith by rules of the Commission or a self-

the manager must determine whether the eligible product or service actually provides lawful and appropriate assistance in the performance of his investment decision-making responsibilities. Finally, the manager must make a good faith determination that the amount of client commissions paid is reasonable in light of the value of products or services provided by the broker-dealer.<sup>78</sup> We discuss these statutory elements in more detail below.

#### *C. Eligibility Criteria for "Research Services" Under Section 28(e)(3); Lawful and Appropriate Assistance*

The eligibility criteria that govern "research services" are set forth in Section 28(e)(3) of the Exchange Act:

For purposes of the safe harbor, a person provides \* \* \* research services 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;

(B) furnishes *analyses and reports* concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts; \* \* \* <sup>79</sup>

In determining that a particular product or service falls within the safe harbor, the money manager must conclude that it constitutes "advice," "analyses," or "reports" within the meaning of the statute and that its subject matter falls within the categories specified in Section 28(e)(3)(A) and (B). With respect to the subject matter of potential "research services," we note that the categories expressly listed in Section 28(e)(3)(A) and (B) also "subsume" other topics related to securities and the financial markets.<sup>80</sup>

regulatory organization of which such person is a member or person associated with a member or in which such person is a participant. 15 U.S.C. 78bb(3)(A)–(C).

<sup>78</sup> 15 U.S.C. 78bb(e). See 1986 Release, 51 FR at 16006–07. The Commission also emphasized the money manager's disclosure and other obligations under the federal securities laws, including the duty to seek best execution of his or her client's transactions. *Id.* at 16007–11.

<sup>79</sup> 15 U.S.C. 78bb(e)(3)(A)–(B) (emphasis added).

<sup>80</sup> See Senate Comm. on Banking, Housing and Urban Affairs, Securities Acts Amendments of 1975, S. Rep. No. 94-75, at 71 (1975), reprinted in 1975 U.S.C.C.A.N. 179, 249 ("[T]he reference [in Section 28(e)] to economic factors and trends would subsume political factors which may have economic implications which may in turn have implications in terms of the securities markets as a whole or in terms of the past, present, or future values of individual securities or groups of securities."). See also S. 249 Hearings, at 329, 330 (Combined statement of Baker, Weeks & Co., Inc., Donaldson, Lufkin & Jenrette Sec. Corp., Mitchell,

Thus, for example, a report concerning political factors that are interrelated with economic factors could fall within the scope of the safe harbor. The form (e.g., electronic or paper) of the research is irrelevant to the analysis of eligibility under the safe harbor.

In evaluating the statutory language, the Commission notes that an important common element among “advice,” “analyses,” and “reports” is that each reflects substantive content—that is, the expression of reasoning or knowledge.<sup>81</sup> 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 subject matter identified in Section 28(e)(3)(A) or (B). Traditional research reports analyzing the performance of a particular company or stock clearly would be eligible under Section 28(e). Certain financial newsletters and trade journals also could be eligible research services if they relate to the subject matter of the statute. Quantitative analytical software and software that provides analyses of securities portfolios would be eligible under the safe harbor if they reflect the expression of reasoning or knowledge relating to subject matter that is included in Section 28(e)(3)(A) and (B).<sup>82</sup> Seminars or conferences where the content satisfies the above criteria also would be eligible.<sup>83</sup>

In contrast, 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 or office furniture), are not eligible as research under the safe harbor. We do not believe that these types of products and services could be said to constitute “advice,” “analyses,” or “reports” within the meaning of the statute. Applying this guidance, a money manager’s operational overhead expenses would not constitute eligible “research services.”<sup>84</sup> For example, travel expenses, entertainment, and meals associated with attending

Hutchins Inc., and Oppenheimer & Co.) (Research under Section 28(e) should include “advice and information on industries, economics, world conditions, portfolio strategy and other areas.”).

<sup>81</sup> The content may be original research or a synthesis, analysis, or compilation of the research of others.

<sup>82</sup> See Senate Comm. on Banking, Housing and Urban Affairs, Securities Acts Amendments of 1975, S. Rep. No. 94–75, at 71 (1975), reprinted in 1975 U.S.C.C.A.N. 179, 249 (“computer analyses of securities portfolios would \* \* \* be covered”).

<sup>83</sup> See 1986 Release, 51 FR at 16007. We note that the FSA has identified seminars as “non-permitted” services. See FSA Final Rules, at Annex, p. 9 (Conduct of Business Sourcebook Rule 7.18.8(d)).

<sup>84</sup> See 1986 Release, 51 FR at 16006–07.

seminars would not be eligible under 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 examples of other overhead items that do not meet the statutory criteria for research (or brokerage) set forth in this release and are not eligible under the safe harbor.<sup>85</sup>

Computer hardware and computer accessories, while they may assist 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.<sup>86</sup> Similarly, the peripherals and delivery mechanisms associated with computer hardware, including telecommunications lines, transatlantic cables, and computer cables, are outside the “research services” safe harbor.

As noted above, even if the manager properly concludes that a particular product or service is an “analysis,” “advice,” or “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.

With respect to data services—such as those that provide market data or economic data—we believe that such services could fall within the scope of

<sup>85</sup> According to the 1998 OCIE Report, advisers used client commissions to pay for many of these items. See notes 65–67 and accompanying text. See also *Sage Advisory Services LLC*, Exchange Act Release No. 44600, 75 SEC Docket 1073 (July 27, 2001) (adviser improperly used client commission credits to pay for undisclosed non-research business expenses such as legal, accounting, and back-office record keeping services, payments of self-regulatory organization (“SRO”) fees, and rent).

<sup>86</sup> In 1986, the Commission suggested that advisers could use client commissions to pay for the portion of the cost of computers that relate to receiving research. See 1986 Release, 51 FR at 16006–07. In light of developments in technology and broad application of the 1986 standard to products and services that are only remotely connected to investment decision-making, as discussed above, we now believe that it is important to clarify that computers fall outside the scope of the safe harbor.

the safe harbor as eligible “reports” provided that they satisfy the subject matter criteria. In the 1986 Release, we included market data services within the safe harbor, finding that they serve “a legitimate research function of pricing securities for investment and keeping a manager informed of market developments.”<sup>87</sup> Because market data contain aggregations of information on a current basis related to the subject matter identified in the statute, and in light of the history of Section 28(e), our interpretation would conclude that market data, such as stock quotes, last sale prices, and trading volumes, contain substantive content and constitute “reports concerning \* \* \* securities” within the meaning of Section 28(e)(3)(B),<sup>88</sup> and thus would be eligible as “research services” under the safe harbor.<sup>89</sup> Similarly, other data would be eligible under the safe harbor if they reflect substantive content—that is, the expression of reasoning or knowledge—related to the subject matter identified in the statute. For example, we believe that company financial data and economic data (such as unemployment and inflation rates or gross domestic product figures) would be eligible as research under Section 28(e).

As discussed above, 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 it also must provide the money manager with lawful and appropriate assistance in making investment decisions. This standard focuses on how the manager uses the eligible research. For example, some money managers appear to be using client commissions to pay for analyses of account performance that are used for marketing purposes.<sup>90</sup> Although analyses of the performance of accounts are eligible research items because they reflect the expression of reasoning or knowledge regarding subject matter included in Section 28(e)(3)(B), these items when used for marketing purposes are not within the safe harbor because they are not providing lawful and appropriate

<sup>87</sup> 1986 Release, 51 FR at 16006. We believe that, in the 1986 Release, the Commission’s indication that quotation equipment may be eligible under the safe harbor was intended to address market data.

<sup>88</sup> 15 U.S.C. 78bb(e)(3)(B).

<sup>89</sup> We note that the FSA has determined that, “Examples of goods or services that relate to the provision of research that the FSA do not regard as meeting the requirements of [a research service] include price feeds or historical price data that have not been analyzed or manipulated to reach meaningful conclusions.” FSA Final Rules, at Annex p. 9 (Conduct of Business Sourcebook Rule 7.18.7).

<sup>90</sup> See 1998 OCIE Report, at 20.

assistance to the money manager in performing his investment decision-making responsibilities.<sup>91</sup>

*D. Eligibility Criteria for "Brokerage" Under Section 28(e)(3); Lawful and Appropriate Assistance*

Under Section 28(e)(3)(C) of the Act, 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 by rules of the Commission or a self-regulatory organization of which such person is a member or in which such person is a participant.<sup>92</sup>

Section 28(e)(3)(C) describes the brokerage products and services that are *eligible* under the safe harbor. In addition to activities required to effect securities transactions, Section 28(e)(3)(C) provides that functions "incidental thereto" are also eligible for the safe harbor, as are functions that are required by Commission or self-regulatory organization ("SRO") rules. Clearance and settlement services in connection with trades effected by the broker are explicitly identified as eligible incidental brokerage services. Therefore, the following post-trade services relate to functions incidental to executing a transaction and are eligible under the safe harbor as "brokerage services": post-trade matching; exchange of messages among broker-dealers, custodians, and institutions; electronic communication of allocation instructions between institutions and broker-dealers; and routing settlement instructions to custodian banks and broker-dealers' clearing agents. Similarly, services that are required by the Commission or SRO rules are eligible under the safe harbor. For example, in certain circumstances, the use of electronic confirmation and affirmation of institutional trades is required in connection with settlement processing.<sup>93</sup>

In 1998, OCIE staff recommended that the Commission provide further guidance on the scope of the safe harbor concerning the use of items that may

facilitate trade execution, based on examiners' reports that

[t]he technological explosion in the money management industry has been met with an increasing use of soft dollars to purchase state-of-the-art computer and communications systems that may facilitate trade execution. \* \* \* The use of soft dollars to purchase these products may present advisers with questions similar to those surrounding computers purchased for research and analysis, i.e., how should an adviser distinguish between 'brokerage' services and 'overhead' expenses.<sup>94</sup>

In addition, we recognize that to the extent that this release would narrow the scope of eligible research under the safe harbor, there is a risk that, without further guidance on brokerage, some services and products that were previously classified as research could be inappropriately reclassified as brokerage.<sup>95</sup> For these reasons, we are providing the guidance set forth below to assist money managers in determining whether items are eligible as "brokerage services" under the safe harbor.

Guided by the statute and legislative history, we believe that Congress intended "brokerage" services under the safe harbor to relate to the execution of securities transactions.<sup>96</sup> In our view, brokerage under Section 28(e) should reflect historical and current industry practices that execution of transactions is a process, and that services related to execution of securities transactions begin when an order is transmitted to a broker-dealer and end at the conclusion of clearance and settlement of the transaction. We believe that this temporal standard is an appropriate way to distinguish between "brokerage services" that are eligible under Section 28(e) and those products and services, such as overhead, that are not eligible. Specifically, for purposes of the safe harbor, we believe that brokerage begins

<sup>94</sup> 1998 OCIE Report, at 35–36, 50.

<sup>95</sup> The NASD Task Force Report made a similar observation, and recommended that the Commission "monitor the use of the safe harbor for brokerage services for such inappropriate attempts to maintain the *status quo* by expanding the brokerage services aspect of the safe harbor." NASD Task Force Report, at 7 n.20.

<sup>96</sup> See Securities Acts Amendments of 1974, H.R. 5050, 93d Cong. (1974) (House bill on safe harbor referred to "brokerage services, including \* \* \* research or execution services"); H.R. Rep. No. 93–1476 (1974) (House Committee Report on H.R. 5050 referred to "brokerage" as "research and other services related to the execution of securities transactions"); Joint Explanatory Statement of the Comm. of Conference, Securities Acts Amendments of 1975, H.R. Conf. Rep. No. 94–229, at 108 (1975), reprinted in 1975 U.S.C.A.N. 321, 338 (House Conference Report on final House bill on Section 28(e) describes the safe harbor as relating to paying more than the lowest available price for "execution and research services").

when the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution and ends when funds or securities are delivered or credited to the advised account or the account holder's agent. Unlike brokerage, research services include services provided before the communication of an order. Thus, advice provided by a broker before an order is transmitted may fall within the research portion of the safe harbor, but not the brokerage portion of the safe harbor.

Under this temporal standard, communications services related to the execution, clearing, and settlement of securities transactions and other incidental functions, *i.e.*, 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) are eligible under Section 28(e)(3)(C). In addition, trading software operated by a broker-dealer to route orders to market centers and algorithmic trading software is "brokerage."<sup>97</sup>

On the other hand, order management systems ("OMS") used by money managers to manage their orders (including OMS developed in-house by the manager and those obtained from third-party vendors) and hardware, such as telephones or computer terminals, are not eligible for the safe harbor as "brokerage" because they are not sufficiently related to order execution and fall outside the temporal standard for "brokerage" under the safe harbor. Products and services such as trade analytics, surveillance systems, or compliance mechanisms, do not qualify as "brokerage" in the safe harbor because they are not integral to the execution of orders by the broker-dealers, *i.e.*, they fall outside the temporal standard described above.<sup>98</sup>

<sup>97</sup> Unlike research, brokerage services can include connectivity services and trading software where they are used to transmit orders to the broker, because this transmission of orders has traditionally been considered a core part of the brokerage service. We believe that mechanisms to deliver research, on the other hand, are separable from the research and the decision-making process.

<sup>98</sup> For example, to the extent that money managers use trade analytics both for research and to assist in fulfilling contractual obligations to the client or to assess whether they have complied with their own regulatory or fiduciary obligations such

<sup>91</sup> As discussed below in the mixed-use section, if the manager uses account performance analyses for both marketing purposes and investment decision-making, the manager may use client commissions only to pay for the allocable portion of the item attributable to use for investment decision-making under Section 28(e). See *infra* Section III.E.

<sup>92</sup> 15 U.S.C. 78bb(e)(3)(C).

<sup>93</sup> See NASD Rule 11860(a)(5); New York Stock Exchange ("NYSE") Rule 387(a)(5); American Stock Exchange Rule 423(5); Chicago Stock Exchange Article XV, Rule 5; Pacific Exchange Rule 9.12(a)(5); Philadelphia Stock Exchange Rule 274(b).

Moreover, error correction trades or related services in connection with errors made by money managers are not related to the initial trade for a client within the meaning of Section 28(e)(3)(C) because they are separate transactions to correct the manager's error, not to benefit the advised account, and thus error correction functions are not eligible "brokerage services" under the safe harbor.<sup>99</sup> The products and services described in this paragraph are properly characterized as "overhead" and are ineligible under Section 28(e).

As with research, in order to obtain safe harbor protection for products and services that are eligible as brokerage, the money manager must be able to show that the eligible product or service provides him or her lawful and appropriate assistance in carrying out the manager's responsibilities, and the manager must make a good faith determination that the amount of commissions paid is reasonable in relation to the value of the research and brokerage product or service received.

#### E. "Mixed-Use" Items

As discussed above, the 1986 Release introduced the concept of "mixed use."<sup>100</sup> Where a product obtained with client commissions has a mixed use, a money manager faces an additional conflict of interest in obtaining that product with client commissions.<sup>101</sup> The 1986 Release stated that where a product has a mixed use, a money manager should make a reasonable allocation of the cost of the product according to its use, and emphasized that the money manager must keep adequate books and records concerning allocations in order to make the required good faith determination.<sup>102</sup> Moreover, the allocation determination itself poses a conflict of interest for the money manager that should be disclosed to the client.<sup>103</sup> It appears that, in practice, some managers may have made questionable mixed-use allocations and failed to document the

as the duty of best execution or for other internal compliance purposes, the trade analytical software is a mixed-use product, and managers must use their own funds to pay for the allocable portion of the cost of the software that is not within the safe harbor because it is attributable to internal compliance purposes. See *supra* note 1.

<sup>99</sup> We note that the staff has taken a similar position. See Charles Lerner, Department of Labor, No-Action Letter (Oct. 25, 1988) (Dept. of Labor ("DOL") sought Commission staff advice regarding applicability of Section 28(e) to commission practices discovered by DOL investigators involving ERISA plans).

<sup>100</sup> See 1986 Release, 51 FR at 16007.

<sup>101</sup> *Id.* at 16006-07.

<sup>102</sup> *Id.*

<sup>103</sup> *Id.* at 16006 n.13.

bases for their allocation decisions.<sup>104</sup> Lack of documentation makes it difficult for the manager to make the required good faith showing of the reasonableness of the commissions paid in relation to the value of the portion of the item allocated as brokerage and research under Section 28(e), and also makes it difficult for compliance personnel to ascertain the basis for the allocation.<sup>105</sup>

We continue to believe that the "mixed-use" approach is appropriate. In that connection, we reiterate today the Commission's guidance provided in the 1986 Release regarding the mixed-use standard:<sup>106</sup> "The money manager must keep adequate books and records concerning allocations so as to be able to make the required good faith showing."<sup>107</sup> As stated above, the mixed-use approach requires a money manager to make a reasonable allocation of the cost of the product according to its use. 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.<sup>108</sup>

#### F. The Money Manager's Good Faith Determination as to Reasonableness Under Section 28(e)

Section 28(e) requires money managers who are seeking to avail themselves of the safe harbor to make a good faith determination that the commissions paid are reasonable in relation to the value of the brokerage and research services received.<sup>109</sup> The Commission reaffirms the money manager's essential obligation under Section 28(e) to make this good faith

determination. The burden of proof in demonstrating this determination rests on the money manager.<sup>110</sup>

A money manager satisfies Section 28(e) if he or she can demonstrate that the item is eligible under the language of the statute, the manager has used the item in performing decision-making responsibilities for accounts over which he exercises investment discretion, and, in good faith, the manager believes that 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. Thus, for example, a money manager may purchase an eligible item of research with client commissions if he or she properly uses the information in formulating an investment decision, but another money manager cannot rely on Section 28(e) to acquire the very same item if the manager does not use the item for investment decisions or if the money manager determines that the commissions paid for the item are not reasonable with respect to the value of the research or brokerage received. Similarly, 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 shelf space.<sup>111</sup> In this instance, the money manager could not make the determination, in good faith, that the commission rate was reasonable in relation to the value of the Section 28(e) eligible products because the commission would incorporate a payment to the broker-dealer for the non-Section 28(e) services. Further, if research products or services that are eligible under Section 28(e)(3) have

<sup>104</sup> 1998 OCIE Report, at 32-34.

<sup>105</sup> *Id.*

<sup>106</sup> As noted above, this proposed interpretation would replace Sections II and III of the 1986 Release.

<sup>107</sup> 1986 Release, 51 FR at 16006. The Commission may further address the documentation of mixed-use items at a later time.

<sup>108</sup> Similarly, if the money manager seeks the protection of the safe harbor and receives both Section 28(e) eligible and ineligible products and services for a bundled commission rate, the manager must use his own funds to pay for the allocable portion of the cost of products and services that are not within the safe harbor.

<sup>109</sup> As we noted in 1986, "[a] money manager should consider the full range and quality of a broker's services in placing brokerage including, among other things, the value of research provided as well as execution capability, commission rate, financial responsibility, and responsiveness to the money manager\* \* \* [T]he determinative factor is not the lowest possible commission cost but whether the transaction represents the best qualitative execution for the managed account." 1986 Release, 51 FR at 16011. See also *supra* note 5.

<sup>110</sup> See House Comm. on Interstate and Foreign Commerce, Securities Acts Amendments of 1975, H.R. No. 94-123, at 95 (1975). The report states that: "It is, of course, expected that money managers paying brokers an amount [of commissions] which is based upon the quality and reliability of the broker's services including the availability and value of research, would stand ready and be required to demonstrate that such expenditures were bona fide." See also 1986 Release, 51 FR at 16006-16007.

<sup>111</sup> In other situations, the Commission has imposed sanctions on money managers and broker-dealers for failing to disclose conflicts associated with the use of brokerage commissions to compensate broker-dealers for marketing particular funds (a practice known as payment for shelf-space). See, e.g., *Edward D. Jones & Co., L.P.*, Securities Act Release No. 8520 (Dec. 22, 2004); *Franklin Advisers, Inc. and Franklin/Templeton Distributors, Inc.*, Advisers Act Release No. 2337 (Dec. 13, 2004). Cf. *Investment Company Act Release No. 26591* (Sept. 2, 2004), 69 FR 54728 (Sept. 9, 2004) (Commission adopted Rule 12b-1(h) under the Investment Company Act, which prohibits funds from using brokerage to pay for distribution).

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.

### G. Third-Party Research and Commission-Sharing Arrangements<sup>112</sup>

Third-party research arrangements can benefit advised accounts by providing greater breadth and depth of research. First, these arrangements can provide money managers with the ability to choose from a broad array of independent research products and services. Second, the manager can use third-party arrangements to obtain specialized research that is particularly beneficial to their advised accounts.

#### 1. Research Services Must Be "Provided by" the Broker-Dealer

Section 28(e) requires that the broker-dealer receiving commissions must "provide" brokerage or research services. The Commission has interpreted this to permit money managers to use client commissions to pay for research produced by someone other than the executing broker-dealer, in certain circumstances (referred to as "third-party research").<sup>113</sup> The essential feature of the "provided by" element is that the broker-dealer has the direct legal obligation to pay for the research.<sup>114</sup> The Commission also has clarified that research provided in third-party arrangements is eligible under

<sup>112</sup> Section 28(e)(1) states in relevant part:

No person \* \* \* shall be deemed to have acted unlawfully or to have breached a fiduciary duty \* \* \* solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion. 15 U.S.C. 78bb(e)(1) (emphasis added).

<sup>113</sup> See 1976 Release, 41 FR at 13679 (Section 28(e) "might, under appropriate circumstances, be applicable to situations where a broker provides a money manager with research produced by third parties"). See also 1986 Release, 51 FR at 16007 ("Although the legislative history of Section 28(e) includes a strong statement that commission dollars may be paid only to the broker-dealer that "provides" both the execution and research services and that the section does not authorize the resumption of "give-ups," it seems unlikely that Congress intended to forbid certain common practices that were then considered permissible and whose elimination would be anti-competitive."); III Report, 19 SEC Docket at 932 (broker need not produce research services "in house").

<sup>114</sup> See 1986 Release, 51 FR at 16007; III Report, 19 SEC Docket at 932.

Section 28(e) even if the money manager participates in selecting the research services or products that the broker-dealer will provide.<sup>115</sup> The third party may send the research directly to the broker's customer so long as the broker-dealer has the obligation to pay for the services.<sup>116</sup> In contrast, a money manager may not rely upon Section 28(e) if he uses the broker-dealer merely to pay an obligation that he has incurred with a third party.<sup>117</sup> The 1998 OCIE Report discussed instances in which some money managers had entered into such arrangements whereby broker-dealers paid for research or brokerage services for which the money managers were obligated to pay.<sup>118</sup> The Commission reminds money managers and broker-dealers that these arrangements are not eligible for the Section 28(e) safe harbor.

#### 2. "Effecting" Transactions

Section 28(e) requires that the broker-dealer providing the research also be involved in "effecting" the trade.<sup>119</sup> The inclusion of this element in Section 28(e) was principally intended to preclude the practice of paying "give-ups."<sup>120</sup> Specifically, when brokerage commissions were fixed before 1975, a "give-up" was a payment to another broker-dealer of a portion of the commission required to be charged by the executing broker-dealer.<sup>121</sup> The

<sup>115</sup> Exchange Act Release No. 17371 (Dec. 12, 1980), 45 FR 83707, 83714 n.54 (Dec. 19, 1980) ("Papilsky Release"). See 1986 Release, 51 FR at 16007. In the Papilsky Release, the Commission addressed Section 28(e) and third-party research in the context of defining "bona-fide research" for purposes of NASD rules that relate to obtaining research in a fixed-price offering.

<sup>116</sup> Papilsky Release, 45 FR at 83714 n.54. See 1986 Release, 51 FR at 16007.

<sup>117</sup> Papilsky Release, 45 FR at 83714 n.54.

<sup>118</sup> OCIE reported that approximately 27% of the broker-dealers examined were paying invoices submitted directly by investment advisers for payment obligations of the investment advisers to the third parties. See 1998 OCIE Report, at 24-25.

<sup>119</sup> 15 U.S.C. 78bb(e).

<sup>120</sup> In enacting Section 28(e), Congress described give-ups as a "regrettable chapter in the history of the securities industry and the limited definition of fiduciary responsibility added to the law by this bill in no way permits its return." Joint Explanatory Statement Of The Comm. Of Conference, Securities Acts Amendments Of 1975, H.R. Conf. Rep. No. 94-229, at 108 (1975), reprinted in 1975 U.S.C.C.A.N. 321, 339.

<sup>121</sup> Give-ups took several forms, but typically occurred when a mutual fund (or its money manager or underwriter) directed an executing broker-dealer to pay a portion of a commission payment to another broker-dealer that was a member of the same exchange as the executing broker-dealer. The give-up often was payment for other services (that may have been unrelated to the trade) provided to the fund (or its adviser or underwriter) by the give-up recipient. See Division of Market Regulation, U.S. Securities and Exchange Commission, Market 2000: An Examination of Current Equity Market Developments (Jan. 1994),

broker-dealer receiving the give-up may have had no role in the transaction generating the commission, and it may not even have known where or when the trade was executed. Because the portion of the commission "given up" is a charge above the cost of execution on client accounts and because the broker-dealer receiving the "e-up" did nothing in connection with the securities trade to benefit investors, the Commission found that these arrangements violated the securities laws.<sup>122</sup> In enacting Section 28(e), Congress addressed the issue of give-ups by indicating that the provision did not apply when the money manager made payment to one broker-dealer for the services performed by another broker-dealer.<sup>123</sup> In the 1986 Release, the Commission indicated that payment of a part of a commission to a broker-dealer who is a "normal and legitimate correspondent" of the executing or clearing broker-dealer would not necessarily be a "give-up," outside the protection of Section 28(e).<sup>124</sup>

1994 SEC LEXIS at 32-33 (citing Special Study, H.R. Doc. No. 88-95, pt. 2, at 316-317 and pt. 4, at 213-14). This type of give-up produced a conflict of interest for the adviser "between the interest of fund shareholders in lower commission charges and the interest of mutual fund advisers and underwriters in stimulating the sale of additional shares through directing a split of commission charges." Special Study, H.R. Doc. No. 88-95, pt. 2, at 318.

<sup>122</sup> See, e.g., *Provident Management Corp.*, 44 SEC 442, 445-47 (Dec. 1, 1970) (finding violations of the antifraud provisions of the federal securities laws where unaffiliated broker-dealers who participated with the fund's officers, adviser, and affiliated broker-dealer in a reciprocal arrangement in which fund transactions were placed with unaffiliated broker-dealer in exchange for payment to affiliated broker-dealer of "clearance commissions" on unrelated transactions for which affiliated broker-dealer performed no function). The Commission has found it a violation of the antifraud provisions of the securities laws to interpose an unnecessary party in a transaction, resulting in payment to the interposed party, and an additional cost to the fiduciary account. See *Delaware Management Co.*, 43 SEC 392 (1967) (interpositioning broker between adviser and market maker caused adviser to pay unnecessary brokerage costs and violated the adviser's duty of best execution).

<sup>123</sup> Joint Explanatory Statement of the Comm. of Conference, Securities Acts Amendments of 1975, H.R. Conf. Rep. No. 94-229, at 109 (1975), reprinted in 1975 U.S.C.C.A.N. 321, 339. See also 1986 Release, 51 FR at 16007; 1976 Release, 41 FR at 13679.

<sup>124</sup> 1986 Release, 51 FR at 16007 ("Section 28(e) was not intended to exclude from its coverage the payment of commissions made in good faith to an introducing broker for execution and clearing services performed in whole or in part by the introducing broker's normal and legitimate correspondent."); 1976 Release, 41 FR at 13678 (Under Section 28(e), money managers may not direct brokers employed by them to "give-up" part of the commission negotiated by the broker and the money manager to another broker designated by the money manager for whom the executing or clearing broker is not a normal and legitimate correspondent.).

Some investment managers today use "commission-sharing" arrangements to execute trades with one broker-dealer and obtain research or other services from a different broker-dealer. In some commission-sharing arrangements, the introducing broker-dealer accepts orders from its customers and then may execute the trade and provide research, while a second broker-dealer clears and settles the transaction. In other commission-sharing arrangements, an "introducing" broker-dealer retains a portion of the commission, and has little, if any, role in accepting customer orders or in executing, clearing, or settling any portion of the trade. Rather, another broker-dealer (often called the "clearing broker") executes, clears, and settles the trade, receiving a portion of the commission for its services. In some instances, the introducing broker is unaware of the daily trading activity of its customers because the orders are sent by the money manager directly (and only) to the clearing broker-dealer.<sup>125</sup>

Where more than one broker-dealer is involved in a commission-sharing arrangement, the Commission takes the view that the "introducing broker [must be] engaged in securities activities of a more extensive nature than merely the receipt of commissions paid to it by other broker-dealers for "research services" provided to money managers."<sup>126</sup>

<sup>125</sup> The 1986 Release suggested that protection of Section 28(e) would not be lost merely because the money manager by-passed the order desk of the introducing broker and called his orders directly into the clearing broker. 1986 Release, 51 FR at 16007.

For purposes of this discussion, commission-sharing arrangements are different from "step-outs." In a step-out, the investment manager directs the executing broker to allocate all or a certain number of shares of an executed trade, e.g., 100 shares of a 1000 share trade, to another broker-dealer for clearance and settlement. In this example, the executing broker executes the entire trade, clears and settles 900 shares, and receives the commission for 900 shares. The second or "stepped-in" broker clears and settles 100 shares and negotiates the commission for 100 shares with the manager. The executing broker may not know what commission is paid to the stepped-out broker or what services (other than clearance and settlement) are provided by the stepped-out broker to the manager. Step-outs have been used, at the client's direction, where the client has a commission recapture arrangement with the "stepped-in" broker. In the past, step-outs were used to reward the "stepped-in" broker-dealer for fund distribution or to obtain "brokerage and research services." See Thomas P. Lemke and Gerald T. Lins, *Soft Dollars and Other Brokerage Arrangements 4-16 to 4-17* (2004). Provided that each broker in a step-out performs substantive functions in effecting trades, e.g., clearance and settlement, such arrangements may be eligible for the safe harbor.

<sup>126</sup> 1986 Release, 51 FR at 16007, quoting Data Exchange Securities, No-Action Letter (Apr. 20, 1981).

Where two broker-dealers are involved in a commission-sharing arrangement that otherwise

Commission-sharing arrangements typically involve clearing agreements pursuant to SRO rules.<sup>127</sup> These SRO rules require that introducing and clearing firms contractually agree to allocate enumerated functions, but do not mandate how the functions should be divided (*i.e.*, they do not specify the functions that must be done by the introducing broker-dealer or clearing broker-dealer).<sup>128</sup> We note, however, that a clearing agreement that satisfies SRO rule requirements does not necessarily satisfy the criteria of Section 28(e). Each broker-dealer must play a role in effecting securities transactions that goes beyond the mere provision of research services to money managers.<sup>129</sup> The nature of the activities actually performed by each broker-dealer determines whether the commission-sharing arrangement qualifies under Section 28(e).<sup>130</sup>

satisfies Section 28(e), one of the broker-dealers must be financially responsible for providing the research. See 1986 Release, 51 FR at 16007; III Report, 19 SEC Docket at 932.

<sup>127</sup> See, e.g., NYSE Rule 382, "Carrying Agreements," 2 NYSE Guide ¶ 2382, Rule 382; NASD Rule 3230, "Clearing Agreements"; NASD Rules of Fair Practice, Section 47, Article III; American Stock Exchange Rule 400 (mirrors the provisions of NYSE Rule 382(b)).

<sup>128</sup> For example, NYSE Rule 382 specifies that each fully-disclosed clearing agreement between SRO members shall allocate to the respective member the following functions: (i) Opening, approving, and monitoring of accounts; (ii) extension of credit; (iii) maintenance of books and records; (iv) receipt and delivery of funds and securities; (v) safeguarding of funds and securities; (vi) confirmations and statements; (vii) acceptance of orders and execution of transactions. NYSE Rule 382(b). Further, the clearing broker must provide annually to the introducing broker-dealer a list of reports to assist the introducing broker to supervise and monitor its customer accounts and to fulfill its responsibilities under the agreement as well as deliver, and retain a copy of, those reports that the introducing broker requests. NYSE Rule 382(e)(1) and (2).

<sup>129</sup> Step-outs may not require clearing agreements but may be within Section 28(e) if each broker performs substantive functions in effecting the trade (e.g., clearance and settlement). See *supra* note 125.

<sup>130</sup> Introducing and clearing brokers still remain subject to all applicable securities laws and regulations and SRO rules. For instance, nothing in this release changes in any way the applicability of anti-money laundering ("AML") laws and regulations applicable to an introducing broker or a clearing broker. See, e.g., Currency and Foreign Transactions Reporting Act of 1970 ("Bank Secrecy Act"), [31 U.S.C. 5311 *et seq.*] (as amended by the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 ("USA Patriot Act")), Pub. L. 107-56, sec. 314, 326, 115 Stat. 272; Treasury regulations adopted under the Bank Secrecy Act [31 CFR Part 103]; Exchange Act Rule 17a-8 [17 CFR 240.17a-8]; NYSE Rule 445; NASD Rule 3011. This interpretation also does not alter the introducing broker and the clearing broker's supervisory obligations. See, e.g., Securities Exchange Act Section 15(b)(4)(E) [15 U.S.C. 78o(b)(4)(E)]; NYSE Rules 342 and 405; NASD Rules 3010, 3012, and 3013. This interpretation also does not alter a broker-dealer's best execution obligation

In connection with commission-sharing arrangements, each party to the arrangement must determine if it is contributing to a violation of law, including whether the involvement of multiple parties to the trade is necessary to effecting the trade, beneficial to the client, and appropriate in light of all applicable duties.<sup>131</sup> In particular, as discussed above, the broker-dealer involved in effecting the trade must also be legally obligated to pay for the third-party research or brokerage service (*i.e.*, the "provided by" requirement).<sup>132</sup>

The following elements are necessary for a commission-sharing arrangement under which research and brokerage services are provided under the safe harbor:

- The commission-sharing arrangement must be part of a normal and legitimate correspondent relationship in which each broker-dealer is engaged in securities activities of a more extensive nature than merely the receipt of commissions paid to it by other broker-dealers for research services provided to money managers (*i.e.*, "effecting securities transactions" requirement).<sup>133</sup> Based on the Commission's experience, we believe that, at a minimum, this means that the introducing broker-dealer must: (1) Be financially responsible to the clearing broker-dealer for all customer trades until the clearing broker-dealer has received payment (or securities), *i.e.*, the introducing broker-dealer must be at risk to the clearing broker-dealer for its customers' failure to pay; (2) make and/or maintain records relating to its customer trades required by Commission and SRO rules, including blotters and memoranda of orders; (3) monitor and respond to customer comments concerning the trading

to its customers. See, e.g., NASD Rule 2320; NASD Notice to Members 01-22 (Apr. 2001).

<sup>131</sup> See 1976 Release, 41 FR at 13679 ("[N]or may money managers, under the authority of Section 28(e), direct brokers employed by them to make "give up" payments."); "[B]rokers should recognize that their compliance with any direction or suggestion by a fiduciary which would appear to involve a violation of the fiduciary's duty to its beneficiaries could implicate them in a course of conduct violating the anti-fraud provisions of the federal securities laws."; III Report, 19 SEC Docket at 933 (Where brokers and money managers were aware that an intermediary was providing research to money managers in exchange for directing brokerage to the intermediary's designated brokers, but brokers had limited participation in providing the research, "those involved should have realized that the arrangement was not permitted by Section 28(e)."; "[B]rokers should have been alerted to the possibility of conduct which contravened applicable fiduciary principles and the federal securities laws.").

<sup>132</sup> See 1986 Release, 51 FR at 16007; III Report, 19 SEC Docket at 932.

<sup>133</sup> See *supra* notes 119-130 and accompanying text.

process; and (4) generally monitor trades and settlements;<sup>134</sup> and

- A broker-dealer effecting the trade (if not providing research and brokerage services directly) must be legally obligated to a third-party producer of research or brokerage services to pay for the service ultimately provided to a money manager (*i.e.*, “provided by” requirement).<sup>135</sup>

#### IV. Request for Comments

The Commission seeks comment on its proposed interpretive guidance regarding client commission practices under Section 28(e) of the Exchange Act. The Commission asks commentators to address whether the proposed interpretation has accurately identified the industry practices for which guidance would be most useful, and to offer comments on any significant issues arising under Section 28(e) that this release has not addressed. The Commission also requests comment as to whether the proposed interpretive guidance would significantly affect the level and distribution of costs among industry participants and, if so, whether these effects would be beneficial to investors or otherwise serve the public interest.

In addition, the Commission solicits comments on the following topics:

*Question 1.* Does the Commission’s interpretation offer sufficient guidance

with respect to the types of “advice,” “analyses,” and “reports” that are eligible as “research services” under Section 28(e)?

*Question 2.* How would investors, money managers, broker-dealers, and others be affected by the Commission’s interpretive guidance that client commissions cannot be used to obtain computer equipment as “research” under Section 28(e)?

*Question 3.* Does the Commission’s interpretation offer appropriate guidance as to the eligibility of market data and trade analytical software under Section 28(e)?

*Question 4.* Does the Commission’s interpretation offer sufficient guidance as to the eligibility of “brokerage” services, functions, and products under Section 28(e)? How would this guidance affect existing arrangements or practices? Is the Commission’s temporal standard sufficiently clear? Are there types of services that should be excluded from the safe harbor, even though they might appear to satisfy the temporal standard? If so, explain why those services should be excluded—for example, is the service unrelated to execution of transactions?

*Question 5.* Does the Commission’s interpretation offer sufficient guidance about third-party research and commission-sharing arrangements?

*Question 6.* How does the Commission’s interpretive guidance differ from the approaches that other regulators, SROs, market participants, trade organizations, and investor advocacy groups have adopted or recommended with respect to client commission practices?

*Question 7.* Are there types of products or services that are commonly paid for with client commissions for which additional guidance would be useful? If so, please provide facts about these products and services and their components, and how they are used. For example, are client commissions commonly used to pay for proxy voting services?

*Question 8.* Should the Commission provide additional guidance on the allocation and documentation of mixed-use items?

*Question 9.* Concerns have been expressed by some industry participants and others that mass-marketed publications (publications that are widely circulated to the general public and intended for a broad, public audience) are part of a firm’s overhead and should not be paid for with client commissions. To what extent are these types of publications currently being paid for with client commissions? Are the purposes and uses of these types of publications distinguishable from those of traditional research products? Should the Commission provide further guidance in this area?

*Question 10.* Should the Commission afford firms time to implement the interpretation? In commenting, please provide specific examples of any potential implementation issues.

Dated: October 19, 2005.

By the Commission.

**Jonathan G. Katz,**  
*Secretary.*

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<sup>134</sup> See 1986 Release, 51 FR at 16007, citing SEI Financial Services Co., No-Action Letter (Dec. 15, 1983), which identified these minimum functions for an introducing broker in a correspondent relationship.

<sup>135</sup> See *supra* notes 113–118 and accompanying text.